On July 26, 2010, the Commission on Wartime Contracting in Iraq and Afghanistan (CWC) held a **hearing** entitled “Subcontracting: Who’s Minding the Store” to address concerns about the subcontracting process in Southwest Asia. As the Commission Co-Chairs noted, “Poorly conceived, poorly structured, poorly conducted, and poorly monitored subcontracting can lead to poor choices in security measures and damage to U.S. foreign-policy objectives, among other problems.” Accordingly, the Commission explored “whether, especially in a high-risk, contingency environment, the government needs additional controls over, or more visibility into, subcontractor performance and costs to ensure the prime contractor is adequately managing its subcontractors.”

(We have reported on several of the CWC hearings and reports before. To find those stories, type “CWC” in the search window on the website.)

Before we delve into DCAA's testimony, we want to note a statement made by the Commission Co-Chairs (Shays and Thibault). They said that the Commission "will issue a major report with proposals for statutory and administrative changes in December, followed by our final report to Congress in July 2011." So we are in our final year of CWC activity. We look forward (with more than a little trepidation) to reading the Commission's recommendations for "statutory and administrative changes." Now on to the hearing….

The hearing consisted of three panels, logically arranged into (1) Government, (2) Prime Contractors, and (3) Subcontractors. Looking at the first panel, we were less than impressed with the "motherhood and apple pie" written statements from most of the participants. DCAA Director Patrick Fitzgerald's **written statement**, however, piqued our interest. Lying amongst his platitudes and smooth-talk were some gems of note. Let's look at those, shall we?

Director Fitzgerald told the Commission that DCAA has 34 full-time auditors assigned to audit contingency contractors in Iraq, Kuwait, and Afghanistan. 17 are assigned to the Afghanistan Branch Office (ABO) and 17 are assigned to the Iraqi Branch Office (IBO). By the end of GFY 2010 (September 30, 2010), DCAA expects to increase its workforce to 40 full-time auditors.

Director Fitzgerald also testified that, “As noted in the Commission’s interim report (June 2009), adequate contractor business systems are the first line of defense against waste, fraud and abuse. In the realm of subcontracting, we find this statement to be profoundly true.” What did he mean by that statement?

As Director Fitzgerald explained to the Commissioners, “With respect to the three LOGCAP IV performance contractors, DCAA has reported all the estimating systems as inadequate and cited their estimating practices as being deficient for ensuring fair and reasonable subcontract prices.” In addition, “DCAA has performed contractors’ purchasing system reviews (CPSRs) for the Defense Contract Management Agency (DCMA) Administrative Contracting Officer (ACO) at all of the three LOGCAP IV performance contractors and has found each system to be inadequate.” Moreover, Director Fitzgerald told the Commission, “During our review of prime contractor billings and incurred cost audits, DCAA has identified situations where the prime contractor has not awarded its fixed-price subcontracts based on fair and reasonable prices leading to unreasonable or unallowable costs being paid by the Government.”

Reasonableness of Subcontractor Costs

It is one of the few unavoidable requirements placed on Government contractors that, prior to making a subcontract award, the prime must first make a written determination that the price it proposes to pay is fair and reasonable. (See FAR 15.404-3(b), which requires a prime contractor (or higher-tier subcontractor) to "conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices.") So when Director Fitzgerald says the LOGCAP IV prime contractors are failing in their duty to perform the requisite analyses, that statement gets our attention.

Director Fitzgerald provided some details to support his assertion. He told the Commission—

In March 2010, DCAA reported estimating system deficiencies at DynCorp related to the inclusion of unsupported subcontract costs … for Corps Logistics and Support Service, Theatre Transportation Mission and Postal Operations in Iraq (commonly referred to as the CTP proposal). During the audit of the CTP proposal, the auditors found the subcontract proposal from DynCorp's then "team member" subcontractor, Agility, to be inadequate. An examination of the U.S.-based Agility business unit disclosed that approximately 40 percent of the proposed direct costs were unsupported. That is, the subcontractor, Agility, was unable to support the reasonableness of the proposed direct labor costs proposed as part of the CTP proposal. Further, in its proposal to the prime contractor, Agility included lower-tier subcontractors to perform the bulk of the subcontract effort. In fact, Agility proposed to use two foreign-based Agility-affiliated subcontractors (sister business units). … During the review of one affiliate's proposal, the Iraq Branch found the lower-tier subcontractor had only prepared a rough order magnitude proposal without supporting detailed data. In the case of the other lower-tier subcontractor, the Iraq Branch was initially denied access supposedly on the basis that its prices were commercial prices and exempt from any requirement for the submission of cost or pricing data. As a result, the auditors determined that almost all of the proposed Agility (and its affiliated subcontractor) costs were unsupported. … As a result, the DCAA audit report classified over $800 million of the proposed subcontract costs predominately related to Agility and its affiliates as unsupported. It is important to point out that the prime contractor had not performed adequate subcontract cost or price analyses. The DCAA reported the contractor proposal was not adequate for the basis of negotiating/awarding a fair and reasonable contract price.

But DynCorp wasn't alone. As Director Fitzgerald told the Commissioners—

Our audits of KBR proposals have disclosed similar significant unsupported subcontract costs. In May 2010, DCAA issued its report on the LOGCAP III Task Order (TO) 151 extension proposal. We identified over $48 million of unsupported subcontract costs. KBR failed to obtain subcontract proposals and conduct the required price or cost analyses. The contractor's failure to obtain adequate support from its prospective subcontractors on this sole-source procurement increases the likelihood of subcontract prices being unreasonable in amount. Similarly, earlier this month, we completed an audit of Fluor's "rebaseline" proposal under LOGCAP IV TO 0002 that incorporated the impact of numerous change orders on the total task order price. The change orders included proposed subcontract costs of approximately $35 million. DCAA reported over 40 percent of the proposed subcontract costs as unsupported because the prime contractor's proposal lacked sufficient supporting documentation (e.g., cost or price analysis, competitive quotations). The majority of the proposed subcontract costs that we reported as unsupported were from foreign subcontractors of Fluor where, despite the sole source nature of the contracting action, Fluor did not obtain cost or pricing data from the related subcontractors.

DCAA's procedures did not stop at evaluating the adequacy and reasonableness of proposed pricing. Indeed, DCAA proposed to disallow the cost of paying already-awarded subcontracts when price reasonableness could not be established. As Director Fitzgerald stated—

During our review of prime contractor billings and incurred cost audits, DCAA has identified situations where the prime contractor has not awarded its fixed-price subcontracts based on fair and reasonable prices leading to unreasonable or unallowable costs being paid by the Government. For example, DCAA has identified several cases where the prime contractor asserted the subcontract price was based on adequate competition; however, our audit disclosed that adequate competition did not exist. Although the prime contractor is required to pay its fixed price subcontract amount, FAR 52.216-7 and the FAR 31.2 principles state the Government only makes payments of amounts determined to be allowable and reasonable. Therefore, where DCAA has determined that the subcontract price is not fair and reasonable DCAA has attempted to calculate a reasonable amount for reimbursement of the contractor's billings attributed to subcontractor costs. However, in those cases where the subcontract is sole source, it is often difficult to obtain cost data to ascertain the reasonable costs without access to the subcontractor's books and records. DCAA access to subcontractor books and records is generally limited and dependent on the flow down by prime contractor to the subcontractor of the appropriate FAR clauses, and in instances of fixed price subcontracts, virtually nonexistent. For example, during DCAA's reviews of Fluor vouchers submitted for payment under a LOGCAP IV Task Order, the prime contractor was unable to show the prices paid to its subcontractor for DFAC and other services were fair and reasonable in amount. Since DCAA does not have access to the subcontractor's books and records, we were unable to determine through other processes the reasonableness of the prices being paid to the subcontractor and subsequently passed on to the Government for reimbursement. As a result, the DCAA auditors have suspended much of the subcontractor's costs from payment on vouchers (invoices) submitted for payment by Fluor. In addition, the contractor has been withholding a portion of the subcontractor billings, so that in total approximately $24.5 million is being withheld from payment until the issue is settled. The FAR audit access clause does not provide for Government access to the subcontractor's costs records when the subcontract is firm-fixed-price.

To wrap up our review of Director Fitzgerald's testimony, we want to recap a couple of his concluding remarks. The following are direct quotes from his written statement.

- Prime contractors have the responsibility to manage their subcontracts (FAR 42.202(e)(2)) and also have a fiduciary responsibility to monitor subcontractor performance and control costs to ensure the U.S. taxpayer resources are used wisely and appropriately. … we have found that prime contractors have not consistently monitored subcontractor performance and subcontractor billings submitted to the prime contractor for inclusion in the prime contractor's billings to the Government. Although the FAR requires the management of subcontracts by the prime contractor and higher tier subcontractors, DCAA intends to recommend a review to the Director, Defense Procurement and Acquisition Policy, of the feasibility of specific contract clauses that would implement the basic FAR provision on management of subcontracts. For example, prime contractors should have systems or processes in place to review subcontractor billing processes to ensure subcontract billings are in accordance with subcontract terms and conditions.

- Based on our audit results we question whether there was adequate/true competition considering the limitations that the contractors have in a contingency environment. In Iraq and Afghanistan, U.S. and coalition military organizations most likely have consumed almost all of the capacity of most or all subcontractors capable of performing in-theater. Therefore, at best, competition within the area of a contingency is limited because the Government-required goods and services generally exceeded vendor capacities (that is, the

Government is the sole or major purchaser of goods and services from all vendors) and all vendors are provided a portion of the requirements in order to satisfy the Government's needs. In such circumstance, we do not believe competition and/or market forces provide better prices to the Government and believe cost data should be provided to determine fair and reasonable subcontract prices.

- DCAA has taken exceptions to several subcontract pricing actions where the prime contractor asserted a fair and reasonable subcontract price based on "adequate competition" where in fact only one bid was received by the prime contractor. DCAA is concerned about the risks created by current regulations permitting awards to subcontractors using competitive pricing procedures when only one bid is actually received. Again, in these cases, we believe it would be beneficial for the prime contractor and contracting officer to have access to subcontractor cost data to determine fair and reasonable contract prices. The Adequate Pricing Subcommittee under Mr. Assad's Panel on Contracting Integrity is taking a look into this area. They are ascertaining the need to revise this "loophole" in the regulation that we believe leads to subcontract prices being awarded at unreasonable prices. I will continue to work this issue as the Chair of this Subcommittee.

We Take Issue with Some of Director Fitzgerald's Statements

This is much to think about in the written testimony of Director Fitzgerald. We completely agree with him that adequate price or cost analysis must be performed by contractors, in order to determine price reasonableness, prior to awarding subcontracts valued in excess of certain dollar thresholds. But we also note that, far too often, government acquisition schedules fail to allow contractors sufficient time to perform the required analyses. As a result, contractors often sacrifice some of the administrative requirements. We're not saying they're correct in doing so, but critics need to look at the driver(s) of improper activities—and one of those drivers is the government's rushed RFP turn-around times.

We also take issue with Director Fitzgerald's statements that DCAA "has performed" CPSRs for the DCMA and, as a result of its audit procedures, "has found each system to be inadequate." First of all, DCAA auditors *don't perform CPSRs*. At most, they perform some procedures to assist the DCMA functional specialists with the purchasing system review, under the auspices of the cognizant contract administration office. Don't believe us? Check out the DCAA Contract Audit Manual (CAM) at 5-603.

Even when DCAA independently reviews a contractor's purchasing system—and

it can only do so when the cognizant Administrative Contracting Officer approves the audit activity—the auditors are *not* performing a CPSR. As the CAM states, “Where the ACO agrees with DCAA concerns, the auditor should perform a purchasing system internal control audit (not CPSR) ….” We will not recite the control objectives and control activities DCAA believes constitute an adequate set of purchasing internal controls. Suffice to say that they are not dissimilar from other DCAA internal control matrices, and are actually worth reviewing when establishing a purchasing system.

But the fact remains that DCAA lacks regulatory authority to determine that any contractor’s purchasing system is inadequate. That authority is vested in the cognizant ACO. (See FAR 44.305-1: “The cognizant ACO is responsible for granting, withholding, or withdrawing approval of a contractor’s purchasing system.”)

We are also concerned with Director Fitzgerald’s unsupported assertion that the current FAR Part 15.403-1 definition of “adequate competition” somehow creates a “loophole” that permits contractors to award contracts at other than fair and reasonable prices. There was no evidence provided to support that assertion. Moreover, based on Director Fitzgerald’s own testimony, the root cause was not a lack of competition, but instead failure to perform adequate price or cost analysis.

Look, we don't know all the facts and circumstances. All we have is the testimony proffered to the Commission. But we get very concerned when we hear somebody say that Contractors followed the regulatory requirements to the letter, but somehow that the results were found to be improper by the audit agency. If the so-called "loophole" is to be closed by new statutory or revised regulatory language, then we need to see some solid evidence that such a change is necessary. And we need to be convinced that doing so will fix the alleged problem. Failing that, we suggest DCAA get back to auditing and let the DCMA functional specialists handle this area.

Conclusion

One has only to search this site for the phrase "supply chain management" to see the importance we place on the topic. Proper management of

subcontractors is absolutely crucial to assuring adequate program execution. Part of that task is to put subcontractors under contract—to identify sources, to evaluate bids, and to negotiate (and document) why the resulting subcontract prices are fair and reasonable. In fact, in November 2008, we told a small gathering at the local NCMA Chapter that, "Acquisition professionals must own all pre-award activities … Don't be afraid of cost analysis. Dig deep into supplier bids. Take whatever time is necessary to gain the proper understanding." So when DCAA tells the CWC that this is an area that needs to be addressed, we have to agree.

Clearly, subcontractor management—ranging from pre-award activities to post-award performance management—is a topic of increasing interest to DOD and other oversight officials. Look for recommended changes and increased emphasis on this area from DCMA, DCAA, and others. If you believe your procedures can be enhanced, then by all means we urge you to get started right away. But we can't help noting that, if you've been reading this site, you would have been sensitized to this issue long ago.