



DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
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IN REPLY REFER TO

PSP 730.5.1

June 30, 2009  
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MEMORANDUM FOR REGIONAL DIRECTORS, DCAA  
DIRECTOR, FIELD DETACHMENT, DCAA  
HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA

SUBJECT: Audit Guidance on Performing Audits of Subcontract Forward Pricing Proposals

Auditors may perform audits of subcontractor forward pricing proposals prior to completion of the prime contractor's proposal and/or its subcontract analyses if certain conditions are met. However, prime contract auditors should report proposed subcontract costs as unsupported when the prime contractor has not completed its price or cost analysis of the subcontract proposal, regardless of whether an assist audit is being performed. CAM sections 9-104, 9-106, and 10-304.8 are being revised to reflect this change in audit guidance. Specific questions that auditors have raised in auditing subcontract proposals are addressed in the enclosed Frequently Asked Questions.

**Audit of Subcontract Forward Pricing Proposals**

In certain major acquisitions or acquisitions being conducted under an Integrated Process Team (IPT), significant subcontract forward pricing proposals may be completed and signed by the subcontractor and submitted to the prime contractor in advance of the prime contractor's proposal being completed and submitted to the Government. To facilitate the contract negotiation and award process, contracting officers often request that the subcontract audit begin prior to the prime contractor proposal being completed. FAR 44.101 defines a "Subcontract" as meaning "any contract as defined in Subpart 2.1 entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders." FAR defines a subcontractor as "any supplier, distributor, vendor or firm that furnishes supplies or services to a prime contractor or another subcontractor."

Audits of subcontract forward pricing proposals may be performed when requested by the contracting officer or prime contract auditor prior to submission of the prime contractor's signed forward pricing proposal or its subcontract analyses provided that all of the following guidelines are met:

1. The subcontract proposal has been approved by the appropriate subcontractor management,
2. The prime contractor has submitted the subcontract proposal to the Government with an assertion from the prime contractor's management that it intends to contract with this subcontractor,

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3. The subcontract forward pricing proposal is adequate for examination based on the requirements set forth in FAR Subpart 15.4, Contract Pricing, and
4. The contracting officer or the prime contract auditor request an audit of the subcontractor proposal and have informed the subcontract auditor that the contracting officer and/or auditor have determined that subcontract audit support is required based on DFARS PGI 215.404-3a(i), *Subcontract pricing considerations*.

In accordance with DFARS PGI 215.404-3a(i), the contracting officer may request an audit of a subcontract proposal at any tier (notwithstanding availability of data or analyses performed by the prime contractor), if the contracting officer believes that such assistance is necessary to ensure the reasonableness of the total proposed price. DFARS PGI 215.404-3a(i) states that such assistance may be appropriate when, for example:

- (A) There is a business relationship between the contractor and the subcontractor not conducive to independence and objectivity;
- (B) The contractor is a sole source supplier and the subcontract costs represent a substantial part of the contract cost;
- (C) The contractor has been denied access to the subcontractor's records;
- (D) The contracting officer determines that, because of factors such as the size of the proposed subcontract price, audit or field pricing assistance for a subcontract at any tier is critical to a fully detailed analysis of the prime contractor's proposal;
- (E) The contractor or higher-tier subcontractor has been cited for having significant estimating system deficiencies in the area of subcontract pricing, especially the failure to perform adequate cost analyses of proposed subcontract costs or to perform subcontract analyses prior to negotiation of the prime contract with the Government; or
- (F) A lower-tier subcontractor has been cited as having significant estimating system deficiencies.

The prime contract auditor should assist the contracting officer in coordinating the overall audit effort relating to significant subcontract pricing actions at the prime contractor. The contracting officer will require the assistance of both the prime and subcontract auditor in ascertaining the need for assist audit (e.g., input related to the examples provided in DFARS PGI 215.404-3(a)(i)). The prime and subcontract auditor should ensure the subcontract proposal is adequate prior to commencing any subcontract audit and the contracting officer should be notified on a timely basis when the subcontract proposal is deemed inadequate. The fieldwork should not commence at the prime contract level until a management-approved prime contractor proposal is received. The prime contract auditor's responsibilities during the audit of the prime contract proposal are detailed below.

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### **Prime Contractor's Responsibilities**

Performing audits of subcontract proposals, either before or after the completion of the prime contractor's proposal, does not relieve the prime contractor of its responsibilities under FAR. FAR 15.404-3(b), *Subcontractor pricing considerations*, requires the prime contractor or higher-tier contractor to conduct appropriate cost or price analysis to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the prime contractor's proposal. The prime contractor is also responsible for ensuring that the subcontractor's forward pricing proposal is adequate to support the prime contractor's price or cost analysis as well as any necessary examination by the contracting officer and DCAA.

### **Prime Contract Auditor's Responsibilities**

As discussed in CAM 9-104.2b, the prime contract audit of the completed prime contractor's proposal should include audit procedures to (1) determine if the prime contractor completed the required cost or price analyses of its subcontractors and (2) review the adequacy of the prime contractor's analyses. For those analyses that are not completed, determine the contractor's completion schedule. The related audit report should identify subcontracts for which the prime contractor has not completed the required analyses (CAM 10-308.2) and the proposed subcontract costs should be reported as unsupported (CAM 9-104.2d). The prime contractor auditor must then assess the need for an assist audit and request the audit if determined necessary (if not already requested by the contracting officer). CAM 9-104.2b outlines concerns similar to those discussed in the PGI above as to when assist audit support may be required to ensure the overall adequacy of the audit of the prime contract proposal. The prime contract auditor should incorporate the results of any assist audits received into his/her report. For example, costs questioned in the subcontract audit should be questioned in the prime contractor proposal audit report. However, as stated above, if the prime contractor has not completed its own cost or price analysis, the balance of the proposed subcontract costs should be reported as unsupported.

The contractor's estimating system should have policies and procedures in place to conduct the required cost or price analyses and provide it to the Government negotiator prior to negotiation of the prime contract price (CAM 5-1209.3). If, due to time or other constraints, the prime contractor cannot complete the required analyses prior to the submission of its prime contract proposal, the prime contractor should have policies and procedures in place to ensure a plan is implemented to complete the analyses prior to the prime contract negotiation. DFARS 215.407-5-70(d)(3)(ii), *Estimating Systems*, states that the contractor's continuing failure to perform subcontractor cost analysis, as required, is a significant estimating deficiency. Therefore, an estimating system flash report should be issued if the contractor fails to perform subcontract cost or price analysis, as required. At major contractors, a limited scope internal control review should then be established to report the issue as a significant internal control deficiency based on the applicable supporting evidence and report the estimating system as inadequate (see MRD 08-PAS-041, dated December 18, 2008).

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**Fixed Price Prime Contracts**

As a reminder, auditors should not perform audits of subcontract proposals where the prime contract is a firm-fixed-price contract and has already been negotiated. An audit of a subcontract proposal must serve a valid Government interest. Generally, this would mean a potential for a Government prime contract price adjustment if the proposal is found to be misstated. An audit is appropriate only when a firm-fixed-price type contract has a special contract clause providing for recovery of later subcontract price reductions.

**Concluding Remarks**

If FAO personnel have any questions, they should contact regional personnel. Regional personnel with any questions should contact Mr. John Shire, Chief, Pricing and Special Projects Division, at (703) 767-3229.

/s/ David E. Johnson  
/for/ Kenneth J. Saccoccia  
Assistant Director  
Policy and Plans

Enclosure:

Frequently Asked Questions on Subcontract Proposals

DISTRIBUTION: C

## FREQUENTLY ASKED QUESTIONS SUBCONTRACT PROPOSALS

**Question 1:** The buying command wants to request an audit of a subcontractor proposal at the time of the subcontractor management-approved proposal submission. Can the FAO audit a subcontract proposal prior to the prime contractor's submission of its management-approved proposal?

**Answer:** Yes. In accordance with DFARS PGI 215.404-3a(i), contracting officers may request an audit of subcontract proposals prior to the completion of the prime contractor's proposal and the prime contractor's analysis of the subcontract proposal if the contracting officer believes that such assistance is necessary to ensure the reasonableness of the total proposed price. Examples of such situations are discussed in DFARS PGI 215.404-3a(i).

FAOs should be responsive to these requests provided the following guidelines are followed:

1. The subcontract proposal has been approved by the appropriate subcontractor management,
2. The prime contractor has submitted the subcontract proposal to the Government with an assertion from the prime contractor that they intend to contract with the subcontractor,
3. The subcontract forward pricing proposal is adequate for examination based on the requirements set forth in FAR Subpart 15.4, Contract Pricing, and
4. The contracting officer, prime contract auditor, or next higher-tier subcontract auditor requests an audit of the subcontract proposal and informs the subcontract auditor that the contracting officer has determined subcontract audit support is required based on DFARS PGI 215.404-3a(i).

**Question 2:** What constitutes a valid assertion from the contractor that they intend to contract with the subcontractor?

**Answer:** The prime contractor should provide an assertion that they intend to contract with the subcontractor, signed by the contractor representative that would typically approve/sign a contractor's proposal (as required by FAR 15.408, Table 15-2, Section 1.A.(11)).

**Question 3:** Does an audit of a subcontract proposal relieve the prime contractor from its responsibility to perform a price/cost analysis of the subcontract proposal?

**Answer:** No. A Government audit of the subcontract proposal does not relieve the prime contractor of its responsibilities. FAR 15.404-3(b) requires prime contractors and higher-tier subcontractors to conduct price or cost analysis of each subcontract proposal and include the results of these analyses in the price proposal or provide a schedule of analyses to be completed prior to negotiations. If the prime contractor and higher-tier subcontractor fail to meet this requirement, an estimating system flash report should be issued regardless of any audit performed on the subcontract.

**Question 4:** Is it appropriate for auditors to perform audits of subcontract proposals where the prime contract is firm-fixed-price and has already been negotiated?

## FREQUENTLY ASKED QUESTIONS SUBCONTRACT PROPOSALS

**Answer:** No. Use of Government audit resources would not be justified where any higher-tier contract or subcontract in the chain is firm-fixed-price and has been negotiated. However, in exceptional cases, a firm-fixed-price type contract may have a special clause providing for recovery of later subcontract price reductions. In this case, an audit may be appropriate. (CAM 9-104.2i.)

**Question 5:** Can the prime contract auditor assist the contracting officer in coordinating audits of subcontracts prior to the prime contractor's submission of its final proposal?

**Answer:** Yes. The prime contract auditor should assist the contracting officer in coordinating the overall audit effort in support of significant pricing actions underway at the prime contractor. The contracting officer will need the prime contract auditor's as well as the lower tier contract auditor's input related to the examples provided in DFARS PGI 215.404-3(a)(i). However, the fieldwork should not be undertaken at the prime contract level until a management-approved prime contractor proposal is received.

**Question 6:** Does the contracting officer's assessment and determination on the need for assist audits restrict the prime contract auditor's assessment on the need for assist audits?

**Answer:** No. While the prime contract auditor may support the contracting officer's efforts under DFARS PGI 215.404-3(a)(i), the prime contract auditor is still required to make an independent assessment of the need for assist-audit support related to the scope of audit of the prime contractor proposal. If the auditor believes additional assist audits are required, they should be requested and the contracting officer should be notified.

**Question 7:** If the prime contractor is denied access to the subcontractor's cost data, does the prime contractor have to perform any analysis of the subcontractor's proposal?

**Answer:** Yes. At a minimum, the prime contractor should perform and document its (1) efforts to complete the FAR 15.404-1(b) required price analysis of its subcontractors and (2) coordination with the contracting officer to obtain any necessary audit/pricing support from the Government.

**Question 8:** If an assist audit has been requested, however the prime contractor has NOT performed the FAR 15.404.3(b) required price or cost analysis to establish the reasonableness of proposed subcontract prices, should the subcontract cost be shown in the prime contract audit report as unresolved or unsupported?

**Answer:** Unsupported. Regardless of whether or not an assist audit has been requested or received, if the contractor has not completed its price/cost analysis the subcontract cost should be shown in the prime contract audit report as unsupported. However, if an assist audit has been received and costs have been questioned, the costs should be questioned in the prime contractor proposal audit report and the balance of the proposed subcontract costs should be reported as unsupported.

## FREQUENTLY ASKED QUESTIONS SUBCONTRACT PROPOSALS

**Question 9:** If the prime contractor has performed the FAR 15.404.3(b) required price or cost analysis to establish the reasonableness of proposed subcontract prices, however an assist audit has been requested, should the subcontract cost be shown in the prime contract audit report as unresolved or unsupported?

**Answer:** Unresolved. Failure to receive requested assist audit reports will necessitate classifying the applicable proposed amounts as unresolved, unless the prime contractor has not completed its price/cost analysis in which case the subcontract will be classified as unsupported.

**Question 10:** If the subcontract forward pricing proposal is found to be inadequate for examination by the subcontract auditor should the FAO at the prime or subcontractor issue an estimating system flash report?

**Answer:** In some cases, both FAOs would issue flash reports. A significant deficiency in the subcontractor's estimating system allowed an inadequate proposal (i.e., a proposal that did not meet the requirements set forth in FAR Subpart 15.4, Contract Pricing) to be submitted to the prime contractor and the prime contractor's estimating system may have failed to determine the subcontract forward pricing proposal was adequate (i.e., the proposal did not meet the requirements set forth in FAR Subpart 15.4, Contract Pricing). However, in some cases, the subcontractor may have denied the prime contractor access to its complete supporting cost or pricing data and therefore the prime was unable to make the complete adequacy determination.