



# Contract Audit New York City

February 3, 2012

# Course Purpose and Objectives

- **Contract Audit**
- The purpose of the session is to provide participants awareness of audit and financial oversight issues of construction, equipment and engineering contracts awarded by government organizations.

# Purposes and Objectives

- Participants will learn through lecture, about the following:
  - The purpose of contract audit oversight
  - Audit Clauses to include in contracts
  - Other Procurement Issues
  - Types of Contracts
  - Types of Audits included in contract audit oversight
  - Audit Issues
  - Performing the Audit
  - Working with Procurement
  - Working with Contractors
  - Internal Audits and Concerns
  - Potential Fraud Issues

# Purpose of Contract Audit Oversight

- Governmental Organizations have large capital budgets
- Construction, Equipment and Engineering Contracts are awarded to complete capital requirements
- There is a need for oversight of these contracts to ensure that:
  - Contracts are awarded appropriately
  - The Contractors are Financially Responsible
  - Costs incurred on non-competed transactions are allowable, allocable and reasonable to protect the public's money
  - Laws and regulations are complied with
  - Potential for fraud, waste and abuse is minimized

# Purpose of Contract Audit Oversight

- According to FAR 42.1 Contract Audit Services
  - The auditor is responsible for --
    - (1) Submitting information and advice to the requesting activity,
    - (2) Reviewing the financial and accounting aspects of the contractor's cost control systems; and
    - (3) Performing other analyses and reviews that require access to the contractor's financial and accounting records supporting proposed and incurred costs.
- The contract audit function:
  - Assists Contracting Officers with Accounting and Financial Services
  - Plans and Implements audits and provides financial information
  - Independently conducts the audits
  - Contracting Officer requests audit prior to negotiation
  - The auditor must have unrestricted access to records

# Contract Clauses and Audit Rights

- The Federal Acquisition Regulations (FAR) is the primary regulation for use by all Federal Executive agencies in their acquisition of supplies and services with appropriated funds.
- Contract Clauses
  - Audit Rights Clauses
    - Cost and Price Analysis
    - Cost or Pricing Data
    - Certified Cost or Pricing Data
    - Price Analysis
    - Cost Analysis
    - Contract Audit as a Pricing Aid
    - Other Clauses

# Audit Rights Clauses

- **Cost and Price Analysis - Cost or price analysis must be performed in connection with every procurement action, including contract modifications.** The method and degree of analysis is dependent on the facts surrounding the particular procurement situation but as a minimum the owner will make independent estimates before receiving bids or proposals. Contracting Officers will ensure strict compliance with the cost and price analysis procedures as set forth in the Procurement Manual.
- Contracting Officers shall request a pre-negotiation audit prior to the negotiation of any non-competed contract or modification resulting from proposals in excess of \$------. The contract file must be fully documented as to the rationale for actions taken.

# Audit Rights Clauses

- **Cost or Pricing Data**
  - Cost or pricing data submitted by a contractor enables the owner to perform cost or price analysis and ultimately enables the owner and the contractor to negotiate fair and reasonable prices. Cost or pricing data may be submitted actually or by specific identification in writing.

# Audit Rights Clauses

- **Certified Cost or Pricing Data**

Except as provided in the contract clauses, certified cost or pricing data are required before accomplishing any of the following actions:

- (a) The award of any negotiated contract expected to exceed \$-----.
- (b) The modification of any sealed bid or negotiated contract when the modification involves a price adjustment expected to exceed \$----- in the aggregate.

# Audit Rights Clauses

- **Certified Cost or Pricing Data (Continued)**
- **The Contracting Officer will include in the contract a clause that provides for reduction of the contract price by any significant amounts that such price was increased because of submission of contractor or subcontractor defective cost or pricing data.**
- When certified cost or pricing data are required, the Contracting Officer shall require the contractor or prospective contractor to submit to the Contracting Officer (and to have any subcontractor or prospective subcontractor submit to the prime contractor or appropriate subcontractor tier) the following in support of any proposal:
  - (a) the cost or pricing data.
  - (b) **a certificate of current cost or pricing data, in the format specified, certifying that to the best of its knowledge and belief, the cost or pricing data were accurate, complete, and current as of the date of final agreement on price.**

# Audit Rights Clauses

- **Certified Cost or Pricing Data (Continued)**
- Except as provided in this contract, the Contracting Officer shall not require submission or certification of cost or pricing data when the Contracting Officer determines that prices are:
  - (a) based on adequate price competition
    - Adequate price competition is defined as:
      - (a) Price competition exists if:
        - (i) offers are solicited;
        - (ii) two or more responsible offerors that can satisfy the requirements submit priced offers responsive to the solicitation's expressed requirements; and
        - (iii) these offerors compete independently for a contract to be awarded to the responsible offeror submitting the lowest evaluated price.
      - (b) based on estimated catalog or market prices of commercial items sold in substantial quantities to the general public

# Audit Rights Clauses

- **Certified Cost or Pricing Data (Continued)**
  - **Established catalog or market prices.**
    - Proposals are exempt from the requirement for submission of certified cost or pricing data if the prices are, or are based on, established catalog or established market prices of commercial items sold in substantial quantities to the general public. In order to qualify for this exemption, the terms of the proposed purchase, such as quantity and delivery requirements, should be sufficiently similar to those of the commercial sales that the catalog or market prices will be fair and reasonable.

# Audit Rights Clauses

- **Certified Cost or Pricing Data (Continued)**
  - (c) Set by law or regulation

Prices set by law or regulation.

- A price set by law or regulation is exempt from the requirement for submission of certified cost or pricing data. Pronouncements in the form of periodic rulings, reviews, or similar actions of a governmental body, or embodied in the laws, are sufficient to establish the price.

# Audit Rights Clauses

- **Price Analysis**

The Contracting Officer is responsible for selecting and using whatever price analysis techniques will ensure a fair and reasonable price. One or more of the following techniques may be used to perform price analysis:

- (a) Comparison of proposed prices received in response to the solicitation.
- (b) Comparison of prior proposed prices and contract prices with current proposed prices for the same or similar end items.
- (c) Application of rough yardsticks (such as dollars per pound or per horsepower, or other units)
- (d) Comparison with competitive published price lists, published market prices of commodities, similar indexes, and discount or rebate arrangements.
- (e) Comparison of proposed prices with independent owner cost estimates.

Price analysis is used primarily for evaluating price reasonableness of competitive bids, but may be used in lieu of cost analysis in accordance with policy.

# Audit Rights Clauses

- **Cost Analysis**
  - Sound pricing depends primarily upon the exercise of good judgment by all personnel concerned with the procurement. Each procurement should be individually considered and a judgment made regarding the need for and extent of a cost and/or price analysis.
  - The Contracting Officer shall, as appropriate, use the techniques and procedures outlined in paragraphs below to perform cost analysis:
    - Verification of cost or pricing data and evaluation of cost elements
    - Evaluating the effect of the offeror's current practices on future costs
    - Comparison of costs proposed by the offeror for individual cost elements
    - Verification that the offeror's cost submissions are in accordance with the contract cost principles and procedures in FAR Part 31
    - Review to determine whether any cost or pricing data necessary to make the contractor's proposal accurate, complete, and current have not been either submitted or identified in writing by the contractor.
    - Analysis of the results of any make-or-buy program reviews, in evaluating subcontract costs.

# Audit Rights Clauses

- **Cost Analysis (Continued)**

The Contracting Officer may waive the requirement of cost analysis by a written determination that cost data sufficient for analysis is not available, notwithstanding attempts to obtain the data, and that price reasonableness has been determined using a suitable pricing technique. The contract file will document the Contracting Officer's attempt to obtain cost data and the contractor's written refusal to furnish such cost data.

# Audit Rights Clauses

- **Contract Audit as a Pricing Aid**
  - Audit Offices provide financial auditing services to Contracting Officers.
  - The Contracting Officer shall use such services to the fullest extent feasible and practicable. Audit services are available in two general forms:
    - (a) Accounting and financial advisory services and
    - (b) Audit reports of contractor's cost/price proposal in support of the Contracting Officer's cost and/or price analysis.
  - Auditors review and examine contractor's policies and procedures affecting costs, the accuracy, currency, completeness and reasonableness of cost representations, the financial capabilities of the contract, the appropriateness of contractual provisions having accounting or financial significance, and the validation of all financial and factual elements in the contractor's cost and pricing data submitted in connection with a proposal and/or claim.

# Audit Rights Clauses

- **Other Clauses to Consider**
  - **Right to Audit**
    - Audit and Inspection of Records for Three Years after completion of contract
    - Include the clauses in subcontracts
  - **Allowability of Costs**
    - Pricing of adjustments
    - Regulation such as FAR 31
    - Provide for G&A method
  - **Accounting Records**
    - Require segregation of cost records on changes
    - Require access to the contractor's/subcontractors' records
    - Provide for penalty if do not get access

# Audit Rights Clauses

- **Other Clauses to Consider (Continued)**
  - **Advance Cost Agreement**
    - Review records after award of contract
    - Accounting system review
    - Review indirect rates and equipment rates
    - Contracting Officer and Contractor agree on rates for use on small changes
  - **Equipment Rates**
    - FAR states actual costs
    - There are rate guides
      - Blue Book
      - Army Corps of Engineers
      - Provide method for payment of fully depreciated equipment
      - Remember—Duplication in Overhead
      - Provide for Overtime and Stand By use

# Other Procurement Issues

## Auditor Needs to be Knowledgeable of Procurement

### **FAR 15.405 Price Negotiation.**

The purpose of performing cost or price analysis is to develop a negotiation position that permits the contracting officer and the contractor an opportunity to reach agreement on a fair and reasonable price. A fair and reasonable price does not require that agreement be reached on every element of cost, nor is it mandatory that the agreed price be within the contracting officer's initial negotiation position.

# Other Procurement Issues

## **FAR 15.406-1 Pre negotiation Objectives.**

The pre negotiation objectives establish the owner's initial negotiation position. They assist in the contracting officer's determination of fair and reasonable price. They should be based on the results of the contracting officer's analysis of the contractor's proposal, taking into consideration all pertinent information including field pricing assistance, audit reports and technical analysis, fact-finding results, independent owner cost estimates and price histories.

# Other Procurement Issues

- **FAR 15.406-2 Certificate of Current Cost or Pricing Data.**

When cost or pricing data are required, the contracting officer must require the contractor to execute a Certificate of Current Cost or Pricing Data, using the format in this paragraph, and must include the executed certificate in the contract file.

## **CERTIFICATE OF CURRENT COST OR PRICING DATA**

This is to certify that, to the best of my knowledge and belief, the cost or pricing data (as defined in section 2.101 of the Federal Acquisition Regulation (FAR) and required under FAR subsection 15.403-4) submitted, either actually or by specific identification in writing, to the Contracting Officer or to

the Contracting Officer's representative in support of \_\_\_\_\_\* are accurate, complete, and current as of \_\_\_\_\_\*\*. This certification includes the cost or pricing data supporting any advance agreements and forward pricing rate agreements between the contractor and the owner that are part of the proposal.

# Other Procurement Issues

- **FAR 15.406-3 Documenting the Negotiation.**
  - (a) **The contracting officer shall document in the contract file the principal elements of the negotiated agreement.** The documentation shall include the following:
    - (1) The purpose of the negotiation.
    - (2) A description of the acquisition, including appropriate identifying numbers
    - (3) The name, position, and organization of each person representing the contractor and the owner in the negotiation.
    - (4) The current status of any contractor systems (*e.g., purchasing, estimating, accounting, and compensation*) to the extent they affected and were considered in the negotiation.
    - (5) If cost or pricing data were not required in the case of any price negotiation exceeding the cost or pricing data threshold, the exception used and the basis for it.

# Other Procurement Issues

- **FAR 15.406-3 Documenting the Negotiation.**
  - (6) If cost or pricing data were required, the extent to which the contracting officer—
    - (i) Relied on the cost or pricing data submitted and used them in negotiating the price;
    - (ii) Recognized as inaccurate, incomplete, or noncurrent any cost or pricing data submitted; the action taken by the contracting officer and the contractor as a result; and the effect of the defective data on the price negotiated; or
    - (iii) Determined that an exception applied after the data were submitted and, therefore, considered not to be cost or pricing data.

# Other Procurement Issues

## **FAR 15.406-3 Documenting the Negotiation. (Continued)**

(7) A summary of the contractor's proposal, any field pricing assistance recommendations, including the reasons for any pertinent variances from them, the owner's negotiation objective, and the negotiated position. Where the determination of price reasonableness is based on cost analysis,

the summary shall address each major cost element. When determination of price reasonableness is based on price analysis, the summary shall include the source and type of data used to support the determination.

(8) The most significant facts or considerations controlling the establishment of the pre negotiation objectives and the negotiated agreement including an explanation of any significant differences between the two positions.

(9) To the extent such direction has a significant effect on the action, a discussion and quantification of the impact of direction given by legislative body, other agencies, and higher-level officials (*i.e., officials who would not normally exercise authority during the award and review process for the instant contract action*).

# Other Procurement Issues

## **FAR 15.406-3 Documenting the Negotiation. (Continued)**

- (10) The basis for the profit or fee pre negotiation objective and the profit or fee negotiated.
- (11) Documentation of fair and reasonable pricing.
- (b) Whenever field pricing assistance has been obtained, the contracting officer shall forward a copy of the negotiation documentation to the office(s) providing assistance.

# Audit Thresholds

- **Federal Threshold—**
  - FAR 15-403-4—Requiring Cost or Pricing Data -- \$650,000

# Types of Contracts

- **FAR Subpart 16.1—Selecting Contract Types**
  - (a) A wide selection of contract types is available to an owner and contractors in order to provide needed flexibility in acquiring the large variety and volume of supplies and services required by agencies. Contract types vary according to—
    - (1) The degree and timing of the responsibility assumed by the contractor for the costs of performance; and
    - (2) The amount and nature of the profit incentive offered to the contractor for achieving or exceeding specified standards or goals.
  - (b) **The contract types are grouped into two broad categories: fixed-price contracts (see Subpart 16.2) and cost-reimbursement contracts (see Subpart 16.3).**

# Types of Contracts

## **FAR 16.104 Factors in selecting contract types.**

There are many factors that the contracting officer should consider in selecting and negotiating the contract type. They include the following:

- (a) ***Price competition.*** Normally, effective price competition results in realistic pricing, and a fixed-price contract is ordinarily in the owner's interest.
- (b) ***Price analysis.*** Price analysis, with or without competition, may provide a basis for selecting the contract type. The degree to which price analysis can provide a realistic pricing standard should be carefully considered. (See 15.404-1(b).)

# Types of Contracts

## **FAR 16.104 Factors in selecting contract types.**

- (c) *Cost analysis.* In the absence of effective price competition and if price analysis is not sufficient, the cost estimates of the contractor and the owner provide the bases for negotiating contract pricing arrangements. It is essential that the uncertainties involved in performance and their possible impact upon costs be identified and evaluated, so that a contract type that places a reasonable degree of cost responsibility upon the contractor can be negotiated.
- (d) *Type and complexity of the requirement.* Complex requirements, particularly those unique to the Government, usually result in greater risk assumption by the owner. This is especially true for complex research and development contracts, when performance uncertainties or the likelihood of changes makes it difficult to estimate performance costs in advance. As a requirement recurs or as quantity production begins, the cost risk should shift to the contractor, and a fixed price contract should be considered.

# Types of Contracts

## **FAR 16.104 Factors in selecting contract types. (Continued)**

- (e) *Urgency of the requirement.* If urgency is a primary factor, the owner may choose to assume a greater proportion of risk or it may offer incentives to ensure timely contract performance.
- (f) *Period of performance or length of production run.* In times of economic uncertainty, contracts extending over a relatively long period may require economic price adjustment terms.
- (g) *Contractor's technical capability and financial responsibility.*
- (h) *Adequacy of the contractor's accounting system.* Before agreeing on a contract type other than firm-fixed price, the contracting officer shall ensure that the contractor's accounting system will permit timely development of all necessary cost data in the form required by the proposed contract type. This factor may be critical when the contract type requires price revision while performance is in progress, or when a cost-reimbursement contract is being considered and all current or past experience with the contractor has been on a fixed-price basis.

# Types of Contracts

## **FAR 16.104 Factors in selecting contract types. (Continued)**

- (i) *Concurrent contracts.* If performance under the proposed contract involves concurrent operations under other contracts, the impact of those contracts, including their pricing arrangements, should be considered.
- (j) *Extent and nature of proposed subcontracting.* If the contractor proposes extensive subcontracting, a contract type reflecting the actual risks to the prime contractor should be selected.
- (k) *Acquisition history.* Contractor risk usually decreases as the requirement is repetitively acquired. Also, product descriptions or descriptions of services to be performed can be defined more clearly.

# Types of Contracts

- Fixed Price
- Cost Reimbursable
  - Cost Plus Fixed Fee
  - Cost Plus Award Fee
  - Cost Plus Incentive Fee
- Incentive Contracts
- Indefinite Delivery Contracts
  - Definite Quantity
  - Requirements
  - Indefinite Quantity
- Time-and-Materials, Labor-Hour, and Letter Contracts

# Types of Contracts

- Federal Acquisition Regulations Part 16
  - **Fixed Price**
  - Fixed-price types of contracts provide for a firm price or, in appropriate cases, an adjustable price. Fixed-price contracts providing for an adjustable price may include a ceiling price, a target price (including target cost), or both. Unless otherwise specified in the contract, the ceiling price or target price is subject to adjustment only by operation of contract clauses providing for equitable adjustment or other revision of the contract price under stated circumstances. The contracting officer shall use firm-fixed-price or fixed-price with economic price adjustment contracts when acquiring commercial items.
  - A firm-fixed-price contract is suitable for acquiring commercial items or for acquiring other supplies or services on the basis of reasonably definite functional or detailed specifications when the contracting officer can establish fair and reasonable prices at the outset

# Types of Contracts

- **Cost Reimbursable Contracts**
- Cost-reimbursement types of contracts provide for payment of allowable incurred costs, to the extent prescribed in the contract. These contracts establish an estimate of total cost for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer.
- Cost-reimbursement contracts are suitable for use only when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.
- A cost-reimbursement contract may be used only when --
  - (1) The contractor's accounting system is adequate for determining costs applicable to the contract; and
  - (2) Appropriate owner surveillance during performance will provide reasonable assurance that efficient methods and effective cost controls are used;
- The FAR states that the use of cost-reimbursement contracts is prohibited for the acquisition of commercial items

# Types of Contracts

- **Cost Reimbursable Contracts (Continued)**
- A cost-plus-fixed-fee contract is a cost-reimbursement contract that provides for payment to the contractor of a negotiated fee that is fixed at the inception of the contract. The fixed fee does not vary with actual cost, but may be adjusted as a result of changes in the work to be performed under the contract. This contract type permits contracting for efforts that might otherwise present too great a risk to contractors, but it provides the contractor only a minimum incentive to control costs.
- A cost-plus-fixed-fee contract normally should not be used in development of major systems once preliminary exploration, studies, and risk reduction have indicated a high degree of probability that the development is achievable and the owner has established reasonably firm performance objectives and schedules.

# Types of Contracts

- **Incentive Contracts**
- Incentive contracts are appropriate when a firm-fixed-price contract is not appropriate and the required supplies or services can be acquired at lower costs and, in certain instances, with improved delivery or technical performance, by relating the amount of profit or fee payable under the contract to the contractor's performance.
- The two basic categories of incentive contracts are fixed-price incentive contracts and cost-reimbursement incentive contracts. Since it is usually to the owner's advantage for the contractor to assume substantial cost responsibility and an appropriate share of the cost risk, fixed-price incentive contracts are preferred when contract costs and performance requirements are reasonably certain. Cost-reimbursement incentive contracts are subject to overall limitations that apply to all cost-reimbursement contracts.

# Types of Contracts

- **Time-and-Materials, Labor-Hour, and Letter Contracts**
- Direct materials means those materials that enter directly into the end product, or that are used or consumed directly in connection with the furnishing of the end product or service.
- Hourly rate means the rate(s) prescribed in the contract for payment for labor that meets the labor category qualification of a labor category specified in the contract that are—
  - (1) Performed by the contractor;
  - (2) Performed by the subcontractors; or
  - (3) Transferred between divisions subsidiaries, or affiliates of the contractor under a common control.

# Types of Contracts

- **Time-and-Materials, Labor-Hour, and Letter Contracts (Continued)**
- A time-and-materials contract may be used only when it is not possible at the time of placing the contract to estimate accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence.
  - (1) *Owner surveillance*. A time-and-materials contract provides no positive profit incentive to the contractor for cost control or labor efficiency. Therefore, appropriate owner surveillance of contractor performance is required to give reasonable assurance that efficient methods and effective cost controls are being used.
  - (2) *Fixed hourly rates*.
    - (i) The contract shall specify separate fixed hourly rates that include wages, overhead, general and administrative expenses, and profit for each category of labor
    - (ii) For acquisitions of noncommercial items awarded without adequate price competition, the contract shall specify separate fixed hourly rates that include wages, overhead, general and administrative expenses, and profit for each category of labor to be performed

# Types of Contracts

- **Time-and-Materials, Labor-Hour, and Letter Contracts (Continued)**
- A time-and-materials contract may be used only if—
  - (1) The contracting officer prepares a determination and findings that no other contract type is suitable. The determination and finding shall be—
    - (i) Signed by the contracting officer prior to the execution of the base period or any option periods of the contracts; and
    - (ii) Approved by the head of the contracting activity prior to the execution of the base period when the base period plus any option periods exceeds three years; and
  - (2) The contract includes a ceiling price that the contractor exceeds at its own risk. The contracting officer shall document the contract file to justify the reasons for and amount of any subsequent change in the ceiling price.

# Types of Audits

- Pre-Award– Financial Capability
- Architect/Engineer Contracts and Modifications
  - Fixed Price
  - Cost Reimbursable
  - Billing Rate (Task Orders)
- Construction/Equipment Supply Claims and Proposals
  - Pre-Negotiation
  - Defective Cost and Pricing
  - Equipment Rate Issues
- Litigation
- Verification of GSA Prices
- Invoice Verification
- Close Out

# Types of Audits

- **Pre-Award– Financial Capability**
- Prior to award of contract, Contracting Officer is to determine financial capability of Contractor to perform the work
- Contract Administrators usually go to Dun and Bradstreet and review Contractor's submission which is not audited or verified
- Contracting Officer should request audit to perform pre-award financial capability review
- RFP and IFBs should require submission of certified financial statements as part of contract requirements

# Types of Audits

- **Pre-Award– Financial Capability**
- Auditor should review financial statements for financial capability
  - Review financial ratios
  - Determine financial capability to perform contract
  - Contact Contractor if questions on the statements or there appears to be issues
  - Issue memorandum to Contracting Officer commenting on the financial capability of the Contractor to perform the contract

# Types of Audits

- **Architect/Engineer Contracts and Modifications**
- **Fixed Price**
  - Contract Award
  - If non-competed on price, the proposal (Including Subcontractors) for the contract should be audited subject to audit threshold
  - Audit the following
    - Labor Rates
    - Indirect Rates (Unless cognizant federal or state agency has established indirect rate)
    - Other Direct Costs
  - Modifications
  - If in excess of audit threshold, the proposed costs of any modifications should be audited

# Types of Audits

- **Cost Reimbursable Contracts**
  - Establish provisional indirect rates
  - Audit actual costs to determine actual overhead rates
  - Audit actual direct costs to determine allowability, reasonableness and allocability
  - Field vs. Home Office indirect rates
- **Billing Rate**
  - Establish billing rate (Labor and Indirect Rates) prior to award

# Types of Audits

- **Construction/Equipment Supply Claims and Proposals**
  - **Pre-Negotiation**
    - Preferred
    - Forward Priced Proposals
      - Audit actual labor rates for proposed labor classifications and/or individuals
      - Audit vendor quotes, prior or current invoices for materials
      - Be aware of quantity discounts on material costs
      - If manufacturing contractor, be aware of standard costing of labor and overhead
      - Equipment costs are determined based on clause in contract
      - Review documentation for other direct costs proposed
      - Review basis for estimates when used as support for proposed costs

# Types of Audits

- **Construction/Equipment Supply Claims and Proposals**
  - **Pre-Negotiation**
    - Claims or audit after the work has been done
      - If the appropriate clauses are in contract, the Contractor should have accounted for costs of claims/changes separately in accounting records
      - Audit actual costs if available
      - If a change or claim, ensure that the costs are added costs as a result of the change/claim

# Types of Audits

- **Construction/Equipment Supply Claims and Proposals (Continued)**
  - **Defective Cost and Pricing**
    - The clause for defective cost or pricing data shall become operative only for any modification to a contract involving aggregate increases and/or decreases in costs, plus applicable profits, expected to exceed the threshold for the submission of cost or pricing data .

# Types of Audits

- **Construction/Equipment Supply Claims and Proposals (Continued)**
  - **Equipment Rate Issues**
    - FAR—Actual Cost
    - Equipment Rate Guides
      - Blue Book
      - Army Corps of Engineers
    - Payment for Fully Depreciated Equipment
    - Interest and Replacement Cost Exclusion
    - Duplication in Overhead
    - Overtime and Standby Use

# Types of Audits

- **Verification of GSA Prices**
  - At times, Contractors have GSA Schedule Pricing
  - Contracting Officers should request Audit to verify/Substantiate the Pricing
  - Verify that it is Current Pricing and that it is on the GSA Schedule
  - Check to see if same service is provided by other supplier on GSA Schedule and inform Contracting Officer especially if the other GSA Price is less
  - Ascertain possibility of discount to GSA pricing is available especially on IT Services
  - (By experience, GSA Schedule pricing is usually higher than cost based –sometimes substantially higher)

# Types of Audits

- **Invoice Verification**

- During the performance of a cost reimbursable contract, it is advisable for the owner to review and approve the costs incurred in support of the submitted invoice.
- This is done by requiring the contractor to submit supporting documentation for labor, materials and other direct costs including subcontractor costs with the invoice
- It is usually advisable for the accounting function to perform this verification process and the internal audit function can review this process as part of its audit activities.

# Types of Audits

- **Close Out**
- Administrative Close out of contract
  - Ensure contract was performed or purchase was received
  - Review documentation to ensure that policies/procedures were followed and all required documentation was received/obtained
    - Contractor releases
    - Third party releases
    - Modification packages are complete
  - Ensure financial reporting of contract is complete and accurate

# Audit Issues

- Audit Rights and Access to Records
- Cooperation of Procurement and Contractors
- Have Understanding up Front with Contractors/Subcontractors on Audit Requirements
- Determination of Allowability and Allocability of Costs
- Have Knowledge of FAR Section 31 on Allowability of Costs
- Equipment Cost Issues on Construction Contracts
- Payment of Interest
- Payment for G&A in delay situation

# Performing the Audit

- The auditor should prepare an audit program to ensure that the costs of the non-competed procurement/modification are allowable, allocable and reasonable as well as accurate, current and complete. The type of audit program depends on the nature of the audit to be performed.
- Obtain copy of proposal/claim and check for accuracy and obtain understanding of the proposal/claim
- Discuss the proposal/claim with the contracting officer or his representative to gain understanding

# Performing the Audit

- Contact contractor's representative, request supporting documentation required for the audit and agree on timeline for obtaining the documentation for the field audit at the location of the accounting records or for an office review (less preferable)
- Certain steps are required for all audits including obtaining and reviewing the contractor's financial statements, understanding their accounting records and sufficient review of internal controls to ensure reliability of the cost and pricing data being reviewed.

# Performing the Audit

- Perform audit steps for each cost element included in the proposal/claim
- The cost elements to perform audit steps and procedures are as follows:
  - Direct Labor
    - Review payroll records to verify labor rates
    - Review labor cost records if costs have been incurred
  - Material
    - Review material invoices, vendor quotes, purchase orders and/or estimates

# Performing the Audit

- Perform audit steps for each of the other cost element included in the proposal/claim
- The other cost elements to perform audit steps and procedures are as follows:
  - Equipment
    - Review contract clauses to ascertain if cost method is specified
    - Review costs or rate books as appropriate
    - Review usage records if costs have been incurred
  - Other Direct Costs
    - Review costs and/or rates for items proposed
    - Ensure that the direct costs are not included in indirect costs in the accounting records to make sure that there is no duplication

# Performing the Audit

- Overhead
  - Ascertain if federal or state cognizant audit agency has audited actual or provisional rates for the contractor
  - If so, obtain copy of their report and use as support as appropriate
  - If no cognizant audit report, obtain copy of overhead structure and costs
  - Ascertain that Specific Expenses Unallowable per FAR Section 31 Have Been Excluded
  - Review overhead costs for allowability and allocability
  - Especially review Legal, Consultants, Dues, Compensation and Costs of Rent to Ensure that it is not with a Related Party
  - Use contractual basis for determining allowability of costs such as FAR, Part 31
- G&A Overhead
  - If separate G&A rate review supporting documentation in the same matter as overhead costs

# Working with Procurement

- Establish professional cooperation with Contracting Officers
  - Ensure Appropriate clauses are in contracts
  - Request audits where proposals are in excess of threshold and where contractor is an unknown or has history of excessive cost proposals
  - Obtain support in obtaining cooperation with contractors when necessary
  - Consultation with Procurement on Issues
  - Assist in negotiations from cost and pricing aspect
  - Follow up on recommended adjustments
  - Ensure audit recommendations are followed

# Working with Procurement

- Ensure Procurement has proper Documentation of Negotiations
  - Pre-Negotiation Position
  - Cost Analysis
  - Technical Analysis
  - Audit Report (if necessary)
  - Record of Negotiations
  - Certificate of Current Cost or Pricing Data
  - Reconciliation of Negotiated Settlement with Cost Estimate, Audit and Pre-Negotiation Position

# Working with Contractors

- **Establish Professional Working Relationship with Contractors**
  - Cooperation on obtaining cost and pricing data
  - Ensure confidentiality of competitive issues (indirect rates, profit margins, etc)
  - Get understanding of Contractor's cost accounting system and accounting records
  - Ensure to get tour of manufacturing plant and/or site of claim/proposal issues
  - When long-term contract, obtain annual submissions of labor rates and indirect rate computations
  - Discuss issues as they arise and audit findings with Contractor

# Internal Audits and Concerns

- Procurement
  - Contracting Process
  - Contract Clauses
  - Contract Administration
  - Negotiating Process
  - Types of Bonds
    - Performance
    - Payment

# Internal Audits and Concerns

- Project Office
  - Oversight
    - Inspection
  - Project Cost Controls
  - Subcontractors
    - Disadvantaged Business Program

# Procurement Fraud Issues

- Cost/Labor Mischarging
- Defective Pricing
- Defective Parts
- Price Fixing/Bid Rigging
- Market Division
- Product Substitution

# Procurement Fraud Issues

- **Cost/labor mischarging.**
  - Schemes by contractors on cost-type contracts to fraudulently inflate the cost of labor or materials.

# Procurement Fraud Issues

- **Defective pricing.**
  - Occurs when a contractor does not submit or disclose to the government cost or pricing data that is accurate, complete, and current prior to reaching a price agreement.
  - Post Award Audits of Contractor Cost or Pricing Data
    - Defective Pricing occurs when a contractor does not submit or disclose to the government cost or pricing data that is accurate, complete, and current prior to reaching a price agreement.

# Procurement Fraud Issues

- An audit may determine if a negotiated contract price was increased by a significant amount because the contractor did not submit or disclose accurate, complete, and current cost or pricing data. To show that defective pricing exists, the audit must establish each of the following five points:
  - (1) The information in question fits the definition of 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 the authorized representatives of the contracting officer and that these individuals did not have actual knowledge of such data or its significance to the proposal.

# Procurement Fraud Issues

- An audit may determine if a negotiated contract price was increased by a significant amount because the contractor did not submit or disclose accurate, complete, and current cost or pricing data. To show that defective pricing exists, the audit must establish each of the following five points:
  - (4) The government relied on the defective data in negotiating with the contractor.
  - (5) The government's reliance on the defective data caused an increase in the contract price.

# Procurement Fraud Issues

- **Defective parts.**
  - A defect in design, specification, material, manufacturing and workmanship, which may cause death, injury or severe occupational illness;
  - would cause loss of major or minor capabilities of the using organization or
  - which would result in a production line stoppage.

# Procurement Fraud Issues

- **Price fixing and bid rigging.**
  - Bid rigging is any activity to suppress and eliminate competition on contracts funded by the United States that reasonably restricts trade and commerce in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1.
  - The Sherman Act, Enacted in 1890, prohibits any agreement among competitors to fix prices, rig bids, or engage in other anticompetitive activity. Bid-rigging and price-fixing conspiracies prohibited by the Sherman Act are subject to a five-year statute of limitations.
  - The competitive process works when competitors set prices honestly and independently. When competitors collude, prices are inflated and the customer is cheated. Increased costs are passed on to the public.
  - Price fixing and bid-rigging is an agreement where, in response to a call or request for bids or tenders, one or more bidders agree not to submit a bid, or two or more bidders agree to submit bids that have been prearranged among themselves.

# Procurement Fraud Issues

- Price fixing and bid-rigging is an agreement where, in response to a call or request for bids or tenders, one or more bidders agree not to submit a bid, or two or more bidders agree to submit bids that have been prearranged among themselves. They usually fall into one or more of the following categories:
  - **Bid Suppression:** One or more competitors who otherwise would be expected to bid, or who have previously bid, agree to refrain from bidding or withdraw a previously submitted bid so that the designated winning competitor's bid will be accepted.
  - **Complementary Bidding:** Complementary bidding (also known as "cover" or "courtesy" bidding) occurs when some competitors agree to submit bids that either are too high to be accepted or contain special terms that will not be acceptable to the buyer. Such bids are not intended to secure the buyer's acceptance, but are merely designed to give the appearance of genuine competitive bidding. Complementary bidding schemes are the most frequently occurring forms of bid rigging, and they defraud purchasers by creating the appearance of competition to conceal secretly inflated prices.

# Procurement Fraud Issues

- Price fixing and bid-rigging is an agreement where, in response to a call or request for bids or tenders, one or more bidders agree not to submit a bid, or two or more bidders agree to submit bids that have been prearranged among themselves. They usually fall into one or more of the following categories:
  - **Bid Rotation:** In bid rotation schemes, all conspirators submit bids but take turns being the low bidder. The terms of the rotation may vary; for example, competitors may take turns on contracts according to the size of the contract, allocating equal amounts to each conspirator or allocating volumes that correspond to the size of each conspirator company. A strict bid rotation pattern defies the law of chance and suggests collusion is taking place.

# Procurement Fraud Issues

- **Subcontracting:** Subcontracting arrangements are often part of a bid-rigging scheme. Competitors who agree not to bid or to submit a losing bid frequently receive subcontracts or supply contracts in exchange from the successful low bidder. In some schemes, a low bidder will agree to withdraw its bid in favor of the next low bidder in exchange for a lucrative subcontract that divides the illegally obtained higher price between them. Almost all forms of bid-rigging schemes have one thing in common: an agreement among some or all of the bidders, which predetermines the winning bidder and limits or eliminates competition.

# Procurement Fraud Issues

- **Market Division:**
  - Market division or allocation schemes are agreements in which competitors divide markets among themselves. In such schemes, competing firms allocate specific customers or types of customers, products, or territories among themselves. For example, one competitor will be allowed to sell to, or bid on contracts let by, certain customers or types of customers. In return, he or she will not sell to, or bid on contracts let by, customers allocated to the other competitors. In other schemes, competitors agree to sell only to customers in certain geographic areas and refuse to sell to, or quote intentionally high prices to, customers in geographic areas allocated to conspirator companies.

# Procurement Fraud Issues

- **Product substitution:**
  - The introduction of counterfeit and/or substandard material and other forms of unauthorized product substitution into the procurement system. An area of increased emphasis is readiness enhancement through vigorous detection and investigation of defective or substituted products that involve military readiness.

# Conclusion

- Audit Issues
  - Make Sure Audit Clauses are Included in the Contracts
  - Mandatory Audit Requirements
  - Have Contractual Basis for determining allowability and allocability of costs such as FAR Part 31
  - Be Knowledgeable of Federal Acquisition Regulations Part 31
  - Work with Procurement/Contracting Officers
  - Maintain Good Professional Working Relationships with Contractors
  - Have knowledge of Procurement Terms and Types of Contracts
  - Have knowledge of Overhead Issues
  - Provide Quality/Timely Audit Services
  - Be Aware of Areas of Fraud Potential