Subcontract Pricing

The Scenario

Panda Enterprises submitted a $500 million firm-fixed price (FFP) proposal to the Department of the Air Force. The Department of the Air Force requested the assistance of the Defense Contract Audit Agency (DCAA) to evaluate the proposal. Upon receiving the proposal, DCAA performed an initial adequacy review and identified the following subcontracts that were above the Truth in Negotiations Act threshold, which required the submittal of certified cost or pricing data:

- $60 million FFP proposal from BJJ Corporation,
- $30 million FFP proposal from Hammer Industries, Inc., and
- $5 million FFP proposal from POP, LLC.

During the risk assessment, the auditors at the prime contractor’s location (Panda Enterprises) requested assist audits from the cognizant DCAA offices. The auditors at the prime contractor’s location also requested that the prime contractor provide them with all of the cost/price analyses performed on the subcontract proposals. The auditors noted the following from their review of the cost/price analyses performed by the prime contractor and their review of the permanent file:

$60 million FFP proposal from BJJ Corporation

- Adequate cost/price analysis was performed; however, the cost/price analysis only addressed labor hours and material costs.
- History of prime contractor negotiating subcontract values significantly less than proposed subcontract values after the award of the prime contract.
- History of prime contractor delaying subcontract negotiations without sufficient explanation.

$30 million FFP proposal from Hammer Industries, Inc.

- Only a price analysis was performed even though the subcontractor did not deny the prime contractor access to records; the analyst stated he “did not know a cost analysis was required” and performed both the review and approval of the price analysis.
- Subcontract proposal included significant (approximately 75 percent) lower tier subcontract effort; Hammer Industries did not identify the indirect costs and profit/fee applicable to the work to be performed by the lower tier subcontractors nor did Hammer demonstrate an added value for the lower tier subcontracted work.
- Subcontractor has numerous outstanding estimating deficiencies.
- No estimated completion date for negotiations.

$5 million FFP proposal from POP, LLC

- POP, LLC is a division of Panda Enterprises.
- Inadequate subcontract proposal was provided.
• History of submitting inadequate subcontract proposals.
• No cost analysis was performed; no estimated completion date could be provided.
• Subcontract had been negotiated the week prior and included a 20-percent profit rate.

Internal Control Weaknesses with Potential Fraud Indicators

• History of inadequate prime and/or subcontract proposals.
• History of negotiating subcontracts significantly lower than proposed values after the award of the prime contract.
• Unexplainable delays in subcontract/vendor negotiations.
• Lack of segregation of duties in personnel who prepare, review, and approve cost estimates.
• Excessive pass-through costs without verifiable evidence of added value.
• Outstanding estimating deficiencies at prime contractor and/or subcontractors.
• Inadequate, partial, or missing cost/price analyses performed by prime contractor.
• Interdivisional Work Transfer Agreement costs proposed without proper justifications
• Improper negotiation/application of profit to Interdivisional Work Transfer Agreement costs.
• Inadequately trained personnel (for example, estimators, analysts, and estimating managers).

General Comments/Lessons Learned. Weak estimating system controls over subcontract pricing can lead to the opportunity for fraud, and in turn, unfair and unreasonable pricing on Government contracts. Although it is important for auditors at the prime contractor’s location to request assist audits, as needed, from the subcontractor’s cognizant DCAA office, it is equally as important for the auditors at the prime contractor’s location to perform various audit procedures (for example, reviews of the prime contractor’s cost/price analyses, reviews of permanent files or historical information, inquiries, and comparative analyses) to evaluate the strength of the contractor’s estimating system controls.