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THE ROLE OF THE GOVERNMENT AUDITOR IN DEFENSE SUBCONTRACTING

Contract Audit in the Department of Defense

In the public interest the Department of Defense reserves a right to audit the costs of a contract whose price is not firmly established when the contract is entered into. This right is implemented through standard contract clauses contained in the Armed Services Procurement Regulation. To accomplish the requirement thus imposed, each of the three military departments has established a staff of contract auditors who review the cost claims of military contractors for acceptability under contract terms. These staffs also review and report on contractors' proposals for costs to be incurred under contemplated contracts. In both cases the audit function is advisory to procurement officials, except that under Navy cost type contracts determination of allowability of costs is made by the Navy auditor. The Department of Defense goes beyond prime contracts for audit purposes, and requires that when a negotiated prime contract contains an "audit" clause the prime contractor must insert a similar clause in each subcontract thereunder. Fixed price subcontracts in which the price is based on adequate price competition, established catalogs, or market prices of commercial items sold in substantial quantities to the general public are exempt from this requirement.

There are various types of subcontract "audit" clauses (see ASPR 7-104.41 and .42; 7-203.29 and .31; 7-303.28 and .29; and...
7-402.30 and .32) but the general concept in each is the same. The costs of subcontractors entering into a negotiated subcontract under a negotiated prime are subjected to audit verification, except where there is adequate price competition or commercial sale of the items covered by the subcontract.

Audit of subcontractor costs thus becomes an important aspect of subcontract administration. Under the basic policies of the Department of Defense, subcontract administration is the responsibility of the prime contractor. The question at once arises as to why there is any need for an article on the role of the Government auditor in subcontract administration. Reworded—why should the contract auditors of the Department of Defense assume from the prime contractor the audit responsibility related to subcontract administration?

The Subcontract Audit Problem

There is a provocative aspect to this question. Military department contract auditors auditing a negotiated subcontract under an incentive-type prime recently uncovered serious errors in the subcontractor's cost statement. The subcontractor acknowledged that his costs were overstated and agreed to a price reduction of almost $1 million. The effect of this subcontract repricing was to reduce costs under the incentive-type prime contract by an equivalent amount. The prime contractor would therefore receive some $200,000 of additional profit under the 80%-20% incentive feature of his contract, other things being equal. An inquiry was immediately raised as to whether it was proper for Government auditors to take action which resulted in increasing the prime contractor's profit without any effort on his part. Again, was it appropriate for military department auditors to act for the prime contractor at all? This article will explain the role of the military department auditor in accepting or questioning costs claimed by subcontractors when such costs form part of the total costs of the prime contract and, hopefully, will clarify some of the thinking which gives rise to the above questions.

Let us first dispose of the initial question. In auditing the costs of the subcontractor, and in finding therein an overstatement of almost $1 million, the military department auditors were acting for the responsible administrative contracting officer and not for...
the prime contractor. The administrative contracting officer under cost reimbursement prime contracts or other contracts subject to repricing must pass on negotiated subcontracts proposed for such contracts. Audit support is essential to the effective accomplishment of this responsibility. Audits made by the prime contractor could well be as useful as those made by Government auditors. The fact that audit findings in the cited instance resulted in additional profit becoming available to the prime contractor is of secondary importance. This situation came about only because of the type of contract used.

Under a cost reimbursement contract the audit result would have been exactly the same but the prime contractor's profit would not have been increased. The subcontractor's mistake was quite obvious and should have been recognizable by any contract cost auditor employed by the prime contractor or by the Government. It would seem most inequitable to challenge the contractor's right to additional profit on the grounds that Government auditors rather than his own uncovered an obviously incorrect subcontractor cost computation.

Responsibilities of the Administrative Contracting Officer

The administrative contracting officer's responsibilities with respect to review and assent to individual subcontracts are listed under ASPR 3-903.4. Audit assistance is normally required in connection with his considerations under 3-904.4 (a) (v)—"Cost or price analysis or price comparisons accomplished, with particular attention to whether cost or pricing data are accurate, complete and current." (Emphasis supplied.) Under ASPR 3-903.4 (b), (ii), (iii) and (iv), which are concerned with special situations including lack of competition, apparently unreasonable pricing, and close prime/subcontractor business affiliations the contracting officer will usually require audit assistance. ASPR 3-903.4 (b) (v) states that a careful and thorough evaluation by the contracting officer is particularly necessary when "a subcontract is to be placed on a cost-reimbursement, time and material, labor hour, fixed-price incentive or fixed-price redeterminable basis." Under current policies of the Department of Defense, audit assistance must be provided the contracting officer on all proposed subcontracts of this kind to exceed $250,000 ($500,000 in the case of proposed...
The contracting officer may request and receive audit assistance on proposed subcontracts of lesser amount if he believes such assistance is desirable.

To a large extent the contracting officer's subcontract responsibilities as to which audit assistance is required parallel those which a prudent prime contractor would exercise in effectively managing his subcontracting program. These responsibilities extend to second-tier subcontractors and beyond. The contracting officer's administration of a surveillance and advisory nature "should be conducted down the subcontract chain so far as is needed to protect Government interests." (AFPI 3.903.54)

**Limits on Prime Contractors' Responsibilities**

There is a school of thought which holds that every defense prime contractor should employ a staff of subcontract auditors to make audits required under the ASPR clauses and to assist in the evaluation of estimates of future costs submitted by potential or existing subcontractors. This would implement fully the philosophy that subcontract administration is the responsibility of the prime contractor. Some well-known companies in the defense industry do indeed employ audit staffs for this purpose and little fault can be found with the results of their efforts. Even in these cases, however, there are obstacles to complete implementation of the basic philosophy. One problem that comes readily to mind is the audit of cost reimbursement subcontracts under a cost reimbursement prime. The peculiar nature of cost reimbursement contracts, and subcontracts thereunder, long ago created considerable uncertainty as to a cost reimbursement prime contractor's responsibilities with respect to its subcontractor's cost reimbursement vouchers. Many people will argue that the Government's responsibility for control over appropriated funds extends to the last link in a cost reimbursement prime-subcontracting chain. U.S.C. Title 10, Sec. 2313 (a) (2) entitles Government agencies to audit cost reimbursement subcontract costs. Section 2276 imposes penalties on attempts to deprive the Government of the benefits of a "full and free audit" by the designee of the head of an executive department. Whatever the arguments under the Code may be it is now a matter of long standing practice for the military departments to audit the costs of cost reimbursement subcontracts. The contracting officer may request and receive audit assistance on proposed subcontracts of lesser amount if he believes such assistance is desirable. To a large extent the contracting officer's subcontract responsibilities as to which audit assistance is required parallel those which a prudent prime contractor would exercise in effectively managing his subcontracting program. These responsibilities extend to second-tier subcontractors and beyond. The contracting officer's administration of a surveillance and advisory nature "should be conducted down the subcontract chain so far as is needed to protect Government interests." (AFPI 3.903.54)

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reimbursement subcontractors under a cost reimbursement prime. Even those companies who maintain their own staffs for the audit of subcontracts are willing to have the Government audit the costs of their cost reimbursement subcontractors. Rarely, if ever, are claims of this nature audited by other than Government auditors.

Avoidance of Duplicate Effort

In accomplishing the previously noted parallel responsibilities of the administrative contracting officer and the prime contractor in the administration of subcontracts, avoidance of unnecessary duplication of audit effort becomes a prime objective of both. In particular situations, therefore, the use of information supplied by Government audit personnel is encouraged even for those prime contractors who maintain their own contract audit staffs. Air Force Procurement Instructions cover these situations in more detail (AFPI 54.206) than do Army and Navy instructions. For example, where a subcontractor holding prime or subcontracts from military department sources and regularly audited by one of the military departments is visited by a prime contractor auditor, there will be, with even the closest possible coordination between military department auditors and those of the prime contractor, a costly duplication of effort which must be paid for by the taxpayer, who receives little or nothing in return. The obvious means of preventing such duplication is for the cognizant military department auditor to make the needed audit, the results of which will be made available, in whole or in part to the prime contractor.

The defense industry is tightly knit and its top companies are highly specialized. The knowledge and abilities of any one company in the industry may be required in varying degree under differing programs. In some programs it may act as prime contractor and program manager, with companies of equal size and importance among its subcontractors. In other programs it may be a subcontractor to primes who are its own subcontractors on different programs. There is a constant interplay of costs and know-how within the industry. Any attempt to implement fully the concept that each prime contractor is responsible for accomplishing the requirements of the audit clauses which it must insert in its subcontracts would mean that auditors of company
"A" might be examining the cost records of company "B" under one program while simultaneously the auditors of "B" would be examining the records of "A" in connection with another. And consider the plight of company "C" which might be subcontractor to both. Auditors of both "A" and "B" could very well be in its plant at the same time struggling manfully to accomplish simultaneous audits of "C's" overhead accounts. In the case of component manufacturers it does not take too much imagination to visualize auditors from half a dozen primes in its plant at the same time.

The above considerations are in no sense exaggerated. The Department of the Air Force has audit responsibility for one well-known component manufacturer who must deal with more than 100 separate administrative contracting officers under dozens of different programs. If each prime for whom this manufacturer acts as a subcontractor were to send out its own auditors another building would probably have to be constructed by the subcontractor to contain them all.

The audit cognizance program of the Department of Defense recognizes the problems its contractors would encounter if they were forced to deal separately with auditors of each military service and there are only three. Each major contractor plant in the defense industry has been assigned to one or another of the three services for contract audit purposes. The auditor responsible for this plant makes all audits required by the individual services. In accomplishing audits for other services, the responsible plant auditor is governed by the requirements of the service whose contract he is auditing. This is not a particularly difficult task since the audit requirements of the three services are closely parallel with constant efforts being made to eliminate any differences. The audit cognizance program has been extended to cover the requirements of Government agencies outside the Department of Defense so that military department auditors will upon request conduct audits for other Government agencies doing business with the contractor.

The system outlined above has proven readily adaptable to the audit of subcontracts being accomplished by the company for whom the service auditor has Government audit responsibility. The economic benefits of having one set of contract auditors and
one alone making audit determinations for all contracts and subcontracts held by the defense contractor are easily recognized. There is a tremendous cost savings. Auditors employed by prime contractors to audit the costs of their subcontractors would incur salary and travel costs which would be recognizable as part of the overhead under their Government contracts. The costs of recruiting and training one hundred or more prime contractor contract audit staffs stagger the imagination. There would be no offsetting savings to the Government through reduction of its audit efforts since it would still be required to maintain auditors in the contractor's plants to audit the company's prime contracts and any cost reimbursement subcontracts under the cost reimbursement primes of other contractors.

**Consistency in Audit Findings**

The audit coordination program of the Department of Defense differs from the audit cognizance program in that it is directed toward assurance that a contractor's accounts will receive consistent audit treatment from the auditors who are cognizant of the company's various plants. This is by no means a simple task. To a degree seldom appreciated by outsiders audit is a judgmental process. Even the expansion of ASPR Section XV to encyclopaedic proportions could not make it otherwise. The problem is compounded by the inability of the accounting profession to agree on much more than certain common text book fundamentals of which few indeed extend to the problems of cost allocation. But the defense subcontractor is entitled to common audit treatment of his accounts in each plant, as long as the end result is consistently accumulated and is reasonable. The introduction into his plants of prime contractor auditors who may disagree violently with concepts previously accepted by the military department auditors, or vice versa, can completely upset the objectives of the DOD audit coordination program. Prime contractors who view with articulate disfavor the use of ASPR Section XV cost reimbursement principles as a guide for determining the costs of other types of contracts can hardly be expected to enforce such principles upon their subcontractors. In light of these considerations, the use of prime contractor auditors in subcontractor plants which are under the audit coordination program is not encouraged. The
same considerations govern, albeit less rigidly, the use of prime contractor auditors in the plants of subcontractors who have been informally coordinated by the military services.

**Other Factors**

There are other situations in which the use of Government auditors instead of those of the prime contractor for the audits of subcontractors is desirable. Some subcontractors will not permit prime contractor access to their records. They fear to have potential or actual competitors gain knowledge of their business through the close analysis of accounts and management decisions which is a requisite of effective contract auditing. In such instances the only answer is for the Government to make the audit required by the administrative contracting officer, with use of the Government audit report by the prime contractor.

There is a reverse side to this particular coin. A surprisingly large number of defense contractors do not wish to audit their subcontractors, or to receive through Government audit any information beyond that normally available through public sources, on the grounds that receipt of such information would make them vulnerable under the antitrust laws. The author must leave debate on this problem to those better versed in legal concepts than himself.

Military department auditors reviewing the costs of a subcontractor may encounter situations in which the subcontractor fears that the prime will obtain through the Government audit report trade secrets or other information which the subcontractor wishes to hold confidential, so far as the prime is concerned. In such instances it is customary for the Government auditor to designate in his report to the contracting officer those items which are to be held in confidence. In extreme cases, and particularly where it is understood that the audit report will be used as a negotiating vehicle by the prime contractor, confidential information relating to the subcontractor can be at his request physically separated from the remainder of the audit report. If, however, the auditor takes exception to costs whose supporting data are considered confidential by the subcontractor, a vexing situation develops. Fortunately these have been few in number and all have been resolved on a case-by-case basis.
The use of interdivisional work orders or orders between parent and affiliate or parent and subsidiary is a common practice in the defense industry. So far as the contracting officer is concerned, orders of this kind have most of the characteristics of subcontracts, and audit is required wherever it would be needed in the case of recognized subcontracts, perhaps more often and in greater depth than would be the case if prime and sub were at arms length. In these situations it is clearly in the public interest that audit of "subcontract" costs be made by Government personnel.

Similar considerations but in lesser degree are governing in those cases where the prime contractor subcontracts all, or a substantial portion of his prime contract to one or to a very limited number of subcontractors. Contractor utilization of Government audit information is obviously to the mutual interest of the prime contractor and the public, and is often the only practicable method of obtaining essential information.

Coordination of Prime and Military Auditors

Prime contractors may request Government audit service in connection with the pricing of their subcontracts. Such requests are addressed to the administrative contracting officer cognizant of the prime, who is authorized to accept or reject them. Prime contractor requests for Government audit service will normally specify those areas of the subcontractor's pricing proposal as to which audit information is desired, and the uses to which the data furnished by the auditor will be directed. Neither the prime contractor nor the contracting officer may impose any limitation upon the scope of the audit.

Over the years the contract audit organizations of the military departments have accumulated a vast body of knowledge concerning the accounting and cost estimating practices of the companies which compose the defense industry. A prime contractor contemplating a cost reimbursement, fixed-price incentive, fixed-price redeterminable or other subcontract listed under ASPR 3-903.4 (b) (v) may consult with appropriate military department audit personnel as to the adequacy of the prospective subcontractor's accounting system whenever an appraisal of that system has previously been performed by the Government. If the prime
The prospective subcontractor, before entering into price negotiations with the prime will, or should, submit evidence of the reasonableness of his proposed price. If no price comparisons are available, such evidence will most often consist of a statement of anticipated costs under the contemplated subcontract. A statement of forecasted costs, even if supported by narrative explanations, is seldom convincing in itself, particularly to the administrative contracting officer, who normally will be unwilling to assent to a proposed subcontract price without the assurance provided by informed analysis of the subcontractor’s proposal. The certification required under PL 653, 87th Congress, may lead subcontractors to be more exacting in preparing their proposals, but it provides no substitute for effective analysis. Such analysis as a minimum looks carefully at the anticipated direct costs, the forecasted overhead, expected tooling costs, and other factors, seeking to determine if they provide, in reasonable amounts and relationships with one another, a generally reliable estimate of what it will cost to perform the proposed subcontract.

Evaluations of subcontractor price proposals postulated on the
potential subcontractor's anticipated cost of performance are foreign to most prime contractors, who are more accustomed to defending their own proposals than to analyzing the proposals of other firms. American industry has customarily relied on its skill in comparing prices, item by item, to achieve the best buy, and the purchasing departments of most defense contractors tend to follow this practice in dealings with their subcontractors. In contrast, the Government is accustomed to evaluating proposed prices on a "cost to make" basis, a situation into which it has largely been forced by its pressing need to procure items which have not been previously manufactured, and in which price competition simply does not exist. Government reliance on audit review of proposed subcontractor costs as an aid to this process is a natural consequence. As in the case of incurred cost audits, some prime contractors maintain their own staffs to make such evaluations.

Neither Government contract auditors nor those of the prime contractors are endowed with the gift of prophecy when it comes to the costs of future subcontracts. But Government auditors who have been auditing the costs of a prospective subcontractor on a regular basis can put their acquired knowledge of the subcontractors' operations, including his accounting system and his cost estimating methods, to good use in appraising the reasonableness of proposed factors and relationships entering into the subcontractor's cost estimate. If the subcontractor has had previous experience in producing the items covered by his proposal the auditor can usually proffer informed comment on quantitative estimates of labor hours and material requirements, but otherwise comments of this kind are best left to engineers. In review and analysis of subcontractor proposals the Government contract auditor will usually function as one member of a team reviewing the whole proposal.

Contract auditors are increasingly being called upon to review subcontractors' methods of forecasting fund requirements under major defense programs. Considerations previously discussed in this article apply with equal force here, the sole exception being that audit emphasis is directed more toward appraising the reasonableness of fund forecasting methods than toward the reliability of the forecast itself.
After the Audit

The Government auditor reviewing a subcontractor's claim of costs incurred or an estimate of costs to be incurred will normally discuss his findings with the subcontractor to assure that he has properly understood all of the elements that make up the subcontractor's proposal, with particular emphasis on that portion of the supporting material which is to be held in confidence. The subcontractor will not receive a copy of the auditor's report. The Government auditor upon request will attend prenegotiation fact-finding sessions between the prime and subcontractor and may attend meetings held to negotiate the actual subcontract.

Where evaluations of proposed subcontract costs have been made by the prime contractor's auditors or cost analysts, the Government auditor may review the work of the prime's staff on a selective basis as part of his regular audit effort, or in connection with the pricing of individual subcontracts.

Summary

Strict application of the basic Department of Defense subcontracting philosophy would require that the contract audit needs of the responsible administrative contracting officer be met through contract audit reports issued by the staff of the price contractor. Practical considerations, the most important of which is the cost of compounded duplicative effort, have dictated a reverse situation in which the contract audit needs of the prime contractor in respect to the costs of his subcontractors are frequently met through Government audit reports prepared for the administrative contracting officer and released by him to the prime. This procedure has been operating satisfactorily and the problems surrounding its application have been satisfactorily resolved.
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