

# The Importance of Supplier Price Reasonableness

## The Impacts of an Inadequate Cost/Price Analysis

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“That’s just like ...  
your opinion, man.”

# Topics to be Covered Today

- ▶ Regulatory standards applied to subcontracting
  - What does “price reasonableness” mean?
  - Do the same standards apply pre-award vs. post-award?
- ▶ DCMA/DCAA challenges to subcontract cost allowability
  - Who has the burden of proving price reasonableness if challenged?
  - What happens if the contractor cannot prove the reasonableness of its subcontractor prices?
- ▶ Recent legal cases about supplier price reasonableness
  - *KBR*, 563 F. App’x 769 (Fed. Cir. 2013) (cert. denied)
  - *KBR*, 07 Fed. Cl. 16 (2012)) and Appeal (Fed. Cir. 2014)
  - *Laguna Construction Co.*, ASBCA No. 58569, 5/29/2014
  - December 2014 DoD IG findings about DCAA audit report No. 3311-2009W10170001

# Regulatory Standards

- ▶ Pre-award/Proposal submission
- ▶ Post-award
- ▶ When does the FAR apply?

# What is “Price Reasonableness”?

## FAR 15.402

- ▶ Contracting Officers shall purchase supplies and services from *responsible* sources at *fair and reasonable prices*.
- ▶ To accomplish this, they will:
  - Use techniques such as, but not limited to, *price analysis*, *cost analysis*, and/or *cost realism analysis* to establish a fair and reasonable price
  - If a fair and reasonable price cannot be established ... from the analyses of the data obtained or submitted to date ... *require the submission of additional data sufficient ... to support the determination of the fair and reasonable price*

# Applicability to Contractors?

- ▶ FAR cannot apply absent a contract clause
  - Hence, FAR direction to Government COs is not applicable to contractors
- ▶ But FAR rules establish expectations by Government reviewers (DCMA/DCAA)
- ▶ FAR rules also can be used to provide guidance regarding how to *support* reasonableness of subcontract prices
  - Hence, support for reasonableness of subcontract costs when challenged

# Requirements for Pre-Award Support

## FAR 52.215-20

- ▶ The offeror shall prepare and submit certified cost or pricing data, data other than certified cost or pricing data, and supporting attachments in accordance with the instructions contained in Table 15-2 of FAR 15.408, *which is incorporated by reference with the same force and effect as though it were inserted here in full text*
- ▶ The instructions in Table 15-2 are incorporated as a mandatory format

# What Is Required?

## FAR Table 15-2

- ▶ *For all items proposed*, identify the item and show the source, quantity, and price
- ▶ Conduct *price analyses* of all subcontractor proposals
- ▶ Conduct *cost analyses* for all subcontracts when certified cost or pricing data are submitted by the subcontractor
- ▶ Include these analyses as part of your own certified cost or pricing data submissions for subcontracts expected to exceed the appropriate threshold in FAR 15.403-4 (TINA threshold)



# What Is Required?

## FAR Table 15-2 (Cont'd.)

- ▶ For any acquisition expected to exceed the TINA threshold:
  - Provide data showing the degree of competition and the basis for establishing the source and reasonableness of price for those acquisitions
  - Requirement applies to *all acquisitions*, including subcontracts, purchase orders, material orders, etc.
  
- ▶ Provide data showing the basis for:
  - 1) *Establishing the source*
  - 2) *Reasonableness of the price*

# Summary of Pre-Award Requirements

- ▶ The prime contractor:
  - Is responsible for determining price reasonableness for *all prospective subcontracts and supplier awards* at the time of proposal submission to the customer
  - Must identify all awards in excess of TINA threshold and obtain certified cost/price data if no exemption applies
  - Must perform cost analysis on data received
  - May have to submit its cost and price analyses as part of its proposal

# Post-Award Requirements

- ▶ For subcontracts identified and awarded after award of a prime “flexibly priced” contract, price reasonableness must still be established and documented in order to support allowability of incurred subcontractor costs
- ▶ Government has recently begun to challenge reasonableness of subcontractor costs
  - Implications for:
    - Purchasing System
    - Estimating System
    - Accounting System

# Common Challenges to Subcontractor Cost Reasonableness

- ▶ Failure to follow contractor policies/procedures
  - Required documents not in procurement file
  - Deviations from established practices
- ▶ Used inappropriate contract type
  - Type not found in FAR Part 16
- ▶ Subcontract incorrectly identified as commercial item
  - Failure to perform/document commerciality determination
- ▶ Non-existent or ineffective subcontract administration or surveillance
- ▶ Non-existent or inadequate cost/price analysis implicates reasonableness of subcontract price

# Most Common Challenge is ...

- ▶ Subcontractor's costs are not reasonable in amount because the initial price was unreasonable
- ▶ May result in a challenge to some – or ALL – payments made to the subcontractor, even though goods were received and/or services were provided and accepted

# What is Cost Reasonableness?

## FAR 31.201-3

- ▶ A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business
- ▶ No presumption of reasonableness shall be attached to the incurrence of costs by a contractor
- ▶ If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, *the burden of proof shall be upon the contractor* to establish that such cost is reasonable.

# Contractors Were Warned!

- ▶ 2010—Director, DCAA tells Commission on Wartime Contracting “DCAA has reported ... estimating systems as inadequate and cited ... estimating practices as being deficient for [failing to ensure] fair and reasonable subcontract prices. ... 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.”

# Contractors Were Warned!

- ▶ A LOGCAP–related DCAA audit report classified over \$800 million of proposed subcontract costs as unsupported.
- ▶ DCAA noted 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.



# Contractors Were Warned!

- ▶ DCAA (05 / 2010) LOGCAP–related audit report identified over \$48 million of unsupported subcontract costs. KBR failed to obtain subcontract proposals and conduct the required price or cost analyses.
- ▶ DCAA (2010) LOGCAP–related audit report identified 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). Despite the sole source nature, Fluor did not obtain cost or pricing data from subcontractors.

# Contractors Were Warned!

- ▶ DCAA 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.”
- ▶ “DCAA identified several cases where the prime contractor asserted the subcontract price was based on adequate competition; however, [the] audit disclosed that adequate competition did not exist.”

# Contractors Were Warned!

- ▶ “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.”

# Contractors Were Warned!

- ▶ “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.”
- ▶ *Since 2010, DoD contractors have been on notice that DCAA will be looking for cost/price analyses to support subcontractor cost reasonableness.*

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ Court of Federal Claims, affirmed on Appeal (Sept. 2013), SCOTUS denied *certiorari*
- ▶ LOGCAP—CPAF Task Orders for Dining Facility (DFAC) support
- ▶ KBR awarded one of 5 “Master Subcontracts” to Tamimi for support at multiple locations, including Camp Anaconda, Iraq
  - Gratuities, kick-backs and bribes
- ▶ Task Orders awarded based on “best value”
  - Awards often were made to other than the lowest bidders under the rationale that geographic and other logistical considerations weighed in favor of the higher-priced vendor

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ PPI hired to construct permanent dining facilities but Army objected to KBR management, so Tamimi agreed to supervise
  - PPI had neither a contract nor a SOW
  - KBR had no Purchase Requisition for Tamimi
  - KBR had no SOW for Tamimi
  - KBR had not been paying Tamimi
- ▶ Army changed its mind and directed KBR to acquire the permanent facilities
  - How to price the transaction from PPI to Tamimi to KBR?
- ▶ Tamimi DFAC pricing under fire from DCAA
  - FFP—higher of estimated or actual headcount

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ Finally paid Tamimi @ 50% invoiced amounts
- ▶ Negotiated price reduction change subcontract without any pre-negotiation memo and without any contemporaneous notes of the negotiations
- ▶ DCAA issued a Form 1 in 2008 suspending a total of \$41.1 million—including fee billed by KBR on the questioned amount
- ▶ KBR appealed to the U.S. Court of Federal Claims

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ The court finds that the Army did not foist upon plaintiff the fixed price subcontract arrangement with vendors such as Tamimi. ... Plaintiff wanted the work, got on the ground early, and took on the risk under its costplus contracts that it would not be able to pass on to the Government its subcontractors' prices negotiated in a challenging environment when the prime contractor had few options.
  - No one should be heard to play the violin tune of we-couldn't-abandon-our-commitment-to-feeding-the-troops. Sincere as plaintiff's commitment was to providing for the troops, this is no proxy for proof of reasonable costs.



# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ “Regardless of how DCAA arrived at its final amount, the issuance of the Form 1 charged plaintiff with the burden to prove the reasonableness of its costs and establish its entitlement to the sum that the Government was questioning. ... *plaintiff is not entitled to claim a presumption of reasonableness simply because the Government has not demonstrated persuasively why the questioned costs are unreasonable.*”
- ▶ “The Government agreed to compensate KBR for costs reasonably incurred under LOGCAP III; it did not agree to be an insurer of any business decision that KBR attempted to implement and will not be held to such a standard.”
- ▶ Court found about \$11 million to be reasonable and allowable; the remaining \$30 million was not awarded

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- ▶ Sustained on appeal

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ Another CoFC case: 07 Fed. Cl. 16 (2012)
- ▶ The SK 465 subcontract was awarded to ABC International pursuant to competition
  - A Request for Proposals was issued, multiple proposals were received from potential subcontractors, the proposals were evaluated, and a winner was selected
  - Although the evaluation showed that ABC was the low bidder, there was an error in the evaluation spreadsheet prepared by the KBR Subcontract Administration team
  - Instead of being \$100,000 lower than the next lower competitor (Eurest), the reality was that ABC's proposed price was *\$1 million higher* than Eurest's bid. The error was not discovered until after the subcontract had been awarded to ABC
  - In addition, the KBR Pre-Negotiation Memo was acknowledged (by both parties) to be "inadequate" and poorly documented/supported

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ Multiple change orders to ABC's subcontract
  - Change order prices formed a significant basis for the Army's assertion that subcontract pricing was unreasonable
  - ABC's change order pricing was determined by KBR to be reasonable, based on a comparison to ABC's original pricing (which had been determined to be fair and reasonable based on competition).
  - But since the original proposal evaluation had been flawed, the comparison to it in order to determine the reasonableness of the proposed change order pricing was invalid.
  - In addition, the KBR Subcontract Administration team's change order analysis had significant mathematical flaws

# Kellogg Brown & Root Services, Inc. (KBR)

- ▶ “KBR has not shown that it employed sound business practices and acted as a reasonably prudent business in accepting ABC’s proposed prices for Change Order #1.”
  - The court accepts KBR’s decision not to hold a competition [for the changed work] as reasonable, given the sense of urgency conveyed by Major Hunter and the Army. *That urgency, however, is insufficient to justify the acceptance of unreasonable prices.*
- ▶ Ineffective subcontractor cost/price analysis cost KBR @ \$8 million
- ▶ Affirmed on appeal

# Laguna Construction Company (LCC)

- ▶ ASBCA No. 585569 (May, 2014)
- ▶ The Government claimed that Laguna awarded two subcontracts without adequate competition and failed to “document that these award prices were reasonable.”
- ▶ In addition, other subcontracts were awarded in which Laguna “failed to justify award ... to other than the lowest bidder,” and similarly failed to document that subcontractor award prices were reasonable

# Laguna Construction Company (LCC)

- ▶ DCAA issued a 2006 audit report that said that LCC’s “subcontract management system and related internal control policies and procedures are inadequate and cannot be relied upon to ensure subcontracts are awarded in accordance with [FAR requirements] or [that] subcontract payments made by [LCC] are in accordance with FAR 52.216–7, Allowable Cost and Payment.”
  - “Due to the deficiencies in the internal controls related to [LCC’s] subcontract management system we believe a significant risk is present relative to allocability, allowability and reasonableness of subcontract costs billed to the U.S. Government. We believe this deficiency is serious enough to render the subcontract management system inadequate.”

# Laguna Construction Company (LCC)

- ▶ Government disallowed \$2.4 million plus G&A = \$3.8 million
- ▶ “The legal predicate of the government's claim ... is appellant's failure to document the reasonableness of subcontract awards under this contract that were not based upon competition.”
- ▶ Government’s claim dismissed as being untimely under the Contract Disputes Act Statute of Limitations



# DoD IG Audit Report Examining DCAA Audit

- ▶ 12/23/2014 audit examining DCAA Audit Report No. 3311-2009W10170001
- ▶ DCAA examined 70 subcontractor invoices (\$13.5 million) related to \$33 million in subcontract awards
  - Zero dollars were adequately supported
  - DCAA questioned 20% of the total (\$6.6 million)
  - Auditor failed to consider contractor's rebuttal and additional info provided

# DoD IG Audit Report Examining DCAA Audit

- “... the 20–percent decrement is arbitrary because DCAA lacked a legal, regulatory, or other appropriate basis for establishing the amount of questioned costs it reported and included in the accompanying Form 1.”
- “The decrement also failed to provide the contracting officer a rational or otherwise justifiable basis for limiting the potential disallowance to only 20 percent of what DCAA considered to be inadequately supported costs.”
- “Questioning costs in this manner did not serve a useful purpose to the contracting officer in negotiating a fair and reasonable settlement on the claimed subcontract costs.”

# Conclusion

- ▶ Subcontractor prices must be analyzed and found to be fair and reasonable
- ▶ The cost/price analyses must be rigorous
- ▶ Negotiation memoranda and notes must be generated and retained
- ▶ The foregoing is necessary to support subcontractor cost reasonableness if challenged by DCAA/DCMA
- ▶ Failure to execute the foregoing risks cost disallowances and business system inadequacy

# Questions?

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