

Subcontract Pricing Deficiencies



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Risk Assessment- Research and Planning

The field audit office (FAO) management selected for post-award audit a \$400 million firm-fixed price DoD contract to operate, control and maintain global satellite communications.¹ An audit team was assembled to perform the assignment. The lead auditor assigned a member of the team to review the subcontract costs. The assigned auditor conferred with the lead auditor who had already completed most of the general risk assessment procedures.

¹Post-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 lead auditor had already requested and received the following from the contractor, Prime Contractor, Inc.

- The final proposal and final certificate of current cost or pricing data
- A listing of additional or updated cost or pricing data provided during or after negotiations but prior to date of price agreement
- A copy of the contract and modifications
- A listing of major subcontracts
- The accounting system reports of the actual costs incurred on the contract with cost element detail



Risk Assessment- Research and Planning

In reviewing the lead auditor's working papers, the auditor noted the following information about Prime Contractor, Inc. relative to the audit objectives.

- The contractor provides satellite communication services to the DoD and commercial customers.
- The contractor's sales for the year the contract was awarded were \$645 million with about 65 percent being Government contracts. The contractor's current sales were \$875 million with about 75 percent being Government. The majority of the Government contracts were fixed price with some time and material (T&M).



Risk Assessment- Research and Planning

- At the time of contract award, DCAA had audited the contractor's accounting and estimating systems the prior year. DCAA considered the systems adequate and reported no significant deficiencies.
- The Defense Contract Management Agency (DCMA) performed a Contractor Purchasing System Review (CPSR) 16 months after contract award. That review determined the contractor did not perform timely and adequate cost or price analysis on subcontract proposals to ensure fair and reasonable subcontract prices. This was non-compliant with Defense Federal Acquisition Regulation Supplement (DFARS) 252.244-7001 (c) (10).



Risk Assessment – Research and Planning

- DCMA performed a follow-up Contractor Purchasing System Review (CPSR) a year later and determined that Prime Contractor, Inc. had not adequately implemented its proposed corrective actions for the significant deficiency. As a result, the Administrative Contracting Officer (ACO) was currently withholding 5 percent of the progress payments for all contracts until the deficiency was corrected.
- The DCAA electronic permanent file documented a Defense Hotline complaint from the prior year regarding Prime Contractor, Inc.'s subcontract awards. The Hotline complaint had been forwarded to the audit office for information. The complaint submitted by the President of Never Win, Inc. stated that Never Win, Inc. had bid on several subcontract requests for proposal (RFPs), but Prime Contractor, Inc. had always awarded the subcontracts to Windfalls For Us, Inc. The complainant seemed very disgruntled with the whole proposal and award process and implied something was not 'right.'



Risk Assessment – Review the Contract and Price Negotiation Memorandum (PNM)

The lead auditor's review of the contract and the PNM showed the following:

- The 3-year contract was completed during the previous year.
- The contract required compliance with TINA as it included all the Federal Acquisition Regulation (FAR) clauses for price reduction for defective cost or pricing data. These requirements also flowed down to applicable subcontracts.



Risk Assessment – Review the Contract and Price Negotiation Memorandum (PNM) (Cont'd)

- The PNM stated that the negotiated price represented Prime Contractor, Inc.'s final proposed costs plus negotiated profit. The Procuring Contracting Officer (PCO) included a statement in the PNM that they had relied on this cost and pricing data.
- DCAA was only requested to provide a rate check² for the labor and indirect rates. DCAA did not perform any specific audit work related to the proposal being negotiated. The PCO also obtained DCAA rate checks for the major subcontracts in the proposal. The DCAA-provided rates matched the proposed rates in the contractor and subcontractor proposals.

²In connection with a pricing action, a PCO may request from DCAA specific information concerning a contractor's costs without requesting a full audit or evaluation of the contractor proposal. DCAA provides data from its files that DCAA already has made a determination on, such as current audited or agreed-to forward pricing rates for labor and indirect costs. DCAA refers to this contracting office request as a rate check or rate request.



Risk Assessment – Review the Contract and Price Negotiation Memorandum (PNM) (Cont'd)

- The PNM stated that Prime Contractor, Inc. provided verbal assurances during negotiations that most major subcontracts had been awarded. They were negotiating the few remaining subcontracts. Prime Contractor, Inc. anticipated that the subcontracts would be awarded in the next couple of days, prior to the date of final price agreement. To support this statement, they provided a spreadsheet listing the major subcontracts; award date or anticipated award date; awarded subcontract price; and basis for award (e. g., competitive, sole source, negotiated). The PCO attached the contractor-provided list to the PNM.
- The lead auditor notified the PCO that DCAA had selected the pricing action for a defective pricing audit. The PCO did not identify any specific concerns and added that Prime Contractor, Inc. had gotten the follow-on contract largely based on their performance on the previous contract. The PCO provided the lead auditor information from the cost/price analyses performed by their staff.



Risk Assessment - Overrun/Underrun Analysis

The lead auditor determined that the initial audit baseline for defective pricing was the contractor's final proposal since Prime Contractor, Inc. had confirmed that no additional data had been provided prior to the date of price agreement. The lead auditor then performed an overrun/underrun analysis by comparing the contract's total actual cost incurred by cost element to the contractor's final proposal.

- All the major cost elements except indirect costs had substantial cost underruns. In total, the contract was underrun by \$145 million.
- Subcontract costs represented 32 percent of the \$365 million audit baseline and had a \$60 million cost underrun.



Preliminary Analytical Procedures and Follow-up



The auditor, supervisor and lead auditor discussed the subcontract costs and decided to perform a more detailed underrun/overrun analysis to identify possible sources for the underrun.

Analytical Procedure: Compared proposed costs by individual subcontract with the incurred costs paid on the individual subcontracts.

Result: Subcontracts with Get More, Inc., Profit Is King, Inc., and Windfalls For Us, Inc., accounted for most of the \$60 million subcontract cost underrun. Windfalls For Us, Inc. represented \$28 million of that total. The auditor recalled that Windfalls For Us, Inc. was the subcontractor named in the Hotline complaint.



Preliminary Analytical Procedures and Follow-up (Cont'd)

Analytical Procedure: Compared contractor/subcontractor negotiated subcontract prices on the major subcontract listing provided by Prime Contractor, Inc. at negotiations with the incurred or charged subcontract costs in the contractor's accounting records.

Result: The costs incurred for the Get More, Inc., Profit Is King, Inc., and Windfalls For Us, Inc. subcontracts were close to \$60 million less than the negotiated subcontract prices shown on Prime Contractor, Inc.'s listing provided at negotiations. The auditor also noted from Prime Contractor, Inc.'s listing that the purchasing manager had awarded both the Get More, Inc. and Profit Is King, Inc. subcontracts on a sole source basis.



Preliminary Analytical Procedures and Follow-up (Cont'd)

Thus, the auditor concluded from the analyses that the incurred costs for Get More, Inc., Profit Is King, Inc., and Windfalls For Us, Inc. were underrun in comparison to the proposed costs in the final proposal and the negotiated prices shown on the subcontract listing provided to the PCO at negotiations. The underruns in both cases were about \$60 million.

The auditor followed-up with the PCO and ACO about the identified underrun with the three subcontracts. Neither could explain why there would be an underrun. The PCO added that the purchasing manager had told them during negotiations that those subcontracts had been awarded and that the contractor/subcontract negotiated prices were reflected in the final proposal.



Audit Team Meeting and Brainstorming for Fraud Risk Assessment



The auditors assigned to the post-award audit and the supervisor met and discussed the information gathered from the risk assessment and the results from the overrun/underrun testing. The team decided that the cost elements with the significant underruns should be audited in more depth.

The team also brainstormed about potential non-compliances, due to error or fraud, which could materially affect the risk of defective pricing. Several auditors recalled that there had been a lot of press when Prime Contractor, Inc.'s satellite communications system was selected over that of a competitor's. One auditor suggested conducting an internet search on the contractor and procurement as an additional information gathering procedure.



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

The group reconvened a day later to review the information from the internet search and complete the brainstorming risk assessment process. The auditor who performed the search found a major news article discussing the importance of the award to Prime Contractor, Inc. The article stated that the contractor had been losing much of its commercial business base over the last eight months and this major DoD contract award would put them back on solid financial footing. All agreed that losing business in the period prior to contract award could have created an environment where the contractor might overprice the contract to offset its losses.



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

The team also agreed that the purchasing system deficiency identified by DCMA could have existed when the contract was negotiated and awarded. The lack of timely and adequate cost or price analysis on subcontract proposals would pose a potential risk factor for defective pricing. The auditor responsible for auditing the subcontract cost added that it seemed odd that three subcontracts that Prime Contractor, Inc. told the PCO were negotiated prior to the end of contract negotiations ended up costing the contractor substantially less. One of the subcontractors also was named in the Defense Hotline complaint.



Entrance Conference and Proposal Walk Through

The audit team held an entrance conference with the contractor's audit liaison, proposal manager, and program manager. The contractor representatives explained in detail each cost element in the final proposal, the certified cost or pricing data supporting the final proposed costs, and how the actual incurred costs in the accounting system related to the final proposed costs. In response to the lead auditor's question, the proposal manager provided a detailed presentation about the estimating internal controls and how the controls were designed to mitigate the risk of proposal error or fraud in the proposal process, particularly in such a large and decentralized company. In addition, the auditors asked the following questions regarding subcontract costs, the purchasing system deficiency, and the contractor's knowledge of any fraud related to the proposal or contract.



Entrance Conference and Proposal Walk Through (Cont'd)

Auditor Question: "Was management aware of any subcontracting deficiencies prior to the award and negotiation of this contract?"

Contractor (audit liaison) Response: "No, the purchasing manager ran a pretty tight ship."

Auditor Question: "What about the purchasing system deficiency that DCMA reported on in the CPSR report?"

Contractor (audit liaison) Response: "We didn't find out about that until the CPSR. As we told the ACO, we are working with our internal audit group to revamp the process for evaluation and award of subcontracts. We expect to complete that evaluation and implement our corrective actions in the next quarter"



Entrance Conference and Proposal Walk Through (Cont'd)

Auditor Question: "What interim control procedures did management implement to address the lack of adequate subcontract analyses prior to completion of the process evaluation by internal audit?"

Contractor (program manager) Response: "We didn't really change our procedures per se. The purchasing manager retired a few months ago and his replacement has been working hard to get up to speed on the CPSR issues. I am aware though that the Director of Proposals has been asking the new purchasing manager to review the cost price analyses that were done for some of the more significant subcontracts."



Entrance Conference and Proposal Walk Through (Cont'd)

Auditor Question: "Please explain why the subcontract costs paid were lower than the subcontract costs identified to the PCO as negotiated during prime contract negotiations."

Contractor (program manager) Response: "I am a little surprised by this and will need to look into it. My understanding from the purchasing manager was that all the major subcontracts were awarded prior to the end of our negotiations. However, we sometimes include economic price adjustment clauses in our subcontracts for significant changes in a subcontractor's raw material costs."



Entrance Conference and Proposal Walk Through (Cont'd)

Auditor Question: "Does management have knowledge of any fraud or suspected fraud affecting this proposal or contract?"

Contractor (audit liaison) Response: "Not to my knowledge but I will check with our legal department that operates our internal hotline and conducts our internal investigations."



Entrance Conference and Proposal Walk Through (Cont'd)

Auditor Question: "Has management received any allegations of fraud or suspected fraud related to negotiation and award of this contract or program, for example from employees, former employees, subcontractors, etc.?"

Contractor (proposal manager) Response: "I will need to check with our internal hotline, but I don't think so. Oh wait, I remember our Chief Financial Officer got this call from a guy complaining that his company never won any of the subcontract bids they submitted, including for this contract. I recall that the internal investigations officer reviewing the hotline discussed the complaint with me and the purchasing manager, but did not investigate because they did not consider the allegations credible."



Audit Team Meeting to Determine Detailed Audit Steps

The audit team met to determine the audit scope and detailed audit procedures to address the potential risk indicators for fraud and/or defective pricing indicators identified in the team brainstorming. The team decided on the following detailed steps for auditing the subcontract costs.



Audit Team Meeting to Determine Detailed Audit Steps (Cont'd)

- For the three subcontracts identified in the preliminary analytical procedures as having significant cost underruns, determine whether information explaining the underruns was in the contractor's files and available or known by contractor personnel prior to DoD/contractor agreement on price for the prime contract. To make that determination, the auditor will perform the following audit procedures:
 - Evaluate the subcontract file documentation to determine the basis for the subcontract awards including cost/price analyses performed.
 - Review prime contractor negotiation memorandums, post-award actions, subcontract documents, invoices and correspondence to determine when the contractor became aware that the subcontract costs paid would be less.



Results from Audit Procedures

The auditor examined the subcontract file documentation for the three subcontracts selected for further review and documented the results.

- The subcontract files were very poorly documented for the sole source awards to Get More, Inc. and Profit Is King, Inc. The auditor did not find signed copies of the subcontracts in the file; only copies marked draft or with type-written signatures. The files also did not have negotiation memoranda or other documentation. In addition, the auditor found that the contractor failed to:
 - Obtain subcontractor certified cost or pricing data as required by the prime contract.
 - Perform adequate cost/price analysis to support subcontract price reasonableness.
 - Conduct market research for alternative sources.
 - Complete adequate sole source justifications.



Results from Audit Procedures (Cont'd)

- The Windfalls For Us, Inc. subcontract file included more information.
 - The contractor awarded the subcontract competitively based on solicitations sent to five companies.
 - Three companies declined to bid and the contractor excluded one company as technically inadequate. The excluded company was Never Win, Inc. whose president had submitted the Defense Hotline complaint. Never Win, Inc.'s proposal was more than 30 percent lower than the bid submitted by Windfalls For Us, Inc.



Results from Audit Procedures (Cont'd)

- The original subcontract price matched the amount in the subcontract proposal used in the contractor's prime proposal and the amount that the PCO was told was the negotiated subcontract price. However, the contractor issued a modification 4 months after subcontract award substantially decreasing the price. The justification for the reduction was "agreed to change in scope." The modification did not include any change to the performance work statement.
- Emails in the subcontract file suggested a personal relationship existed between the buyer and Windfalls For Us, Inc.'s proposal manager. The introductory and closing comments contained discussions of attending social events such as ball games, concerts, and family barbeques.



Additional Audit Procedures

After reviewing the results to date, the supervisor and lead auditor concurred that the auditor should perform some additional steps on the subcontract costs.

- The auditor first discussed with the PCO and ACO the identified subcontract cost underruns and deficient subcontract files for Get More, Inc. and Profit Is King, Inc. subcontracts. The auditor stated that insufficient information was available to determine if Prime Contractor, Inc. was aware of more current, accurate and complete information about the three subcontracts prior to price agreement on the prime contract.



Additional Audit Procedures (Cont'd)

- The auditor individually contacted the supervisory auditors at the DCAA audit offices cognizant of Get More, Inc. and Profit Is King, Inc. to discuss the identified cost underruns and deficient prime subcontract files. The auditor suggested that there could be documentation in the subcontractors' files that might reasonably explain the cost underruns. Each supervisory auditor agreed that the most effective and efficient means of addressing the situation would be for the prime auditor to request an agreed-upon procedures engagement. This review would compare the specific subcontract information and documents in Prime Contractor, Inc.'s files with that in the subcontractors' files and report on any differences and any missing documents.



Additional Audit Procedures (Cont'd)

- The auditor contacted the other bidders for the Windfalls For Us, Inc. subcontract award to confirm the information in Prime Contractor, Inc.'s subcontract files.



Results of Additional Audit Procedures

The auditor performed the additional procedures and documented the results.

- Both the PCO and ACO said they did not have any additional information in their files on the Get More, Inc. and Profit Is King, Inc. subcontracts. The PCO stated that Prime Contractor, Inc. had not provided the executed subcontract agreements during negotiations for either of the subcontracts.



Results of Additional Audit Procedures (Cont)

- The auditor cognizant of the Get More, Inc. reported on the results of performing the agreed-upon procedure engagement.
 - The final proposal in Get More, Inc.'s file was the same as that included in the prime's final proposal with the exception of a line item in the Get More, Inc.'s proposal labeled "management consideration." The line item reduced the proposed subcontract price by 15 percent.
 - The signed subcontract and Get More, Inc.'s certificate of current cost or pricing data were executed after the prime's negotiations with the PCO contrary to the information provided during negotiations.



Results of Additional Audit Procedures (Cont)

- The auditor cognizant of Profit Is King, Inc. reported on the results of performing the agreed-upon procedure engagement.
 - The signed subcontract and Profit Is King, Inc.'s certificate of current cost or pricing data were executed after the prime's negotiations with the Government.
 - Emails in the subcontractor's file dated before prime negotiations with the Government discussed that Profit Is King, Inc. would agree to reduce its proposed labor hours.
 - The final subcontract signed by Prime Contractor, Inc. and Profit Is King, Inc. reflected this decrease in labor hours.



Results of Additional Audit Procedures (Cont)

- The auditor documented the following information about the bidders for the subcontract awarded to Windfalls For Us, Inc. based on telephone discussions and written confirmations.
 - Two subcontractors who declined to bid did not understand why they had been requested to bid. They had never done business with the contractor before and this line of work was not their forte.
 - The confirmation letter for the other subcontractor who had declined to bid came back as undeliverable. When the auditor called the phone number listed in the purchasing files, the person who answered stated that they never heard of the subcontractor.
 - The president of Never Win, Inc. was surprised that his company had been excluded as technically inadequate since he had been told that Windfalls For Us, Inc. had received the award because of a lower bid.



Further Actions

The auditor, supervisor, lead auditor and audit office manager discussed the next steps. All agreed that a written fraud referral would be submitted for the identified subcontract defective pricing as well as the irregular bid circumstances for the subcontract award to Windfalls For Us, Inc. The team also discussed the possibility that the PCO or DoD program management might have been involved with the potential fraud. The auditor was to:

- Contact the local DoD criminal investigator to discuss the audit findings and the forthcoming fraud referral. Confer with the investigator whether DCAA should coordinate the audit findings with the ACO and PCO, issue the report, or perform other related audit duties such as discussed below.
- Calculate the recommended price adjustments for the identified subcontract defective pricing and incorporate these findings into the overall post-award review.



Further Actions (Cont'd)

- Issue business systems deficiency reports for the identified estimating system and purchasing system non-compliances
- Draft an audit lead for future proposals and defective pricing audits to perform procedures to address the identified subcontract pricing deficiencies.
- Assess whether postaward audits should be established for the follow-on contract or other contracts involving the subcontractors associated with the identified irregularities.



General Comments / Lessons Learned

With advent of large contracts that often have complex, multi-tiered subcontracting levels, auditors need to be alert for indicators of subcontract pricing deficiencies in proposal and post-award audits. Audits of subcontract pricing are often where fraud indicators for bid rigging, kickback, and bribery schemes can be identified.

Contractors and their various levels of subcontractors must have strong estimating and purchasing internal controls. Without the implementation of strong controls, a higher risk to the integrity of the proposal preparation process as well as the evaluation, award and oversight of subcontracts exists. Auditors need to thoroughly understand the design and function of these systems to identify anomalies that could indicate potential fraud.



Fraud Indicators

- **A significant variance between proposed and negotiated vendor/subcontract quantities or prices.**
- **Use of different subcontractors or vendors than proposed.**
- **High percentage of sole source (noncompetitive) subcontract awards with poor explanations/documentation.**
- **Non-competitive subcontract award when the contractor's files state that award was based on adequate competition.**



Fraud Indicators (Cont'd)

- **Failure to disclose decreases in subcontract pricings even though parts of the subcontracts are still under negotiation.**
- **Pattern of subcontractor employees buying contractor employees lunches, dinners and/or other items. Individual items could be of low value, but the aggregate value of all items could be material.**
- **Indicators of personal or family associations between contractor and subcontractor employees involved in the awarding and negotiating of subcontracts.**
- **Continued failure to correct known business system deficiencies that impact or allow for subcontract pricing deficiencies.**

