AIR COMMAND AND STAFF COLLEGE

STUDENT REPORT

INTERDIVISIONAL WORK AGREEMENTS

MAJOR NORMAN H. LINDSEY 85-1605

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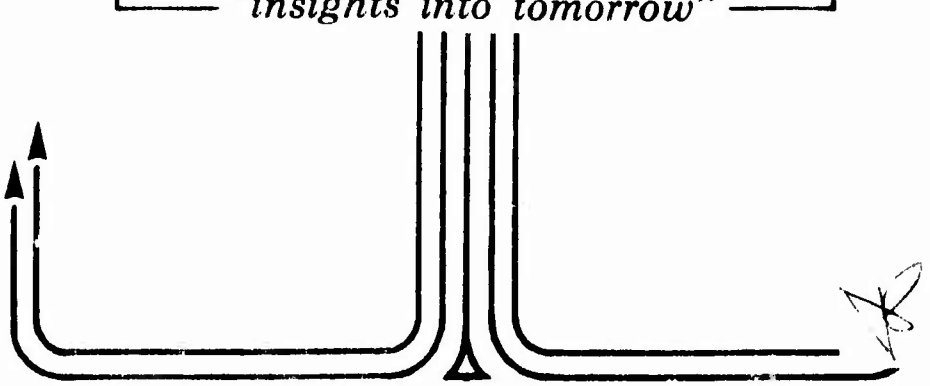

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Interdivisional Work Agreements (IDWA) are transactions that take place between two segments or divisions of the same corporation. This study analyzes the data in the Federal Acquisition Regulations that can be applied to IDWA and the writings of the different DOD Agencies that are concerned with IDWA. The study determines that IDWAs can be a detriment to the Government, but only the Air Force seems to have taken steps through the establishment of policies and regulations to monitor their contracts for IDWA problems. The conclusion of the author is that when DOD contractors utilize IDWA, the role of DOD personnel must be that of watchdog.

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PREFACE

Traditionally, the Government's concern with Interdivisional Work Agreements (IDWA) is the possibility of paying too much for material transferred between divisions of the same corporation. The question arises whether this is still a valid concern. The goal of this study is to analyze IDWA to answer this question and to see if the current Federal Regulations and DOD Agencies' policies and regulations are adequate to protect the Government's interest. The study will also determine if there is anything being done to control IDWA by one service that can be exported to other services.

DOD Agency is capitalized throughout the paper. It is capitalized because DOD Agency specifically refers to the four services that make up the Department of Defense and the organizations that support them.

Any research project owes a debt of gratitude to the organizations and individuals whose cooporation made such a study possible. The author owes two such debts. The author is indebted to the contracting officers, especially, Mr. Eric Shratter, of the Defense Logistics Agency, Birmingham, Alabama, for the help provided in furnishing procurement regulations for research. Also, the author acknowledges Mr. Chuck Lowe and Mr. Wayne Zable of the U.S. Army Procurement Research Office, Fort Lee, Virginia, for the valuable source material they provided.

ABOUT THE AUTHOR

Major Norman Lindsey is an Army Officer assigned to the Ordnance Branch. Prior to attending Air Command and Staff College, he was assigned as the Organizational Effectiveness Staff Officer for the 13th Support Command (Corps), Fort Hood, Texas. He received his B.S.B.A. degree with a major in Personnel Management from the University of Arkansas and M.S. degree with a major in Business Management from the American Technological University of Killeen, Texas. He was commissioned in 1971 through the Army ROTC program and was designated a Distinguished Military Graduate. He is a graduate of numerous military schools, to include Airborne School, the Ordnance Officer Advance Course, the Explosive Ordnance Disposal (EOD) School, the Army's Organizational Effectiveness School, the Army's Materiel Acquisition Management School, and the Army's Basic and Advance Procurement Schools. Major Lindsey holds all the Army's ammunition related specialities to include the Explosive Ordnance Disposal speciality and the Nuclear Weapon Management speciality. In addition, he holds a secondary speciality of Procurement. He has served in various ammunition assignments throughout the world and commanded an Explosive Ordnance Disposal Detachment in Vancouver, Washington, for three years.

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REPORT NUMBER 85-1605

AUTHOR(S) MAJOR NORMAN H. LINDSEY, USA

TITLE INTERDIVISIONAL WORK AGREEMENTS

I. Purpose: To determine what role the DOD Agencies should play when the prime contractor in a major weapon system acquisition utilizes Interdivisional Work Agreement (IDWA) management techniques.

II. Problem: IDWA is a unique method of subcontracting used by multidivisional contractors whereby they transfer material from one division to another. DOD has taken a position that it contracts with the entire firm and not just one division of the firm; therefore, transfers under IDWA should not contain any provisions for profit for the transferring division. The problem is how does a contracting officer monitor the contract to ensure the Government is paying a fair price. This problem is complicated by the lattitude permitted by Federal Regulations to the DOD Agencies to monitor IDWA. The Agencies have responded to this lattitude by developing different approaches to monitoring IDWA. The question arises about these different methods as to whether there are procedures being used by one agency that can be exported throughout DOD to enable all agencies to better monitor IDWA.

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III. Data: The Federal Acquisition Regulation (FAR) does not address IDWA directly; however, provisions of the old Defense Acquisition Regulation (DAR) and the Armed Services Procurement Regulation (ASPR) that are still pertinent do address costing material transferred under IDWA. A contract administration officer (CAO) must cross reference the regulations for guidance when working with contractors who are utilizing IDWA. In order to cross reference the regulations successfully, a CAO must have full knowledge of all the pertinent regulations, as lack of knowledge can be costly to the Government. A cost monitoring review (CMR) by the Air Force found questionable cost of material transferred under provisions of IDWA. The CMR concluded that provisions of the regulations were not being followed by the contractors. The Air Force has recognized that problems arise when contractors use IDWA and has taken steps to correct the situtation by publishing a series of regulations that will establish policies and procedures to monitor IDWAs. The Air Force appears to be the only service to consider IDWA potential problems and has taken steps to correct them.

IV. Conclusion: The use of IDWA can result in a detrimental charge to the Government; however, the exact cost to the Government because of the misuse of IDWA is not known. The cost appears to be small, but the cost could appear to be small because of the lack of monitoring IDWA. The question of total dollars spent on IDWA overcharges would warrant further study. There are other possible problems associated with IDWA such as "flowdown" of provisions and restraint of competition that appears to be taking place, but the data is insufficient to determine the extent of the problems and would warrant further study. Current regulations appear adequate if the CAO is vigilant with the monitoring of IDWAs.

V. Recommendations: Three recommendations are made. First, the procedures established by the Air Force should be exported to the other services for use in developing their own IDWA policies and regulations concerning IDWA. Second, an index listing all policies and regulations concerning IDWA should be developed to assist contract administrators in monitoring IDWA. Third, the FAR should be ammended to address IDWA directly and

CONTINUED

the different provisions of ASPR and DAR that are used as governing regulations in IDWA should be incorporated in the FAR with FAR paragraph numbers for easy reference.

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Chapter One

INTRODUCTION

REASON FOR STUDY

Department of Defense (DOD) prime contractors are required to follow a "make or buy" policy that conforms to criteria specified in Federal Acquisition Regulation (FAR) 15.7. This "make or buy" decision is made to decide which part of a system the contractor will make "in-house" and what components he will obtain elsewhere. The magnitude of the decision to obtain components elsewhere is significant when it is considered that over fifty percent of the total work of the major weapon systems in the procurement program is subcontracted by the prime contractors. (20:1) The current DOD policy is that the contract administration officer assigned responsibility for a contract is responsible for assuring that the prime contractor follows approved subcontracting procedures as outlined in the acquisition regulations. (12:44.0) Because of the latitude permitted by the FAR, the different services have various policies in monitoring the prime contractor's subcontracting procedures. (15:1)

On 7 November 1983 a work group of the Joint Contract Administration Coordinating Council (JCACC) called the Subcontract Management Study Group was established to review existing service policies and practices of subcontract management. The group's membership consists of representatives of each of the DOD Agencies. Its purpose is to review all aspects of the subcontracting procedures of the various DOD Agencies and to make recommendations to the JCACC of necessary changes to the FAR with emphasis on standardization of subcontracting policies throughout the DOD Agencies. (15:2)

This study was requested by the Air Force representative to the JCACC Study Group and will look at one of the many facets of subcontracting. (17:1) The facet to be reviewed, Interdivisional Work Agreements (IDWA), is a subcontracting procedure used by multidivision corporations.

PURPOSE

The purpose of this study is to determine what role the DOD should play when the prime contractor in a major weapon system acquisition uses IDWA management procedures.

METHODOLOGY

First, the author conducted a literature review to analyze what had been written about Interdivisional Work Agreements. Next, the literature was examined to see how the different DOD Agencies approach the administration of contracts in which the contractor uses IDWA. Finally, the author examined problems with IDWA that have been identified by DOD Agencies to see what methodologies were developed in solving those problems that could be used DOD wide.

DEFINITION OF TERMS

Armed Services Procurement Regulation (ASPR) - The regulation governing military procurement practices until it was updated and the title changed to the Defense Acquisition Regulation. Many provisions were left unchanged and are still pertinent as governing regulations.

Component - Used in this study to signify any manufactured part, subassembly or other item that is made and goes into a weapon system. The component loses its identity when it is joined to the major system.

Defense Acquisition Regulation (DAR) - The regulation that updated the ASPR and governed military procurement until replaced by the Federal Acquisition Regulation (FAR). Many of the DAR's provisions were not changed by the FAR and are still pertinent as governing regulations.

Department of Defense Agencies (DOD Agencies) - The four services that make up the Department of Defense and the Department of Defense organizations that support them (e.g., Air Force, Army, Marine, Navy, Defense Logistics Agency (DLA), and Defense Contract Audit Agency (DCAA)). As a of convention, "DOD Agencies" is capitalized throughout this paper.

Federal Acquisition Regulation (FAR) - The regulation governing all federal acquisition. FAR became effective 1 April 1984.

ASSUMPTIONS

It is assumed that the reader is knowledgeable of the DOD procurement system to include the regulations that govern it and the organizations that make up the system. It is also assumed that the reader is knowledgeable of standard DOD contracting terminologies, the procedures of contracting, and the structure of the federal acquisition policy-making system.

A final assumption is made that the reader is knowledgeable of the DOD subcontracting policies, to include the relationships that exist between DOD prime contractors and their subcontractors, and the relationships that exist between the Government and the prime contractor's subcontractors.

OVERVIEW

Chapter Two provides an orientation and contains a background of IDWA.

Chapter Three is a review of the literature to see what has been written concerning IDWA. It includes a synopsis of the literature to include what is said in the federal regulations, and what the DOD Agencies have published.

Chapter Four describes the empirical data that has been gathered which identifies problems caused by IDWA. It analyzes problems that resulted when prime contractors used IDWA procedures and difficulties in the DOD Agency's surveillance of the contractor's IDWA procedures.

Chapter Five addresses potential problems that are suggested by the readings and related interviews.

Chapter Six is a summation of the findings and offers recommendations for standardization of IDWA procedures within DOD. This chapter will include recommendations for further study.

Chapter Two

ORIENTATION

BACKGROUND

An Interdivisional Work Agreement (IDWA) is any portion of a contract which is performed by any segment of the same corporation other than the segment having overall responsibility for management of the prime contract. (5:3) This definition might be expanded to say an IDWA is an agreement between two divisions within a corporation whereby one division will provide needed parts, subassemblies, components, or manufactured items to the other division. This will enable the first division to forgo manufacturing the needed item or to increase its output capacity. For example, General Motors Corporation consists of several automobile manufacturing divisions. It is not uncommon to see Chevrolet engines in Buick, Pontiac, or Olusmobile cars. These separate divisions of General Motors providing components to each other illustrate how an IDWA works.

How an IDWA can create problems is best illustrated by a simple hypothetical example. Corporation Big is made up of three foundary plants, Red, White, and Blue. Corporation Big's plant Blue wins a government award of a cost plus fixed fee contract to provide 100,000 sink-proof pumps to the Navy. The sink-proof pump has a specially machined piston rod that would require most of the capacity of plant Blue to produce. Plant Blue finds it must subcontract the piston rod to another foundary in order to meet the production schedule as outlined in the contract. Since Corporation Big consists of three foundary plants, the corporation's management decides to have the rod made in plant White instead of subcontracting the rod to a vendor. While this example sounds like a normal "make or buy" decision, it has two potential problems. First, because the contract is a cost reimbursement contract, there is little incentive for plant Blue to buy the machined rod from plant White at the cheapest price available. This problem can arise because Corporation Big can influence the cost

charged and paid by its two plants. Second, there are opportunities for the government to pay "padded charges" in the total price of the pumps. These "padded charges" come from charges such as overhead, profit, and capital investment charges which might be added to plant White's bill for the rod. An example of how this "padding" works can be seen in the overhead charge that is added for Big's management expenses that all divisions must add to products sold. If plant White adds this overhead to the rod it sells to plant Blue, and plant Blue then adds the overhead to the price of the pump which includes the expense paid for the rod, the government is paying Corporation Big's overhead expenses twice. This example is a simple one and is intended only to highlight how IDWA can be detrimental to the Government's interest.

Problems with IDWA have been of concern to the government for a long time. An antecedent to the current acquisition regulations, the Green Book, published in 1942, contained the following:

> The following general principles should be observed in connection with purchases or transfers of materials, parts, supplies, or services entering into the products furnished under a government contract.
>
> (a) Intra-company transfers between plants or divisions should be made at cost excluding any internal or intermediate profit.
>
> (b) Purchases from subsidiary, affiliated, or controlled companies or by such companies from parent, affiliated or controlling companies should not be made to result in an increased ultimate cost to the Government. The net cost of such purchases should not be greater than it would have been had they been made from others. It is not the purpose to discourage such inter-company purchases at proper prices when this is in the interest of efficient and expeditious performance of the contract. It is the purpose to prevent undue price increases through such inter-company relations and in such cases the fixed fee or the contract price should duly take all the circumstances into account. (2:240)

Later writings did not add clarity to the topic, but did point out that the possibility existed for problems. A cost accounting textbook said of these early problems:

> The 1949 cost principles included "Intra-Company and inter-company tranactions" as "examples of Subjects Requiring Special Consideration". This has been a moot and highly controversial subject throughout the years in connection with costing and pricing government contracts. (2:240)

The concern about the possibility of a corporation using the opportunities afforded under the terms of an IDWA to add fees and expenses has continued. It was not until the publication of the 1963 edition of the Armed Services Procurement Regulation (ASPR) that an attempt was made to clarify the Government's position. This clarification was done with the publication of ASPR 15-205.22(e). It was not successful since many in business and government felt that it was inequitable. They felt the directive was inequitable because it allowed certain multidivision corporations the opportunity to earn profits above those negotiated in their contracts. (2:240)

Later, DOD revised ASPR 15-205.22(e) so that it would only allow items to be transferred under IDWA at cost, with some minor exceptions. ASPR 15-205.22(e) stated in part:

> Allowance for all materials produced by the contractor or by any division, subsidiary or affiliate of the contractor under common control shall be on the basis of the costs incurred. . . . (2:241)

The business community objected to the revision because they thought that it created an unfair position to a corporation with divisions which operated on a self-sustaining basis. An author writing on government accounting procedures had this to say about their objections:

> The business community offered substantial objections to this proposal. Essentially, industrial associations and representatives pointed out that, in the case of multidivision organizations, each individual division is frequently required to perform on a self-sustaining basis, and its continued life is dependent upon its success. This success is measured in substantial part by the profits it earns. Under the proposed change to ASPR, a division performing under defense contracts would be at a disadvantage as compared with a division performing commercial work. (2:241)

The Government maintained its position and stated that the total profit entitled a corporation was available to be distributed on a prorated basis to the separate divisions who worked on the contract. (2:242) This interpretation of the ASPR provision has carried through today and is reflected in the Federal Acquisition Regulation. (12:31.205-26)

Chapter Three

LITERATURE REVIEW

In order to fully understand what DOD personnel should do when the prime contractor uses IDWAs, we must examine the guiding regulations. The overall guiding regulation for the Federal Government procurement of goods and services is the Federal Acquisition Regulation (FAR). The examination of the FAR and other pertinent regulations will also point out present day concerns regarding IDWAs.

FEDERAL ACQUISITION REGULATION (FAR)

A review of the FAR revealed that it does not address IDWA directly; therefore, it was necessary to review its predecessors, the Armed Services Procurement Regulation (ASPR) and the Defense Acquisition Regulation (DAR), to see what is inferred in the FAR. When the ASPR was updated, its name was changed to DAR. Many provisions of the ASPR such as the Armed Services Procurement Manuals (ASPM) were incorporated directly into the DAR but retained their original ASPR titles. Many provisions of the DAR were unchanged and are not covered in the FAR. Examples of these unchanged provisions are DAR, Appendix O, Subchapters G, the Cost Accounting Standards, and DAR Supplement Number 1. They remain applicable as governing regulations. The DAR was officially replaced by the FAR on 1 April 1984, but many contracts have been written under its provisions and remain in effect to this date.

ASPR gives detailed instructions on procurement procedures, and those unchanged by the FAR are followed today according to a contracting officer. (23:--) One such reference is found concerning IDWAs. ASPM Number 1, published in 1975, gives detailed instructions on accounting procedures for IDWA. It states in part:

> Interdivisional sales or transfers of materials should ordinarly be handled on a cost, no-profit basis to the transferor. However, transactions involving items that are regularly manufactured and widely sold by a contractor may be handled on a basis that recognizes a fair profit return if the contractor's organization is structured along profit center lines and the transferring segment is operated as a virtually separate entity required to perform on a self sufficient basis. (8:4A15)

DAR Appendix O, Subchapter G, the Cost Accounting Standards (CAS), regulates that a contractor can only receive a profit one time unless the item is competitive or is a catalogue price. (9:178) This means that a contractor obtaining a component through an IDWA can not put a profit charge on the component to the division using the component unless the component is being transferred at a price obtained through competition or at the division's catalogue price.

DAR Supplement Number 1 also gives a direct reference to Intra-Company Transactions which is another name for IDWA. This paragraph states:

> Intra-Company transactions shall be studied. The contractor should have written policies on intra-company transactions, including a policy on competition of affiliates and divisions with outside subcontractors, and a policy on whether cost or normal selling prices are used when items or services are obtained from affiliates or divisions. Policies giving preferences to affiliates or divisions for these purchased items are not necessarily undesirable. However, the preference should not be permitted to evolve into inacceptable practices such as obtaining final offers from affiliates, whenever the affiliate offers are higher in price than those received from competing subcontractors. The contractor should also take measures to prevent pyramided profits on work performed within the company. The contractor should be sure that it is getting items of the same quality that the contractor could obtain through competition or by performing the work himself. The contractor's policies should also be compared with the guidelines in DAR 15-205.22. According to these guidelines, the contractor may award orders at the affiliate's or division's actual

cost, thus, eliminating double profit, as long as the award does not otherwise conflict with the intent of the contract, and DAR Section XV. (10:307.2)

The FAR reference that discusses material price and replaced DAR 15-205.22 quoted previously states:

> The price is not in excess of the transferor's current sales price to its most favored customer (including any division, subsidiary or affiliate of the contractor under a common control) for a like quantity under comparable conditions. (12:31.205-26e(3)(i))

The ASPM statement seems to be a contradiction of DAR Supplement Number 1, the CAS, and FAR, but is not. This is just another aspect of the IDWA, and the term profit has many meanings. The ASPM goes into detail showing how materials and other things transfered under IDWA are to be costed.

Another interesting point about the DAR Supplement Number 1 quote is that this paragraph establishes the rule that IDWA should be monitored to prevent unwarranted profits and the contractor should have written policies on IDWAs. This reveals the initial concern to insure the Government pays a fair price is still relevant. The inferrance to this fact is found throughout the FAR. While FAR does not treat IDWA as a separate subject, its provisions may be interpreted to encompass IDWAs.

FAR 15 places total responsibility for the management of the contract performance on the prime contractor. It states:

> The prime contractor is responsible for managing contract performance . . . and administering subcontracts as necessary to ensure the lowest overall cost and technical risk to the Government. (12:15.702)

FAR 15 also reinforces the DAR Supplement Number 1 statement of authority to review the contractor's policy on IDWA when it grants the Government the right to review a contractor's "make or buy" program. It states in part:

> Although the Government does not expect to participate in every management decision, it may reserve the right to review and agree on the contractor's make or buy program when necessary to ensure (a) negotiation of resonable contract prices (b) satisfactory performance. . . . (12:15.702)

The inference to IDWA in the Government's review of the program is found in the FAR's definition of the "make or buy" program:

> Make or buy program means that part of a contractor's written plan for a contract identifying (a) those major items to be produced or work efforts to be performed in the prime contractor's facilities and (b) those to be subcontracted. (12:15.701)

Authority is given for the Government's review to include items made in the contractors facilities. The definition of "make" is broken down even farther when the FAR states, "an item or work effort to be produced or performed by the prime contractor or its affiliates, subsidiaries, or divisions." (12:15.701) Since the definition covers "make" in affiliates, subsidiaries, or divisions, IDWA is inferred because the definition of IDWA is an agreement to obtain needed items made by affiliates, subsidiaries, or other divisions.

FAR Part 15 also contains guidance for monitoring make or buy programs. The contracting officer is charged with reviewing and analyzing all proposals to ensure a reasonable charge to the Government. The FAR states:

> When cost or pricing data are required, the contracting officer shall make a cost analysis to evaluate the reasonableness of individual cost elements. In addition, the contracting officer should make a price analysis to ensure that the overall price offered is fair and reasonable. When cost or pricing data are not required, the contracting officer shall make a price analysis to ensure that the overall price offered is fair and reasonable. (12:15.805-1(b))

Even though IDWA is not mentioned, the regulation is written broad enough to allow the contracting officer to include IDWA in his review to ensure fair and reasonable pricing.

FAR Part 30 establishes the criteria for the Cost Accounting Standards (CAS) and sets forth the policy for the contractor to disclose in writing all practices and follow established cost accounting practices. Here again, IDWA is not referred to, but the language is broad enough to include IDWA. It should be noted that CAS is covered in provisions of the DAR that are still applicable today. (9:178)

FAR Part 30 contains a definition that is quoted as showing the business unit is held responsible for the entire contract regardless of how the management breaks up the structure and divides the work. It states in part, "Business unit, means any segment of an organization or an entire business organization that is not divided into segments." (12:30.102) It goes on to define a segment as "one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office." (12:30.102)

This definition is further explained in FAR Part 44 where a contractor is defined as the total organization. It states, "Contractor---means the total contractor organization or a separate entity of it, such as an affiliate, division or plant that performs its own purchasing." (12:44.101)

FAR Part 30 requires Disclosure Statements to show prices paid on a defense contract. It states, "A Disclosure Statement is a written description of a contractor's cost accounting practices and procedures. . . ." (12:30.201) This is sufficiently broad enough to include disclosure of amounts paid on IDWAs.

FAR Part 44 gives the requirement for a Contractor Purchasing System Review (CPSR) for contractors who are expected to exceed ten million dollars in sales to the Government during the next twelve months. However, this ten million dollar level may be raised or lowered if the head of the agency responsible for contract administration deems it to be in the best interest of the Government. (12:44.302) The FAR provisions relating to CPSR do not address IDWAs, but it is sufficiently broad enough to include IDWAs if the contract administrator conducting the CPSR deems it necessary.

DOD AGENCIES

FAR Part 42 gives the Contract Administration Officer (CAO), who has authority over the contract, the responsibility for assuring that the prime contractor fulfills his management responsibilities. (12:42.302(e)) The following sections will view how the various DOD Agencies go about discharging this responsibility. The sections review the policies, procedures, and regulations DOD Agencies have published concerning IDWAs.

Air Force

The Air Force has a Subcontract Management Division (SMD) in each of its Air Force Plant Representative Offices (AFPRO). The Division's sole mission is integrating and performing continuous surveillance of the contractor's purchasing operations and post award management activities. (15:2)

The Air Force has expressed concern about IDWA and on 13 March 1981 published Air Force Contract Management Division (AFCMD) Regulation 70-31, titled Contracting and Acquisition, Management of Interdivisional Work Authorization. Paragraph 3 states:

> a. An interdivisional transfer of work can only occur between divisions of the same corporate entity. Transfers of work between corporate entities (affiliates, subsidiaries, etc.) are legal subcontracts and, therefore, subject to all subcontracting procedures and provisions.
>
> b. The AFPRO should evaluate contractor management of IDWAs in a similar manner and with the same care as the balance of the prime contract. AFPRO personnel must use surveillance to ensure the contractor has an adequate system for managing IDWAs and that the system is working. (4:2)

The responsibility for the policy is listed in paragraph 4b:

> b. SM [Subcontract Management Division] will be responsible under CMSEP [Contractor Management System Evaluation Program] for verifying adequacy of the contractors' IDWA control system and ensuring that the contractor has procedures defining which organizations are authorized to issue IDWAs. (4:2)

Paragraph 5 is a blueprint to be followed by the AFPRO in evaluating and minitoring IDWAs. Paragraph 5 states:

> a. System Evaluation. The first step in assessing the effectiveness of the contractor's management of IDWAs is to determine the existence and adequacy of the IDWA control system.
>
> (It goes on to list 10 examples of elements that characterize a worthwhile system.)

b. System Surveillance:

(1) AFPRO involvement in IDWA surveillance must begin early in the weapon system acquisition life cycle. Review of make-or-buy proposals and participation in preaward surveys or Manufacturing Management/Production Capability Reviews (MM/PCRS) offer excellent opportunities to determine which contract portions are planned to be accomplished by IDWA. The AFPRO . . . , will evaluate requirements for surveillance and/or support contract administration. Critical tasks can be identified at that time.

(2) SM is the primary focal point for evaluation of the contractor's IDWA management system. It is necessary they review a number of IDWAs for compliance with established policies and procedures.

(a) For visibility of IDWA going to a contractor's facility, a periodic random sample of IDWAs, stratified by dollar values similiar to those for purchase order reviews . . . will be accomplished. . . . (4:3)

This blueprint outlines the procedures the Air Force wishes their representatives to follow to ensure compliance with the FAR.

On May 1981 AFCMDR 70-8, titled Technical Support To Pricing by Subcontract Management, was published. It listed IDWAs as one of the areas used to justify obtaining technical support from CMD. It stated in part:

Requests for assistance from the AFCMD price analyst must specifically identify the task or effort in the proposal and specify which of the following should be considered in the analysis:

. . . . . .

d. Determine and discuss the prime contractor's compliance with their pricing review procedures in their evaluation of interdivisional work authorization (IDWAs). (7:1)

On 15 August 1983 AFCMDR 70-24, titled Contracting and Acquisition, Subcontract Management Mission and Policy, was published. This publication gives the policies, procedures, and standards that govern the subcontract functions throughout

the Air Force Contract Management Division. The emphases given IDWA in the regulation is equal to the emphases given subcontracts and shows that the Air Force is concerned about possible problems with IDWA. Paragraph 1-4(1) states:

> SM is responsible for evaluating the prime contractor's system for management of subcontracts and IDWA. . . . Evaluations of the contractor's management system will focus on their effective control of cost, schedule, and performance of subcontracts/IDWA. (5:4)

The Air Force envisions a total program of subcontract management surveillance to include direct contact between the AFPRO and the system program office (SPO) as early as possible. This contact is formally established in a memorandum of agreement (MOA) which includes the subcontract management support required by the SPO and agreed to by the AFPRO. (5:5) The MOA helps identify potential problems in the pre-award phase. AFCMDR 70-24, paragraph 2-3(c) mentions IDWA as a potential problem requiring early surveillance:

> An early program task is to prepare a list of major/critical subcontracts and IDWAs for contracts assigned to the AFPRO. . . . Every effort will be made to identify these major/critical subcontracts/IDWA in the pre-award phase of the prime contract. (5:5)

Air Force concern with IDWA has continued. For example, on 24 August 1984 AFMCDR 540-31, titled AFSC Field Activity Management Policy, Individual Work Authorization, was published. This regulation points directly to IDWA as a problem area and gives explicit guidance to protect the Government's interest. Paragraph 1 states:

> With the increasing diversification and vertical integration within the aerospace industry, AFCMD contractors acquire substantial amounts of goods and services from other corporate segments or divisions under interdivisional work authorizations (IDWAs). AFPRO review and surveillance of this acquisition method must be commensurate with the value of goods and services so acquired in order to adequately protect the Government's interest. A primary thrust of AFPRO effort shall be to assure that the contractor actively manages IDWA work to the same degree as it manages subcontract work. (3:1)

Paragraph 2b outlines the guidance for review and surveillance called for in Paragraph 1. It includes steps in both pre-award and post-award policy. The steps are outlined as follows:

b. AFPRO review and surveillance of IDWA activity must be structured and managed to assure that:

(1) Pre-Award:

(a) Proposed IDWA costs are separately identified on the prime DD Form 633/SF1411--to include separate breakdowns of cost by element.

(b) Proposed IDWA costs are evaluated in a manner consistent with DAR 3-807.9/FAR 15.805.

(c) Contractor IDWA documentation clearly defines work to be performed, schedules, cost budgets, and applicable prime contract provisions/requirements.

(2) Post-Award:

(a) IDWA costs are transferred in accordance with methods set forth in the contractor's CAS Disclosure Statement.

(b) IDWA effort is performed at the segment or division location identified in the prime contract proposal and the Contracting Officer is notified in advance of proposed changes to the make-or-buy program IAW DAR 7-204.20/FAR 52.215-21.

(c) IDWA performance is monitored by the contractor to assure compliance with applicable prime contract provisions and timely identification/resolution of cost, schedule and technical problems. (3:1)

Army

The Army's method of complying with the requirements of FAR to review their contractors' purchasing systems is to rely on periodic formal Contractor Purchasing Systems Reviews (CPSR) performed by itinerant teams. (15:2) The Army does not consider IDWAs a problem per se and considers the Federal Regulations to be adequate. The author's review of the Army's list of formal publications revealed that nothing has been published on IDWAs. In addition, none of the Army contracting personnel contacted knew of any separate policy concerning IDWAs; therefore, if anything has been published separately on IDWA, it is not generally distributed through the Army's contracting community. (25:--)

Navy

The Navy's approach to reviewing contractors' policies is to use Purchase System Analysts (PSA) at its Navy Plant Representative Office (NAVPRO) to conduct consent-to-subcontract reviews and post-award reviews of subcontract documents and associated documents. (15:2) Contact with Navy procurement specialists revealed that the Navy has not published any regulations or policies concerning IDWAs. (22:--) However, in the author's review of contracting publications, a reference to IDWA was found in a Naval publication, titled Defense Cost and Price Analysis, which restated the positions taken in the FAR and DAR. It stated:

> The Government has taken the position that in contracting with a firm, it is contracting for the entire services of that firm regardless of where it is located and how it is organized. Consequently, the contractor should receive only one compensation for these services. In other words, a firm should not be able to subcontract with itself and thereby obtain a fee. (14:7-9)

This statement is justified by a reference to DAR 205.22(e). (The DAR reference was replaced by FAR 31.205-26.)

Defense Contract Audit Agency (DCAA)

The DCAA mentions IDWA in its Contract Audit Manual. The manual is designed to minimize the requirement of referring to other publications for technical and procedural guidance. It prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in auditing government contracts. DCAAM 7640.1, paragraph 4-212 gives instructions for the auditing of IDWAs. It addresses the topic of price paid for items under IDWAs; however, the material is dated. (11:4-212) All references in the manual are the ASPR and must be cross referenced to the FAR for current information. If the manual were updated, it could be one of the best sources of guidance available for a CAO charged with determining cost applied to an IDWA.

Defense Logistic Agency (DLA)

The DLA's suborganization, the Defense Contract Administration Services (DCAS) is responsible for administering all contracts awarded by Department of Defense with the exception of those retained by the services, principally the Air Force and the Navy. DCAS uses the formal CPSR as the means of maintaining surveillance of contracts. (15:2) In discussions with DCAS personnel at the Birmingham DCAS office, the author was told that no DLA/DCAS policy existed concerning IDWA as the federal regulations were adequate. (23:--)

Government Accounting Office (GAO)

While the GAO is not a DOD Agency, it is involved with monitoring all government contracts. In a telephone interview with Mr. Rod Worth of the Atlanta, Georgia GAO Office, the author was told that IDWA was a topic that has never been addressed by GAO. This was confirmed by a telephone interview with Mr. Bert Hall at the GAO Headquarters in Washington, D.C. (24:--)

Chapter Four

IDWA MANAGEMENT

A review of cases and reports indicates the problem of "gouging" by contractors is not the only problem that occurs when working with IDWA. A recent case evolving from IDWA management showed that difficulties also arise when trying to apply the applicable regulations. In 1966 the Government brought a lawsuit against Yardney Electric Corporation to recover profit that had been paid on material obtained by Yardney from a sister division through the provision of an IDWA. A decision on the case by the Armed Services Board of Contract Appeals (ASBCA) ruled that an agreement made by the contract officer and the contractor to allow profit charged on material transferred under an IDWA was valid. The problem stemmed from two different provisions of the DAR in effect at the time. DAR 15-205.22 disallowed profits being charged on the material. Counter to this was DAR 15-107 which would allow changes to the contract and void other provisions of the DAR such as DAR 15-205.22.

An accounting textbook discussed the Board's point of view concerning DAR 15-107 which was the key point in this case:

> This section deals with advance understandings on particular cost items and notes that "as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in connection with firms or separate divisions thereof which may not be subject to effective constraints". This section then suggests advance agreements between the Government and the contractor in such instances and further provides that "any such agreement should be incorporated in cost-reimbursement type contracts, or made a part of the contract file in the case of negotiated fixed price type contracts, and should govern the cost treatment covered thereby throughout the performance of the contract. (2:244)

The DAR 15-107 provision allowed the agreement to stand, and the Government had to pay extra as stated by another textbook:

> The Board was to find that the prior agreement was in effect and that the provision of DAR 15-107 would allow making such an agreement. (1:66)

Because of the result of this case and two others, Westinghouse Electric Corporation, ASBCA case No. 11932 and Teledyne Ryan Aeronautical, ASBCA case No. 20969, changes were incorporated into the DAR. DAR 15-107 was ammended to include DAR 15-107.6 which states:

> The contracting officer is not authorized by this paragraph to agree to a treatment of cost inconsistent with Parts 2 through 5. For example, an advance agreement may not provide that, not with standing 15-205.17, interest shall be allowable. (2:248)

These cases lead to a conclusion about the role played by the DOD in IDWA situations. If the rules are such that the results are detrimental to the Government, the rules will be ammended.

An interesting point of the Yardney Case was an argument by the Government that the contracting officer was unaware of restrictions on allowing IDWA cost. However, the Board ruled that this lack of knowledge did not void the agreement made. A textbook synopsis of the case relates:

> The Government then argued that its negotiator did not know that intracompany profits were unallowable under the ASPR cost principles. But the Board reasoned that this fact "does not change the character of his assent to the allowability of the intracompany profit. (2:245)

In other words, ignorance of the regulations is no excuse.

In a recent letter to field activities, the Air Staff points out another potential problem concerning IDWAs. It states in part:

> A recent [title omitted] highlighted a potential problem with the flowdown and enforcement of prime contract provisions in Interdivisional Work Authorization (IDWA). The case in point involved work measurement (MIL-STD-[number omitted]), but could just as easily have involved any number of other prime contract provisions. (6:1)

This letter highlights that whenever an IDWA is used, sometimes the requirements contained in the prime's contract were not being followed by supporting divisions. The letter went on to say:

> By definition, all prime contract provisions (absent specific language to the contrary) legally apply to IDWAs. For this reason, a case could be made that there's no legal requirement to "flowdown" prime contract provisions in IDWA documents. As a matter of management logic, however, some mechanism must exist for the issuing division to advise the supporting division of prime contract requirements applicable to the IDWA. (6:1)

The Air Force was telling its field activities that there is nothing in the contract or regulations requiring prime contractors to enforce the provisions of a contract on its sister divisions.

The Air Force directed its field activities to develop some method of monitoring IDWA contracts and to provide specific instructions to contractors that would ensure the provisions of the contract are communicated and followed whenever the prime utilizes IDWA. (6:1) The Air Force also directed a review of some of its major contractors engaging in IDWA. The purpose of this review was to assess the contractor's management, control, estimating, and accounting of IDWAs with the intent of improving the surveillance of IDWAs. The results were as follows:

1. Fourteen of the eighteen detachment reviews identified issues with a total of $7.5M in questioned cost.

2. Improper charging of unallowable overhead cost.

3. Company policies and procedures are inadequate, ineffectively enforced, or require improvement and updating at seven of the detachments reviewed.

4. Several contractors consider IDWA efforts synonymous with "in-house" efforts and do not seek competition with outside vendors. Such "make" decisions lack substantiating data, and cost and price analysis is not performed.

5. Credits due to the prime contract at . . . are not processed in a timely manner. This may result in inappropriate progress payments and the collection of credits on the wrong contracts.

6. Contractor accounting procedures for payment and transfer of IDWA cost need improvement. (13:2)

This review disclosed three things about IDWAs. First, the results showed that concerns about overpricing were valid. Seventy-seven percent of the reviewed contracts had questioned cost; eleven percent of the contracts had improper overhead charges; and five percent of the contracts had accounting procedures that allowed payments to be made to the wrong contracts. (13:2)

Second, the review revealed that several contractors were not obtaining adequate price competition and were indiscriminatly making the item "in-house". The contractors were considering the IDWA as part of their "make or buy" decision. In order to understand what this "make or buy" decision involved, the author reviewed several studies and cases on "make or buy". One study concerning the "make or buy" decision showed that contractors tend to purchase elsewhere when the required component is outside their normal scope of activity; they have limited capacity; they have a desire to limit capital expenditures; they have an unwillingness to disrupt other product lines; or they have a desire to perform efficiently. (21:21) Hence, the contractors were viewing sister divisions as extensions of their own division and were able to "make" the items "in-house" by use of IDWA. Another related study found that contractors are not concerned about the dollar amount paid in buying components because they can pass these costs on to the Government. (18:28) Consequently, their decision to "buy" sometimes leads to less than favorable results to the Government. The Government recognizes this problem and requires all "make or buy" decisions be documented in a proposal which is to be evaluated by the contracting officer. (12:15.7) However, if a contractor considers purchasing a component from a sister division as a "make" decision, then he might slip the higher priced component by the reviewer. This may come about when the contractor does not seek a competitive price from vendors, and hides this fact by stating that he is "making in-house" by purchasing via an IDWA. Then the CAO charged with reviewing the contract might not perceive the fact that the decision was being made without benifit of price competition. As one contracting officer who asked to remain anonymous stated, "Some of these companies are using IDWAs as a license to steal."

Third, the contract review showed that contractors are not necessarily following established policies and regulations. The review concluded that the CAO needed to maintain closer surveillance of the corporations to ensure compliance with current regulations. The review observed:

1. Contractor policies and procedures for the management and control of IDWAs need strengthening.

2. Contractor management of their IDWA programs should be reviewed to ensure that adequate justification and sufficient cost analysis data is provided for Make/Buy decisions that involve affiliate segments.

3. Accounting treatment of IDWAs must be scrutinized to ensure proper transfer of costs.

4. There is no requirement for contractors to notify the Government on a timely basis of significant variances or changes in IDWA activity. This could inhibit the visibility needed in conjunction with prime contract monitorship performed by. . . .

5. Transfers at other than cost must be monitored to ensure contractor compliance with DAR and to assure there is not an unwarranted pyramiding of profit/fee. (13:2)

The number of cases and studies involving IDWA was too small to draw definite conclusions, but an inference can be made. IDWAs are potential problems, but current Federal regulations contain adequate provisions to preclude a detriment to the Government provided DOD personnel maintain surveillance and control. Problems with IDWA can evolve when DOD personnel lose sight of their provisions or are not aware of the potential problems that may arise from trying to enforce the provisions.

Chapter Five

POTENTIAL PROBLEMS WITH IDWA

There are several potential problem areas when IDWAs are used which are suggested by, but can not be substantiated in the readings. These unconfirmed problems are relayed as a matter of academic interest.

The first potential problem is the lack of information printed on IDWAs. The author found only two DOD Agencies that have printed anything in detail concerning IDWAs. They are the Air Force and the Defense Contract Audit Agency (DCAA), but the information printed by the DCAA is dated. The remainder of the DOD Agencies rely on the Federal Regulations. This leads to the conclusion that much of the known information is institutionalized in the contracting personnel. Interviews with contracting personnel confirmed this conclusion when one contracting officer could not reference or find any policy or procedure statements from his agency concerning IDWAs. Another contracting officer from the same agency answered the author's inquiry about how they knew what to look for by merely stating, "We just know." (23:--) This lack of information printed about IDWAs could become a serious problem considering the ASBCA case reviewed in Chapter Four. The Government lost its case when ASBCA ruled that ignorance on the part of the Government's contract negotiator was no excuse. (2:245)

This lack of information also implies that IDWAs are not used very often or they account for very little in the way of problems in the acquisition program of DOD. Two studies by DOD Agencies support this thought. One study concerned the Army's M-1 Tank project. It showed IDWAs accounting for seven-tenths of one percent of total subcontracting on the third buy on the contract. (19:16) The second study was on an Air Force Cost Monitoring Review (CMR) of its affiliates where IDWA contracts were used. This CMR reviewed eighteen contractors and discovered only 7.5 million dollars in questionable cost. (13:2) Although, two incidents are not a large enough sample to draw definite conclusions, they do indicate a trend. The problems occurring with less than one percent of a prime contract using IDWA and the questionable cost of 7.5 million dollars are

finite when compared to the billions of dollars spent on DOD weapon systems each year. A conclusion drawn by the author is that IDWAs have not drawn much interest in light of more notorious cost problems, such as cost over-runs, plaguing DOD.

A second possible problem area is that of competition. IDWAs may give unfair advantages to sister divisions of the prime. The Air Force CMR found some contractors using IDWAs as "in-house" make decisions and not seeking outside competition. (13:2) A related case study on subcontracting supported this thought. It stated:

> One subcontractor cited a case of prejudical proposal evaluation by a prime contractor. The prime contractor was a division of a major corporation. The request for quote (RFQ) was submitted to eight sources including another division of the corporation which needed the work. The subcontract was awarded to the other division due to "superior technical approach and manufacturing capability". The losing subcontractor had previously produced the item with no problem, had the capacity available, and underbid the winning source. This subcontractor felt that the large corporation considered much more than the best bid in their awards and were not always proponents of competition. (18:68)

While this quote may be a case of "sour grapes" on the part of the subcontractor, it does highlight the possibility of IDWAs causing a decrease in competition. An interesting note found by the author in the same study was the conclusion that the prime contractors create most of the problems preventing subcontractors from being competitive. (18:67)

A third problem area was hinted at in the Air Force letter, related in Chapter Four, which highlighted potential problems with "flowdown provisions". (6:1) This "flowdown" of provisions could indicate much farther reaching complications than is otherwise obvious. For example, government contracts sometimes contain social and economic provisions used for a number of purposes. The Government thinks nothing of paying extra dollars for a contract to gain long term social benifits or to promote social justice. These government programs are partially enforced through provisions in the procurement contracts. However, a contractor might use an IDWA to circumvent one of these social programs. For example, consider the contract for the sink-proof pumps that was awarded to Corporation Big in Chapter Two. Corporation Big's chairman is prejudice against "sloe-eyed blonds" who are listed in FAR 19.703 as meeting eligibility requirements for participating in the set asides for small disadvantaged business concerns in FAR 19.702. Using an IDWA,

the chairman might be able to get components from plant White to plant Blue that plant Blue would be required to subcontract to a small disadvantaged business.

There is no attempt in this example to interpret the laws which might be violated, but merely to demonstrate how IDWA might be utilized to violate or circumvent provisions of the regulations.

These three potential problem areas could not be substantiated in the literature and are only related for academic interest. However, they do indicate how IDWA can be manipulated to the detriment of the Government.

Chapter Six

CONCLUSIONS AND RECOMMENDATIONS

What role should DOD personnel play when the prime contractor in a major weapon system utilizes IDWA management procedures? The data available for review was insufficient to develop definite answers to the question; however, several recommendations can be made based on the inference from the literature.

First, the concern about IDWAs being a potential cost increase problem appears to be valid; although, the extent of the problem is not determinable from current data. In light of more crucial cost problems plaguing the acquisition process, DOD has seemingly regarded cost increase as a result of IDWA as a minor problem. This could explain the lack of data concerning IDWA being published by DOD Agencies. While the exact cost appears to be small, those visible costs may just be the "tip of an iceberg". Therefore, the total dollars spent on IDWA and possible overcharges are areas that warrant additional study.

Second, the Air Force believes problems with IDWA tend to appear where visibility by the responsible administrator is lacking. The review summarized in Chapter Four pointed out that many problems with IDWA could be eliminated if the people charged with monitoring the contracts maintained closer surveillance. An interesting note is that the Air Force recommended that IDWAs be separated from subcontracts so that visibility could be maintained more easily. The Air Force seems to be the only service to recognize that visibility of IDWA is a problem and to take steps to remedy the problem. These steps include the publication of several regulations covering the different aspects of IDWA management. Other DOD Agencies have shown little concern for potential problems with IDWA. When the author interviewed Army and Navy contracting personnel, he found many of them to be only vaguely aware of the IDWA concept. Several interviews were conducted before contracting personnel familiar with IDWA were found. It appears that the comment of the contracting officer quoted in Chapter Five about the contracting officers "just knowing the regulations" is valid. Unfortunately, if the regulations concerning IDWA are institutionalized in the

contracting personnel, new contracting personnel will not be familiar with the regulations, especially the old regulations such as ASPR and DAR. One recommendation the author would make to improve the Air Force system is to publish an index of ASPRs, DARs, FARs, and other pertinent guidance on IDWA. The index would contain paragraph references of the different "dos and don'ts" the Government regulations contain. An index containing all that is written directly or indirectly concerning IDWA would be a quick and easy reference for all personnel associated with contracting. Since the FAR does not address IDWA directly, the index would become a complete reference of information concerning IDWA. With the complex and complicated accounting procedures associated with IDWAs, DOD personnel need all the help available. This recommendation for the index is especially important in light of the Yardley Case cited in Chapter Four where the Government became a victim because the contracting officer was not aware of the different provisions of the governing regulations.

A third problem area inferred from the literature is the possibility of IDWA arrangements circumventing the provisions of the original contract. This problem was alluded to in an Air Force letter discussed in Chapter Five. The extent of this problem is unknown and would be an area warranting further study.

A final recommendation the author would make is to include the name "Interdivisional Work Agreement" in the language of the FAR and make direct reference to it. In addition, all the different provisions of the ADPR and DAR that explain IDWA should be incorporated into the FAR as FAR paragraphs.

In conclusion, nothing definite can be said about the prime contractor's use of IDWA procedures except that IDWA can create problems detrimental to the benifit of the Government. In answer to the question about what role should DOD personnel play when the prime utilizes IDWA, the author contends that "DOD personnel must play the role of watchdog since IDWAs are potential problems." All DOD Agencies must educate themselves to the potential problems of IDWA. The approach the Air Force is taking to place emphasis on IDWA is a good starting point and should be exported to the other DOD Agencies for study and inclusion as necessary.

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