

Forward Pricing Proposal – Labor Categories

The Scenario

Risk Assessment-Research and Planning:

The auditor was assigned to audit a price proposal for a \$525 million time and materials (T&M) follow-on contract covering a base and 2 option years. The audit request stated that the contractor was performing on the current predecessor contract and that the follow-on contract would be a sole source award. In studying the permanent file, the auditor noted that the contractor was moderate sized with \$80 million in sales the previous year. Based on the most current incurred cost submission, the contract mix included both prime and subcontracts and was about 70 percent T&M and 30 percent cost reimbursable. The auditor documented audit history with the contractor as follows:

- DCAA did not audit the proposal for the current predecessor contract.
- The only internal control audit performed was a post award accounting system that was completed in the last year with no reported deficiencies.
- Incurred cost audits for the contractor are 2 years behind, but all submissions have been received and determined adequate for audit. The last incurred cost audit report did not identify any significant findings.

The auditor discussed the proposal for the follow-on contract with the requesting Procurement Contracting Officer (PCO) and the Administrative Contracting Officer (ACO). Neither stated any concerns or issues with the follow-on proposal nor with the contractor's performance on the current predecessor contract. The ACO stated that the contractor had recently submitted a description of its estimating system policies and procedures, but the ACO had not yet requested an audit of it. The ACO agreed to provide the auditor a copy of the submitted estimating system description.

The auditor then assessed the proposal and determined it was adequate for audit. The auditor documented the following risk and materiality factors regarding the proposal and the contractor's basis of estimate (BOE).

- Labor was the most significant cost element representing nearly 70 percent of the total costs.
- The contractor based the direct labor and indirect rates for the proposed T&M labor category fixed rates on the most current Forward Pricing Rate Agreement (FPRA) with the Defense Contract Management Agency (DCMA). DCMA and the contractor had negotiated the FPRA less than six months ago.
- The contractor used actual historical information from the current predecessor contract to calculate the proposed direct labor hours. This approach was consistent with the recently submitted estimating system policies and procedures.

Initial Discussion with Contractor's Representative and Request for Information:

The auditor contacted the contractor's representative to discuss the proposal audit request and to schedule an entrance conference that the contractor's proposal manager would also attend. Since the contractor based the follow-on proposal largely on historical cost information from the

current predecessor contract, the auditor requested the contractor's representative to provide the following information for the current predecessor contract prior to the entrance conference:

- final proposal,
- job cost report for incurred cost to date, and
- detailed report of labor incurred by employee that identified:
 - T&M labor category charged;
 - actual hours incurred; and
 - actual labor rate incurred.

The auditor confirmed the verbal request with a written request.

Preliminary Analytical Procedures:

The auditor examined the data provided by the contractor's representative, the current predecessor contract, and the follow-on proposal and then performed the following analytical procedures:

- compared the statement of work and BOE for the current predecessor contract with the proposed statement of work and BOE for the follow-on contract;
- compared the hours incurred by labor category to those originally proposed and negotiated on the current predecessor contract;
- computed the average historical direct labor hourly rate for each labor category on the current predecessor contract and compared it to the negotiated direct labor FPRA rates in the follow-on proposal;
- compared the indirect rates used to calculate the T&M labor category rates on the current predecessor contract with the claimed rates in the last incurred cost submission; and
- performed a T&M profit margin test for the last two years of the current predecessor contract by using the incurred cost submissions to compare total contract billed amounts with total actual costs incurred.

Results of the Preliminary Analytical Procedures:

Based on the analytical procedures performed, the auditor documented the following:

- The follow-on contract would be a continuation of the statement of work from the current predecessor contract with no new tasking. The current predecessor contract was also T&M and also included a base and 2 option years. However, the contractor had used salary survey analyses as the basis for the proposed direct labor rates for the current predecessor contract

while the follow-on contract's proposed direct labor rates were the corresponding negotiated FPRA rates.

- The contractor had charged about the same number of hours for each labor category on the current predecessor contract as it proposed for the same labor category on the follow-on contract.
- The average actual incurred direct labor hourly rates were significantly lower than the hourly rates in both the proposal submitted for the current predecessor contract and the follow-on contract proposal for all labor categories except the administrative ones.
- The incurred indirect rates used to calculate the T&M labor category rates on the current predecessor contract were generally comparable to the claimed indirect rates in that year's incurred cost submission.
- The profit margin test showed the contractor was earning an 85 percent profit rate on the current predecessor contract. The contractor and PCO negotiated a 10 percent profit rate on the current predecessor T&M labor category rates.

Entrance Conference:

The auditor met with the contractor's representative and the proposal manager who oversaw preparation of the follow-on proposal and approved it for submission to the PCO. The proposal manager provided a walk-through of the follow-on proposal explaining, in detail, the basis for all cost elements and rates, the available supporting documentation, and the related estimating policies and procedures. During the meeting, the auditor asked the following questions about the follow-on proposal, current predecessor contract, estimating practices, and potential fraud risks.

Auditor Question: "Why were the proposed direct labor rates on the current predecessor contract based on salary surveys as opposed to forward pricing rates?"

Contractor Response: "At the time of that proposal, we were a much smaller company and did not have approved forward pricing rates. We also did not have a sufficient work force to staff the contract and needed to hire about 60 percent of the proposed labor. Salary surveys seemed the most reasonable method for estimating the direct labor category rates."

Auditor Question: "The proposed direct labor hours are based on history from the current predecessor contract. Will the same employees who are currently performing on that contract be used for the follow-on?"

Contractor Response: "Yes. Our customer seems very satisfied with the work so we see no reason to change anything."

Auditor Question: "We computed average historical direct labor hourly rates by labor category as per the estimating policies and procedures and compared the rates to both the proposed direct labor rates on the follow-on contract as well as the rates in the current predecessor contract. The historical rates were lower for all categories except the administrative ones. Please explain why that might be the case."

Contractor Response: "I suppose we were able to bring the new hires on at hourly rates lower than we proposed but salary surveys are not an exact science. We were lucky and did not need to hire for the administrative categories. Also as explained in the walk-through, the follow-on proposal direct labor rates are from our FPRA. Our proposed rates were reviewed and accepted by the ACO."

Auditor Question: "Where do you or other company managers see the biggest vulnerability for fraud in the estimating process?"

Contractor Response: "We have two primary areas that we are concerned about in estimating. The first is significant underbidding to win a contract creating an incentive for program managers to "cheat" to maintain an acceptable profit margin. In many cases, it is the program managers who provide the cost information that we use to develop the proposal. The second is bidders proposing subcontracts or teaming arrangements with companies with which they have an inappropriate relationship such as receiving kickbacks or the company is owned by a relative. To combat these risks, we have designed a structured tiered review process based on the proposal amount and significance that can include the Chief Financial Officer (CFO) and maybe even the Chief Executive Officer (CEO). We also have a robust ethics training program that covers both of these risks."

Auditor Question: "Is the company aware of any allegations of fraud or suspected fraud made by employees, former employees, regulators or others related to this contract or to labor mischarging?"

Contractor Response: "No, to my knowledge we have not received nor are investigating any such allegations. However you should probably confirm that with our Office of General Counsel since they have responsibility to monitor those matters."

Auditor Question: "What potential fraud or suspected fraud related to this contract or to labor charging on this contract is the company aware of?"

Contractor Response: "Again our Office of General Counsel is better equipped to answer that question, but I am not aware of anything. So I will ask them and then provide you their response."

Audit Team Brainstorming for Fraud Risk Assessment:

The auditor and supervisor met to discuss the results of the risk assessment to date and to brainstorm about the risk of fraud in the audit. They documented the following risk indicators.

- The follow-on contract will be a large dollar sole source award.
- The contractor was earning a profit significantly higher than the profit negotiated on the current predecessor contract.
- The difference between the average historical direct labor rates and the rates proposed for both the current predecessor and follow-on contracts indicated that the contractor may have been paying its technical employees a lot less than the direct labor rates in the current predecessor contract. This could be an indicator that potential defective pricing exists on the

current predecessor contract. The employees used for the current predecessor contract also may not have been qualified for the labor category to which they were assigned and billed.

To address the risk factors, the auditor and supervisor decided to perform additional procedures, in addition to those in the standard audit program, to review the historical labor that the contractor said would continue on the follow-on contract. They also decided not to rely on the DCMA FPRA rates and perform, per the audit program, the audit procedures to be used when there are no audited rates. Specific audit steps to be performed included:

- Determining the employees whose direct labor rate is more than 25 percent lower than the direct labor rate for the labor category to which they were assigned. For those employees, perform a 100% review of their personnel information to include:
 - determining if they meet the required qualifications for the T&M labor category to which they were assigned;
 - comparing employee job title and descriptions with the job title and descriptions of the T&M labor category to which they were assigned; and
 - verifying the employee hire date.
- Performing the same testing for other employees selected for review using a statistical sample with a sufficient sample size to address a high risk that employees may not have been assigned to the appropriate labor category (high expected error rate).

Results from Audit Procedures:

The auditor performed the planned testing and identified the following potential issues.

- Employee resumes disclosed that 45 percent of all the employees tested did not meet the required education and/or experience qualification requirements in the contract for the T&M labor category to which they were assigned and billed.
- Employee resumes for an additional 32 percent supported that they met the education and/or experience requirements in the contract but their actual employee labor category title and description was significantly different from the T&M labor category title and description. The most common examples of this were employees with the software engineer job title being assigned and billed as Sr. Project Engineers. The auditor also noted that the resumes for these employees were very similar in look and format, unlike the other resumes reviewed in the testing.
- Twenty-eight percent of the employees tested had hire dates in the personnel records prior to award of the current predecessor contract. Another 40 percent were hired within two weeks after the contract award with letters dated prior to contract award.

Expanded Audit Procedures and Results:

The auditor discussed the results of the historical labor testing with the supervisor and both concluded that a fraud referral (DCAA Form 2000) should be submitted on the potential direct labor rate defective pricing on the current predecessor contract. The auditor also raised concerns

about the apparent unqualified labor. The auditor recalled that the current predecessor contract required the contractor to submit employee resumes to the PCO to approve employees assigned to the contract but wondered why the PCO would approve unqualified personnel. After the discussion and brainstorming, the supervisor suggested comparing the resumes in the personnel records to those submitted to the ACO for the current predecessor contract to determine if the contractor was inflating the submitted resumes so that the employee met the contract labor qualifications for their assigned T&M labor category.

The auditor contacted the PCO and requested the resumes that the contractor had submitted and compared them to the employee resumes in the personnel records. The auditor first noted that the submitted resumes were all very similar in look and format but very different from those in the personnel records. Overall, the comparison testing disclosed that over 50 percent of resumes submitted to the PCO had been altered so that the employee met the contract labor qualifications.

Further Actions:

The auditor and supervisor decided on the following actions related to the identified audit issues and fraud indicators.

- Submit a DCAA Form 2000 fraud referral for potential defective pricing and billing of unqualified labor on the current predecessor contract.
- Brief PCO, ACO and local DoD Criminal Investigator on the results of the audit testing and discuss the following follow-up action items:
 - continuation of the audit of the current proposal in light of the forthcoming fraud referral; and
 - DCAA performing a preliminary assessment of the FPRA proposal to determine whether a defective pricing/post award review should be performed;
 - DCAA recommendation that the ACO request DCAA to perform an estimating system audit as soon as possible.
- Issue a deficiency report for the identified noncompliances with Defense Federal Acquisition Regulation Supplement (DFARS) accounting system criteria (DFARS 252.242-7006) which would recommend that the ACO withhold payments on the current predecessor contract until the system deficiencies are corrected.
- Draft an audit lead for incurred cost audits to increase testing for T&M contracts including verification that employees are qualified for the labor categories charged and billed and to question all unqualified labor on the current predecessor contract.
- Draft an audit lead for future T&M proposal audits to verify that employees who will be working on the prospective contract are qualified for the labor categories proposed.
- Perform T&M profit margin tests on other T&M contracts and initiate a defective pricing audit on all those with profit margins significantly higher than negotiated.

General Comments/Lessons Learned:

A T&M contract is used to buy goods and services on the basis of direct labor hours at specified hourly rates that include direct labor wages, allocated indirect costs and profit. Direct materials are billed at cost along with appropriate allocated indirect costs. A labor hour contract is a type of T&M contract without the contractor supplying materials. The Government should only use T&M contracts when it cannot estimate, within reason: the work to be done; the period of performance; or the cost. Neither type of contract provides a positive profit incentive for the contractor to manage the labor force or control costs. Therefore, T&M contracts represent a higher risk area for the auditor and the Government and require greater surveillance.

In recent years the practice of contractors using and billing unqualified employees on T&M contracts to maximize profit has become more prevalent resulting in numerous fraud investigations. An increased audit fraud risk exists not only for incurred cost audits but also proposal audits, particularly when historical or actual labor is the basis for the proposed labor. This trend has also prompted the Government to include additional requirements in T&M contracts such as submittal of resumes and more specific qualification requirements, to ensure that employees meet the assigned labor category qualifications. Auditors need to exercise professional skepticism and be creative in designing testing to address the risk that the contractor may be willing to fabricate or alter records to demonstrate contract compliance to the Government.

FRAUD INDICATORS

- **Significant differences between proposed and actual labor rates or number of hours with no corresponding changes in work scope or job requirements.**
- **Task-by-task billings consistently at the ceiling level established in the contract. An exception would be if the contract/work order specifies how many hours to bill.**
- **Individuals proposed as "key employees" not working on the contract.**
- **Proposed labor not based on existing work force. Massive new hires needed. New hire labor rates significantly lower than proposed.**
- **Employees' skills do not match the skill requirements as specified for their labor category or the contract requirements.**
- **Employees typically charged indirect by the company being charged direct to the contract.**

- **Partners', officers', supervisors' and other high level employees' time being charged in noncompliance with the contract terms or with the company's established accounting policies and procedures.**
- **Changes in the company's labor charging policies and procedures depending on the type of contract [fixed-price, cost-type, time and material (T&M) or commercial].**
- **Repeated noncompliance with Cost Accounting Standards 402, "Consistency in Allocating Cost Incurred for the Same Purpose," for labor. An example involving labor would be repeatedly charging administrative labor direct sometimes and indirect other times when the employees are essentially performing the same function under like circumstances.**