

# **Defective Pricing Selective Disclosure**



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# Risk Assessment- Research and Planning

The auditor was assigned to perform a post-award<sup>1</sup> audit of SHIPSRUS, Inc.'s \$40 million firm-fixed price Navy contract for dry dock services. The supervisor stated that the contract had been randomly selected from a database of pricing actions under the field audit office's (FAO) annual defective pricing selection process. The auditor was instructed to first perform the risk assessment audit steps in the standard audit program and then determine whether to proceed with detailed audit procedures.

<sup>1</sup>Post-award audits are often referred to as defective pricing audits since the purpose of the audit is to determine if a negotiated contract price was increased significantly due to the contractor not submitting or disclosing current, accurate, and complete cost or pricing data. The Truth in Negotiations Act (TINA) (10 U.S. Code § 2306a) requires the contractor to certify that the submitted data is current, accurate and complete as of the date of price agreement. The Government is then on equal footing with the contractor when negotiating the contract. If the contractor fails to comply, TINA provides the Government with a price reduction remedy that includes interest and penalty provisions.



# Risk Assessment- Research and Planning

The supervisor explained that the audit had to identify sufficient evidence to establish the five points necessary to support a finding of defective pricing and support recommended price adjustments.<sup>2</sup> The supervisor added that DCAA had very little audit experience with this contractor. The auditor reviewed the permanent file and did an internet search on the company name. The auditor documented the following information about the contractor.

<sup>2</sup>The five points for defective pricing are: 1) The information in question fits the definition of certified cost or pricing data; 2) Accurate, complete, and current data existed and were reasonably available to the contractor before the agreement on price; 3) Accurate, complete, and current data were not submitted or disclosed to the contracting officer or one of their authorized representatives; 4) The Government relied on the defective data in negotiating with the contractor; and 5) The Government's reliance on the defective data caused an increase in the contract price.



# Risk Assessment- Research and Planning

- Per the DCAA internal control questionnaire (ICQ) for the year of contract award, SHIPSRUS, Inc. was a privately owned business that provided dry dock services to the Navy and commercial customers. The contractor had \$80 million in annual sales with 60 percent related to Government contracts and mostly through firm-fixed price (FFP) contracts.
- The contractor's website indicated the company was owned by a former naval officer who had extensive program management experience. In the five years that the contractor had been in business, its Government sales had steadily increased and included both prime and subcontracts. The contractor performed dry dock services at a variety of locations across the country including Baltimore, Seattle, Pascagoula, Norfolk, and Mobile. The contractor also performed dry dock services in Los Angeles and Fort Lauderdale for commercial cruise ships.



# Risk Assessment- Research and Planning

- The most recent DCAA audit was of a proposal submitted by the contractor for dry dock services at the Navy's Norfolk shipyard. The audit that was performed 18 months ago questioned labor costs because the proposed labor rates were not the most current available.
- DCAA had not performed any business system reviews.
- An audit lead annotated that a contractor disclosure<sup>3</sup> had been submitted by a prime contractor alleging that SHIPSRUS, Inc. had used non-conforming materials to perform dry dock services on several subcontracts. The auditor discussed the matter with the DCAA Justice Liaison Auditor (JLA) who stated that the matter was currently under investigation.

<sup>3</sup> FAR 52.203-13, Contractor Code of Business Ethics and Conduct, requires contractors to timely disclose in writing to the Government credible evidence of a violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in 18 USC or a violation of the civil False Claims Act.



# Risk Assessment – Review of Pricing Action Information

The auditor notified the contractor's representative that DCAA would need to schedule a walk-through of the proposal as part of its risk assessment of the contract.

The auditor also requested:

- a copy of the awarded contract including modifications;
- the final proposal;
- the final certificate of current cost or pricing data;
- a listing of any updated cost or pricing data provided during or after negotiations; and
- an accounting system job cost reports of the actual costs incurred on the contract by cost element and significant cost sub-elements.



# Risk Assessment – Review of Pricing Action Information

The auditor reviewed the information provided by the contractor and the price negotiation memorandum (PNM) obtained from the Procurement Contracting Officer (PCO). The auditor documented the following information relevant to the audit:

- The 2-year firm-fixed-price Navy contract was for dry dock services at the New Orleans shipyard. The contract was awarded for \$40 million and had contract line items (CLINs) for the various required dry dock services. The contract was completed 6 months ago.
- The final proposal submitted by the contractor was for \$38 million, of which labor represented 60 percent of the total proposed costs.



# Risk Assessment – Review of Pricing Action Information

- PNM stated that the contractor provided updated indirect rates during negotiations increasing the updated final proposed price to \$40 million. The PCO relied on the final proposal (\$38 million) plus the increased indirect costs (\$2 million) to negotiate the contract price.
- The proposal identified three existing Navy contracts for dry dock services at Mobile, Pascagoula, and Norfolk as similar and comparable to the proposed contract.
- The request for proposal required submission of certified cost or pricing data, and the contract included the requisite price reduction for defective pricing contract clauses.
- The contractor executed a final certificate of current cost or pricing data shortly after negotiations concluded.



# Risk Assessment – Review of Pricing Action Information

When requesting the PNM, the auditor notified the PCO that the pricing action had been selected to determine if a post-award audit was warranted. The PCO did not identify any specific concerns for defective pricing, e.g. contract performance or billing issues. The PCO stated that they had not requested a DCAA audit of the proposal since the contractor had approved forward pricing rates. In addition, the PCO believed, at the time, that they could determine a fair and reasonable price based on their experience with the contractor performing these same services on other Navy contracts.



# Preliminary Analytical Procedures and Overrun/Underrun Analysis



The auditor consulted with the supervisor and then performed the procedures in the following order.

Analytical Procedure: Determine audit baseline for defective pricing by cost element and assess materiality of cost elements.

Result: Audit baseline was \$40 million calculated by adding the increased indirect costs (\$2 million) for updated rates provided during negotiations to the final proposal amount (\$38 million). Labor represented 55 percent of the total costs.

Analytical Procedure: Perform an overrun/underrun analysis by comparing actual costs incurred to baseline costs proposed by cost element.

Result: Direct labor cost was underrun by \$3 million and was the only cost element with a significant underrun or overrun.



# Preliminary Analytical Procedures and Overrun/Underrun Analysis



Analytical Procedure: To identify the cause of the underrun, compare by labor category the direct labor cost incurred to the baseline direct labor cost proposed.

Result: All direct labor categories except administrative categories had significant underruns.

Analytical Procedure: To further refine the analysis, compare by labor category actual direct labor rates incurred to proposed direct labor rates from audit baseline.

Result: Proposed baseline direct labor rates generally corresponded with incurred direct labor rates.



# Preliminary Analytical Procedures and Overrun/Underrun Analysis



Analytical Procedure: Compare by labor category incurred labor hours to proposed baseline labor hours.

Result: All direct labor categories except administrative categories had significant labor hour underruns.



# Meeting with Contractor and Proposal Walk-Through



The auditor contacted the contractor's representative to arrange for a walk-through of the final proposal and the indirect rate data provided at negotiations. This demonstration would explain the basis for each cost element/sub-element and the certified cost or pricing data submitted to support the proposal. It would also identify how the costs were accumulated in the accounting system and the internal controls in place to ensure TINA compliance. The auditor and supervisor met with the contractor's representative and the proposal director. The auditor documented the following information from the meeting including the contractor's responses regarding fraud risk and management knowledge of fraud.



# Meeting with Contractor and Proposal Walk-Through (Cont'd)

- The contractor was currently drafting estimating system policies and procedures in preparation for an upcoming DCAA audit of the system. These merely formalized, in writing, the internal controls and processes they were following.
- This would be the first contract to be performed at the New Orleans shipyard location.
- The contractor provided the following information on the cost or pricing data used to estimate the proposed labor hours.
  - The contractor based its proposed labor hours on the average of the actual hours incurred for performing the dry dock services on the three other Navy contracts (Norfolk, Mobile and Pascagoula locations).



# Meeting with Contractor and Proposal Walk-Through (Cont'd)

- The contractor used these three contracts because other Government contracts for dry dock services were too dissimilar from the requirements in the request for proposal under audit or the other contracts had not yet been awarded.
- The contractor explained that the labor hours incurred might have been less than those proposed because actual ship repairs and maintenance were not as extensive as expected.
- The contractor stated that management had not considered proposal pricing as a high fraud risk area and felt that they had sufficient internal controls to preclude defective pricing.



# Meeting with Contractor and Proposal Walk-Through (Cont'd)

- The contractor stated that management did not have any knowledge of fraud or suspected fraud affecting this or any of their contracts.
- The contractor also stated that management was unaware of any allegations of fraud or suspected fraud that could affect the negotiation and award of this contract.



# Audit Team Brainstorming for Fraud Risk Assessment



The auditor and supervisor met to discuss the results of the risk assessment and to brainstorm about potential risks for defective pricing due to error or fraud. The auditor commented that the main indicators noted were that the contractor was currently under investigation (which the contractor did not mention or seem to know about during the walk-through) and the lack of defined estimating policies and procedures. The supervisor added that the company president was a former Naval officer with fairly recent program management experience in the Navy program office. Another risk factor was that many of the contractor's Navy contracts were sole source. This could indicate that the Navy program office requesting the dry dock services may be improperly steering contracts to the contractor.



# Audit Team Brainstorming for Fraud Risk Assessment (Cont'd)

Based on these factors and the significant underrun in labor hours incurred, the team decided to primarily focus its audit on labor hours. To determine whether the contractor provided the most current cost data for labor costs, they would verify the contractor's assertions that the three other Navy contracts were the best available sources for historical data to develop the proposed labor hours. The auditor noted that the contractor's website identified Navy contracts for dry dock services at two other locations (Baltimore and Seattle) that were not used in developing the proposed labor hours. The team decided to perform the following testing:



# Audit Team Brainstorming for Fraud Risk Assessment (Cont'd)

- Use the Electronic Document Access<sup>4</sup> (EDA) online system to identify a universe of the contractor's Government contracts for dry dock shipping services.
- Determine if the identified contracts were active before the date of final price agreement for the contract under audit. If that was the case, review the statement of work (SOW) and determine if the services performed were similar enough to the proposed services to warrant being included with the other Navy contracts in developing the proposed labor hours.

<sup>4</sup> Electronic Document Access (EDA) Program is a web based system that provides authorized users secure online access, storage, and retrieval of acquisition documents such as contracts, contract modifications, vouchers, contract deficiency reports and government bills of lading. The website is located at <http://eda.ogden.disa.mil/>.



# Results from Audit Procedures

The auditor performed the planned testing and documented the results.

- The auditor identified three additional contracts for dry dock services at the San Diego, Baltimore and Seattle locations that were awarded prior to the date of final price agreement on the contract being audited. The contractor completed all three contracts and follow-on contract awards were in process when the contract under audit was negotiated and awarded.
- The CLIN descriptions of the dry dock services and the overall SOW for these three additional contracts were virtually the same as those for the contract under audit, as well as, the other three contracts that were used to develop the proposed labor hours.



# Expanded Audit Procedures and Results

The auditor discussed the results of the testing with the supervisor. They both agreed that the dry dock services provided on the three contracts seemed to be similar to the services performed for the audited contract. Therefore, the contractor should have used the historical information from the three additional contracts to estimate the direct labor hours for the proposal. They decided to perform additional audit steps regarding potential defective pricing due to excluding the seemingly relevant cost or pricing data.

- Consult with a technical specialist from Supervisor of Shipbuilding, Conversion and Repair (SUPSHIPS) to see if they agreed that the services for the excluded contracts were similar enough to warrant inclusion in developing the proposed labor hours.



# Expanded Audit Procedures and Results (Cont'd)

- Confirm with the PCO whether these other contracts were referenced or discussed during the proposal review and negotiation processes.
- Request the incurred costs for the excluded contracts and determine what impact their inclusion might have had on the proposed labor hours.

The results of these additional procedures were as follows:

- The SUPSHIPS technical representative agreed that the dry dock services performed on the three excluded contracts were generally the same as those for the contract under audit. Since these contracts had been completed, they saw no reason why the contractor would exclude them in developing the proposed labor hours.



# Expanded Audit Procedures and Results (Cont'd)

- The PCO stated that they were not aware of the three excluded contracts the auditor had found and pointed out that these had been awarded by a different contracting command. The PCO was aware of the three contracts cited in the proposal and thought it reasonable for the contractor to base the estimated labor hours on those contracts. The contractor also had specifically stated to the Navy cost analysts reviewing the proposal that this was the only historical information they had on which to base the labor hour estimates.



# Expanded Audit Procedures and Results (Cont'd)

- The contractor representative questioned why the auditor needed the actual cost data for the other contracts, but finally agreed to provide the records. Using the contractor's proposal methodology, the auditor added the actual hours for the excluded contracts to the other historical labor hour information. The auditor determined that adding the excluded contracts reduced the estimated proposed labor hours by 15,000 hours equaling \$1.8 million.



# Further Actions

The auditor, supervisor, and audit office manager concluded that a written fraud referral should be submitted. The contractor did not include all the historical information relevant to developing the proposed labor hours used to negotiate the final contract price. In addition, the audit team agreed on the following next steps.

- Calculate the recommended price adjustment for the identified defective pricing and issue the audit report.
- Contact the local DoD criminal investigator to discuss the audit findings and the forthcoming fraud referral.



# Further Actions (Cont'd)

- Issue a business systems deficiency report for the identified estimating system non-compliances.
- Draft an audit lead for future proposals to verify the completeness of historical cost information used in developing proposal estimates.
- Coordinate with the PCO and Administrative Contracting Officer (ACO) regarding the audit findings so they can be considered in future evaluations of the contractor's proposals. Discuss if there are other contract awards that should be audited for defective pricing.



# General Comments/ Lessons Learned

Establishing the five requirements for defective pricing can be difficult. When defective pricing risk indicators are evident, auditors need to use creative inquiry techniques to determine whether relevant data existed prior to price agreement that was not properly disclosed to the Government. These techniques might include a combination of analytical tests, observation, inspection, inquiry, tests of detailed records, and/or third party confirmations. Audit teams should brainstorm to identify what other records the contractor might have had that could address potential defective pricing in the risk area(s) identified. For instance, the auditor could consider what records might exist to prove or disprove the theory that proposed labor hours were inflated.



# General Comments/ Lessons Learned (Cont'd)

In addition, while the fraud indicators are more likely to be found during a defective pricing audit, the auditor may also find the same indicators during a proposal or estimating system audit. Identifying proposed costs that differ from historical costs during a proposal audit helps prevent the Government from incurring the increased costs in the first place.



# Fraud Indicators

- Failure to correct known system deficiencies, especially those that the contractor agreed to correct.
- Failure to consider all relevant historical data in developing proposed costs.
- Specific knowledge that is not disclosed regarding significant cost issues that would reduce the proposed cost.



# Fraud Indicators (Cont'd)

- Repeated denial by responsible contractor employees of the existence of historical records that are subsequently found.
- Refusing to provide requested data.
- Inconsistencies between contractor statements and records reviewed.
- Multiple instances of defective pricing involving similar patterns or conditions.

