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## **Estimating System – Pricing Module Not Adjusted for Changes in Manufacturing Processes**

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### **The Scenario**

In 2015, Government auditors audited ABC Worldwide's \$100 Billion firm-fixed-price (FFP) proposal in response to the Department of Defense's solicitation for 500,000 Cure All Diseases Injectors. In accordance with the Federal Acquisition Regulations (FAR) 15.403, "Obtaining certified cost or pricing data," ABC certified that it submitted current, accurate, and complete data as required by the Government's solicitation. During the risk assessment phase of the audit, the auditors learned that ABC has produced the Cure All Diseases Injectors for more than 25 years and they found that ABC's estimates, based on production history, were reasonable in prior audits. Similar to prior audits, the auditors used the data that ABC described in its proposal narrative to evaluate the proposed cost. ABC used production history from 2010 through 2012 for estimating the cost used to prepare the proposal. However, unbeknownst to the experienced or seasoned estimators, ABC changed its production process in 2013 for the Cure All Diseases Injectors production.

While examining the 2013 production data, estimators identified several breaks in production. However, the estimators did not query the responsible Manufacturing Department officials to determine the cause for the breaks. Instead, they decided to ignore the 2013 production history and use only the 2010 through 2012 history in the cost module for pricing the proposal. When the auditors questioned the estimators about excluding 2013 production history, the estimators told the auditors that they did not use the history because ABC had too many breaks in production during the period and they did not rely on the data. The auditors accepted the estimators' rationale without further evaluation. After the audit, the Estimating Department personnel learned of the 2013 changes. However, the estimators that were hired after the audit did not communicate this information to either the auditors or the Department of Defense.

In 2013, the new Manufacturing Department management upgraded manufacturing equipment and changed the method ABC used to introduce the medication into the injectors. These changes resulted in a more streamlined manufacturing process for the Cure All Diseases Injectors; a reduction in production and assembly personnel; and an increase in the quality control personnel. Additionally, ABC changed its production level for the Cure All Diseases Injectors from a production lot of 10,000 to 50,000 after the changes. Also, ABC implemented a requirement for twice a day quality control inspections for the 50,000 lot production from a once a day inspection for the 10,000 lot production. ABC has not disclosed any of these changes to the Government. Additionally, ABC has not updated its accounting and estimating policies, procedures, and disclosure statement for its current production practices and changes to cost accumulation practices from the prior lot size to the current lot size. In 2016, the Government subsequently negotiated the proposed FFP contract with ABC for \$100 billion.

### **Internal Control Weaknesses with Potential Fraud Indicators**

- Inadequate communication between responsible officials – in this scenario communication between the personnel in the Estimating and Manufacturing Departments.

- Changes in Manufacturing Department personnel could be a risk factor for fraud due to inexperience, lack of knowledge, and scheduled departures.
- Estimators did not determine if 2013 lot production sizes were consistent with prior years that would have also identified changes made in the Manufacturing Department.
- A current, accurate, and complete disclosure statement was not maintained.
- Current operating policies and procedures were not maintained.
- The pricing module was not updated for manufacturing changes, potentially overstating proposed firm-fixed-prices and potentially resulting in the submission of a defectively priced proposal.
- Estimators' familiarity with the auditors' methodology for evaluating proposals – For example, the estimator's knowledge that the auditors' heavy reliance on production history provides the estimator with some assurance that the auditors will not catch certain types of weaknesses in the system and subsequently the data provided.

**General Comments/Lessons Learned.** Inadequate communication between responsible management personnel can make existing internal controls ineffective and lead to deficiencies in business systems. It can also cause the submission of inaccurate information to the Government. It is equally important for auditors to maintain their objectivity so that familiarity with auditing the contractors' data does not lead to decisions to not perform the appropriate audit procedures.

In this scenario, had either the estimators or the auditors pursued the reason for the 2013 production breaks, they would have increased their chances of identifying the manufacturing changes; the inconsistency with Defense Federal Acquisition Regulation Supplement (DFARS), 48 Code of Federal Regulations (CFR) 252.215-7002, "Cost estimating system requirements," and the potential violation with section 2306a, title 10, United States Code, "Cost or Pricing Data: Truth in Negotiations Act (TINA)." The estimators' failure to notify the responsible Government official of changes to the Manufacturing Department's production process and to update the estimating system's pricing module created a shortcoming in the system. This significant deficiency, defined in DFARS 252.215-7002(a)(5), materially affected the Government's ability to rely on the estimates. In addition, due to this significant deficiency, the estimators did not submit current, accurate, and complete pricing data to the Government as the Truth in Negotiations Act requires.

Seasoned, inexperienced, and newly hired estimators can create situations for ineffective internal controls and create opportunities for fraud risk. However, upon the Government officials learning that they negotiated the contract without knowledge of the changes made in the ABC's Manufacturing Department, the auditors will most likely perform a defective pricing audit.