Ch 5 - Recognizing and Adjusting for Defective Pricing

- 5.0 - Chapter Introduction
- 5.1 - Identifying Possible Defective Pricing
- 5.2 - Developing The Government Position On Price Adjustment
- 5.3 - Completing Settlement Action

5.0 Chapter Introduction

This chapter covers the activities associated with identifying and adjusting for defective pricing:

Defining Defective Pricing (FAR 52.215-10(a)). Defective pricing is any contracting action subject to the Truth in Negotiations Act (TINA) where the negotiated (other than sealed bidding procedure) contract price including profit or fee was increased by a significant amount because:

- The contractor or a subcontractor at any tier furnished to the Government cost or pricing data that were not complete, accurate, and current as certified in the contractor's Certificate of Current Cost or Pricing Data;
- A subcontractor or a prospective subcontractor at any tier furnished to the contractor cost or pricing data that were not complete, accurate, and current as certified in the contractor's Certificate of Current Cost or Pricing Data; or
- Any of the above parties furnished data of any description that were not accurate.

Defective Pricing Remedies (FAR 15.407-1, 15.408, 52.215-10, and 52.215-11). When defective pricing occurs, the Government is entitled to a price reduction to eliminate any significant overpricing related to the defective data. That reduction must consider increases in both cost and profit or fee related to the defective data.

In addition to a price adjustment, the Government is also entitled to:

- Interest on any overpayments that resulted from the defective pricing of supplies or services accepted by the Government.

- A penalty equal to the amount of any overpayment, if the contractor knowingly submitted cost or pricing data which were incomplete, inaccurate, or not current.

The Government entitlement to these remedies is incorporated in the prime contract using one of the following clauses:

- Price Reduction for Defective Cost or Pricing Data, or
- Price Reduction for Defective Cost or Pricing Data -- Modifications.

The prime contract also requires that covered subcontracts must include the substance of the appropriate clause above.

New Contract Threshold (FAR 15.403-4(a)(1)). For a new contract, the applicable cost or pricing data threshold is the threshold that is in effect on the date of agreement on price, or the date of award, whichever is later. The cost or pricing data threshold is currently $500,000. This amount is subject to review and possible adjustment on October 1, 2000 and every five years thereafter.

Subcontract and Modification Cost or Pricing Data Threshold (FAR 52.215-13 and 52.215-21).

For prime contract modifications, new subcontracts at any tier, and subcontract modifications, the applicable cost or pricing data threshold is established by the prime contract.

- For most contracts, the applicable cost or pricing data threshold is the current threshold on the date of agreement on price, or the date of award, whichever is later.
- Some older contracts specify a dollar threshold that does not automatically change as the current threshold changes. However, a specific dollar threshold can be updated using a bilateral contract modification.

TINA Cost or Pricing Data Requirements (FAR 15.403-4(a)(1)). Unless an exception applies, the Truth in Negotiations Act (TINA), as amended, requires you to obtain cost or pricing data before accomplishing any of the

following actions when the price is expected to exceed the cost or pricing data threshold:

- The award of any negotiated contract (except for undefinitized actions such as letter contracts).
- The award of a subcontract at any tier, if the contractor and each higher-tier subcontractor have been required to furnish cost or pricing data.
- The modification of any sealed bid or negotiated contract (whether or not cost or pricing data were initially required) or subcontract.
    - When calculating the amount of the contract price adjustment, consider both increases and decreases. (For example, a $150,000 modification resulting from a reduction of $350,000 and an increase of $200,000 is a pricing adjustment exceeding the current cost or pricing data threshold.)
    - This requirement does not apply when unrelated and separately priced changes for which cost or pricing data would not otherwise be required are included for administrative convenience in the same contract modification.

Exceptions to TINA Cost or Pricing Data Requirements (FAR 15.403-1). The same laws that establish requirements for cost or pricing data also provide for mandatory exceptions. **Never** require cost or pricing data, when an exception applies.

Except from TINA requirements if...	**Standard for Granting the Exception**
The contracting officer determines that the agreed-upon price is based on adequate price competition.	A price is based on adequate price competition when one of the following situations exists: • Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and both of the following requirements are met: • Award will be made to the offeror whose proposal represents the best value where price is a substantial

	factor in the source selection; and • There is no finding that the price of the otherwise successful offeror is unreasonable. Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer. • There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers in response to the solicitation's expressed requirement, even though only one offer is received from a responsible, responsive offeror and both of the following requirements are met: • Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, e.g., circumstances indicate that: • The offeror believed that at least one other offeror was capable of submitting a meaningful, offer; and • The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and • The determination that the proposed price is based on adequate price competition and is reasonable is approved at a level above the contracting officer. • Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from price competition.
The contracting	Pronouncements in the form of periodic rulings, reviews, or similar actions of a

officer determines that the item price is set by law or regulation.	governmental body, or embodied in the laws, are sufficient to demonstrate a set price.
The contracting officer determines that you are acquiring a commercial item.	A new contract or subcontract must be for an item that meets the FAR commercial-item definition. A contract or subcontract modification of a commercial-item contract must not change the item from a commercial item to a noncommercial item.
The head of the contracting activity waives the requirement.	The head of the contracting activity (HCA) (without power of delegation) waives the requirement in writing. The HCA may consider waiving the requirement if the price can be determined to be fair and reasonable without submission of cost or pricing data. Note: Consider the contractor or higher-tier subcontractor to whom the waiver relates to have been required to provide cost or pricing data. Consequently, award of any lower-tier subcontract expected to exceed the cost or pricing data threshold requires the submission of cost or pricing data unless an exception otherwise applies to the subcontract.

Other Prohibitions Against Requiring Cost of Pricing Data (FAR 15.403-1(a) and 15.403-2).

Never require cost or pricing data for:

- Any contract or subcontract action with a price that is equal to or less than the simplified acquisition threshold. When calculating the price adjustment related to a contract modification, consider both increases and decreases, unless unrelated and separately priced changes for which cost or pricing data would not otherwise be required are included for

administrative convenience in the same contract modification.
- The exercise of a contract option at the price established at contract award or initial negotiation.
- Proposals used solely for overrun funding or interim billing price adjustments.

Cost or Pricing Data Requirements Authorized by the Head of the Contracting Activity (FAR 15.403-4(a)(2)).

If none of the exceptions or prohibitions described above apply, the head of the contracting activity (without power of delegation) may authorize the contracting officer to require cost or pricing data for any contract action below the cost or pricing data threshold.

- The head of the contracting activity must justify the requirement.
- Documentation must include a written finding that cost or pricing data are necessary to determine whether the price is fair and reasonable and the facts supporting that finding.

Cost or Pricing Data (FAR 15.401 and 15.406-2). Cost or pricing data:

- Are all facts that, as of the date of price agreement or, if applicable, another date agreed upon between the parties that is as close as practicable to the date of agreement on price, that prudent buyers and sellers would reasonably expect to affect price negotiations significantly.
- Must be certified as accurate, complete, and current in accordance with FAR 15.406-2.
- Are factual, not judgmental, and are therefore verifiable.
- Include the data that form the basis for the prospective offeror's judgment about future cost projections. The data do not indicate the accuracy of the prospective contractor's judgment.
- Are more than historical accounting data; they are all the facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred.
- Include such factors as:
    - Vendor quotations;

- Nonrecurring costs;
- Information on changes in production methods and in production or purchasing volume;
- Data supporting projections of business prospects and objectives and related operations costs;
- Unit-cost trends such as those associated with labor efficiency;
- Make-or-buy decisions;
- Estimated resources to attain business goals; and
- Information on management decisions that could have a significant bearing on costs.

Data Submission (FAR 15.406-2(c), 15.408, and Table 15-2). FAR Table 15-2 makes a clear distinction between submitting cost or pricing data and merely making available books, records, and other documents without identification.

- The offeror's requirement to submit cost or pricing data is met when all accurate cost or pricing data reasonably available to the offeror have been submitted, either actually or by specific identification, to the contracting officer or an authorized representative (e.g., the cognizant auditor).
- As later information comes into the offeror's possession, the offeror should promptly submit it to the contracting officer in a manner that clearly shows how the information relates to the offeror's price proposal.
- The requirement for submission of cost or pricing data continues up to the time of agreement on price, or another date agreed upon between the parties involved.
- The offeror must include an index (appropriately referenced) of all the cost or pricing data and information accompanying or identified in the proposal. Any additions or revisions to the original data submission must be annotated on a supplemental index.

Judgment and Cost or Pricing Data (Texas Instruments, Inc., 87-3 BCA ¶20,195 and Grumman Aerospace Corp., 86-3 BCA ¶19,091).

Cost or pricing data are facts and do not include any contractor judgment used to estimate future costs. However, there are cases where the Boards of Contract Appeals (BCAs)

have found that fact and judgment were so entwined that the judgments must be disclosed.

Example 1: A BCA ruled that a contractor was required to submit a computer-generated report used for estimating unit cost and forward pricing, even though the report contained both cost history and judgment. The judgment was not cost or pricing data. However, the cost history that served as the basis for that judgment was cost or pricing data. The BCA ruled that the report was not excluded from disclosure simply because it included judgment along with the cost or pricing data.

Example 2: A BCA ruled that a contractor was required to submit a draft cost analysis report. The contractor erroneously contended that the narrative analysis contained in the report did not constitute facts and that the bottom line contained in the report was itself meaningless if the Government was provided with the numbers required to perform the arithmetic to reach that bottom line. However, given the nature of the report, the BCA found that the narrative analysis added meaning to the raw figures and could not be said to lack factual content simply because it contained elements of judgment. Moreover, the draft status of the report did not affect its availability for disclosure to the Government, even though the contractor had an internal policy against releasing draft documents.

Situations Requiring a Certificate of Current Cost or Pricing Data (FAR 15.406-2(e)). Whenever you obtain cost or pricing data, you must obtain a Certificate of Current Cost or Pricing Data unless you find after data submission that the proposal qualifies for an exception to the submission requirement. Never require a Certificate of Current Cost or Pricing Data when a proposal qualifies for an exception.

If you determine after data submission that a proposal should be excepted from the cost or pricing data requirement, treat the data received as information other than cost or pricing data.

Certificate Wording (FAR 15.401, 15.403-4, and 15.406-2(a)). FAR prescribes the following wording for the Certificate of Current Cost or Pricing Data:

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 15.401 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 offeror and the Government that are part of the proposal.

Firm _____

Signature _____

Name _____

Title _____

Date of execution*** _____

* Identify the proposal, quotation, request for price adjustment, or other submission involved, giving the appropriate identifying number (e.g., RFP No.).

** Insert the day, month, and year when price negotiations were concluded and price agreement was reached or, if applicable, another date agreed upon between the parties that is as close as practicable to the date of agreement on price.

*** Insert the day, month, and year of signing, which should be as close as practicable to the date when the price negotiations were concluded and the contract price was agreed to.

The offeror must use the exact language in FAR 15.406-2(a). Accepting any variation from the FAR language could potentially invalidate the certificate.

For example: Suppose an offeror innocently replaced part of the last sentence "...includes the cost or pricing data supporting any advance agreements and forward pricing rate agreements between the offeror and the Government that are part of the proposal," with the following words "...includes the cost or pricing data supporting estimates of all direct labor hours and direct material costs in the proposal." If the contracting officer accepted the modified certification and labor rates or overhead rates were later found to be based on defective data, the contracting officer may have unwittingly weakened a legitimate defective pricing case.

Contractor Sweeps. Defective pricing could result, if any person in the contractor's organization knew that cost or pricing data submitted by the offeror were not accurate, complete, and current, when price negotiations were concluded and price agreement was reached or (if applicable) on another agreed-upon date. For example, defective pricing could occur if a subcontract buyer knew that a subcontractor intended to revise its proposal downward by $50,000, and failed to advise others in the prime contractor's organization.

To assure compliance with TINA requirements, many contractors have instituted programs for conducting extensive reviews of available cost or pricing data after negotiations are complete, but before submitting the Certificate of Current Cost or Pricing Data.

- These reviews are commonly known as "sweeps."
- The objective is to identify any new or revised data required to assure that all cost or pricing data are accurate, complete, and current.
- The offeror then submits the new or revised data to the Government with the Certificate of Current Cost or Pricing Data.
- In some cases, offerors have taken several months to complete a sweep for a single contract.

If a contractor requires more than 30 days to submit a Certificate of Current Cost or Pricing Data, the delay could indicate serious flaws in the contractor's estimating system. Consider the potential for such flaws as you analyze future cost proposals.

Additional Data After Agreement on Price (FAR 15.408 and Table 15-2).

Whenever the contractor submits new or revised cost or pricing data after agreement on contract price but prior to contract award, you should require the contractor to provide an index of the data and a statement that explains how the data relate to the offeror's price proposal.

- **Review The Data and Related Explanation.** Determine if the new or revised data will have a significant impact on the negotiated price.
- **Establish Your Position On The Need To Adjust Contract Price.** If the data indicate that the negotiated price was increased or decreased by any significant amount because the contractor did not submit accurate, complete, and current data before price agreement, establish your position on any price changes needed before contract award. Consult with agency legal counsel to assure that your position conforms to the requirements of the law and agency policy.

For example: The DoD Inspector General (DODIG) has established the following position on the treatment of cost or pricing data identified by offerors after agreement on price but before contract award:

  - Do not increase the contract price as a result of data submitted after price agreement.
  - Reduce the agreed-upon price if the data indicate that the negotiated contract price was increased by any significant amount because the contractor did not submit the data before price agreement.
- **Reach Agreement With The Offeror.** Because you do not yet have a binding contract, the contracting officer and the contractor must negotiate, using the new or revised data submitted by the offeror.
- **When Needed, Obtain An Updated Certificate Of Current Cost Or Pricing Data.** If contract price changes based on the new or revised data, you must decide whether to rely on the certification submitted with the data or require a new certification. Consult with agency legal counsel to assure that your position conforms to the requirements of the law and agency policy.
  - If the discussions with the offeror are limited to cost or pricing data covered by the existing

Certificate of Current Cost or Pricing Data, a new certificate will normally not be necessary.
    - If the discussions with the offeror are based on data not covered by the existing Certificate of Current Cost or Pricing Data, require the offeror to submit a new certificate. That certificate must certify that the data were accurate, complete, and current as of the close of the reopened negotiations or (if applicable) on another agreed-upon date.
- **Document Your Actions.** Whatever action you take, assure that it is clearly documented in the contract file.

Document Reliance on Cost or Pricing Data (FAR 15.406-3(a), 15.407-1(a), 15.407-1(b)(3), Conrac Corp., 78-1 BCA ¶12,985, Norris Industries, Inc., 74-1 BCA ¶10482, Aerojet Ord. Tenn.,
95-2 BCA ¶27,922, and Gen. Dynamics Corp., 93-1 BCA ¶25,378).

Your price negotiation memorandum must indicate what cost or pricing data you relied upon when negotiating contract price. Courts and BCAs have refused to support Government allegations of defective pricing when the contractor argued successfully that the Government did not rely on the defective cost or pricing data. The strongest evidence of reliance on cost or pricing data is a clear price negotiation memorandum.

- Reliance exists when you directly or indirectly use offeror cost or pricing data to establish a contract price or a contract price negotiation objective.
    - Direct reliance occurs when you use cost or pricing data obtained directly from the offeror's proposal.
    - Indirect reliance occurs when you use audits, cost estimates, should-cost studies, technical evaluations, or any other evaluations which in turn considered the contractor's cost or pricing data.
- Reliance is not limited by what you "should have known." For example, a contractor cannot argue that a careful comparison with another proposal by the company would have revealed an error.
- Reliance is not negated by offeror price reductions or concessions made in the give-and-take of negotiations,

unless the reduction or concession is specifically tied to updated cost or pricing data.
- Reliance does not exist if you knew, at the time of price agreement, that specific data provided by the contractor were not accurate, complete, and current. In fact, FAR requires you to notify the contractor if you learn prior to price agreement that the cost or pricing data are not accurate, complete, and current.

5.1 Identifying Possible Defective Pricing

Indicators That Cost or Pricing Data Are Defective (DCAM 14-117). You may uncover indicators of defective cost or pricing data during day-to-day operations or during reviews of contractor operations (e.g., technical reviews for negotiating other related contracts, purchasing system reviews, or contract performance reviews). Examples of situations that may raise your concern about possible defective pricing include:

- Incurred costs (either generally or in a particular category) seem to be running significantly less than projected.
- Operations included in the contractor's proposal are not actually performed in completing the contract.
- Direct cost items included in the proposal appear to be priced higher than they should be based on information available to the contractor (and not disclosed to the Government) at the time of contract price agreement.
- Data presented during later negotiations with the same company provide information that is significantly different from that presented in earlier negotiations.
- Data collected during market research for a subsequent contract are inconsistent with the certified data.
- Defective pricing is identified on related contracts.
- Operating budget plans (e.g., indirect cost budgets) contain data that are different from the data in the contract proposal.
- Labor-mix estimates do not include data on the actual labor mix on the same or similar contracts.
- Review of other proposals indicates that the value of the contractor's inventory was erroneously computed or the latest valuation was not reflected in the contractor's proposal.

- Estimating system reviews reveal deficiencies in procedures for identifying and submitting cost or pricing data.
- Contractor pricing personnel or negotiators informally state that they failed to follow contractor internal pricing policy or estimating and/or purchasing manual instructions.
- Technical review of contract performance indicates that quantity estimates were erroneous because the contractor did not use current product drawings or failed to read drawings correctly.
- Purchasing reviews indicate that the contractor did not submit available evaluations of vendor quotations or failed to reveal changes in its evaluations.
- Purchasing reviews indicate that purchase order cancellations were not disclosed to the Government.
- Later technical evaluations indicate that the contractor did not disclose projected increases in business volume that would affect current and projected overhead and general and administrative expense rates.
- Contract performance reviews indicate that the contractor duplicated cost estimates for the same task.
- The make-or-buy plan submitted with the proposal is significantly different than the plan being used in contract performance.
- New or revised production processes which will be used in contract performance were not disclosed.

Discuss Concerns with the Contractor. After contract award, investigate whenever you suspect that the data provided by the contractor or subcontractor were not accurate, complete, and current as of the close of negotiations or (if applicable) on another agreed-upon date.

To assure that you understand the situation, you may wish to contact the contractor to discuss your suspicions before contacting the cognizant auditor. During your discussions:

- Describe the data that you suspect are defective.
- Unless it would jeopardize the Government's position, describe the reasons that you suspect that the data are defective.

- Obtain the contractor's position on whether the cost or pricing data were accurate, complete, and current.

Document your suspicions and the results of your discussions with the contractor. Place a copy in the affected contract file(s).

Discuss Concerns with Auditor. If you are not satisfied with the contractor's position, you may wish to informally contact the cognizant auditor before requesting a defective pricing audit. A situation that appears suspicious may, in fact, result from using acceptable accounting and estimating practices.

Consider Defective Pricing Significance (FAR 15.407-1(b), 52.215-10, 52.215-11, DCAM 14-120.1, and Kaiser Aerospace & Electronics Corp., 90-1 BCA ¶22,489).

The FAR defective pricing clauses provide that the Government is entitled to remedies if a contract price was increased by any "significant amount," because the contractor provided cost or pricing data that were not complete, accurate, and current. However, it does not define what amount is significant.

One BCA found that the Government was entitled to a reduction of $5,000 even though that amount was only two-tenths of one percent of the contract price. The decision pointed out that the language of the Truth in Negotiations Act does not vest in a contractor the right to keep amounts obtained through supplying defective pricing data on the grounds that the amount so obtained was insignificant in relation to the overall contract price.

However, substantial resources are required to identify, pursue, and settle defective pricing allegations. Accordingly, you should consider the materiality of alleged defective pricing before you decide to pursue the allegation.

There are no universal Government policy on materiality, but DCAA provides one useful guideline. In DCAA potential price adjustments of less than five percent of contract price or $50,000, whichever is less, are normally considered immaterial and not pursued unless:

- A contractor's deficient estimating practices have resulted in recurring defective pricing; or
- The potential price adjustment is due to a system deficiency which affects all contracts priced during the period.

Request a Defective Pricing Audit (FAR 15.407-1(c)). If you still suspect that the contract price significantly increased because of defective cost or pricing data, request an audit to evaluate the accuracy, completeness, and currency of the cost or pricing data submitted by the contractor through the close of negotiations. As part of your request, provide the following information:

- Identify the data that you suspect are defective.
- Describe, in detail, your reasons for suspecting that the data are defective.
- Provide the auditor a copy of:
  - The PNM if one was not previously provided.
  - The final proposal index of cost or pricing data provided by the contractor.
  - Any cost or pricing data provided to the contracting officer to support the contractor's pricing proposal, but not previously provided to the auditor.
- If the auditor needs any additional information or support to complete the audit, you should provide it in a timely manner.

5.2 Developing The Government Position On Price Adjustment

Requirement for Prompt Audit Resolution (FAR 15.407-1, DODD 7640.2, and OMB Circular A-50).

The first step in developing a Government position on a price reduction for defective pricing is a post-award audit. Although the FAR requires contracting officers to request a Government audit when they suspect defective pricing, most audits that identify defective pricing are undertaken as part of a systematic agency audit program or defective pricing reviews conducted by the GAO and Inspectors General.

Regardless of why the audit was initiated or which organization performed the audit, Public Law and Office of

Management and Budget (OMB) guidance require audit resolution within six months of the date that the audit was issued. Resolution occurs when the Government prenegotiation objective on the defective pricing is documented and approved in accordance with agency requirements.

- For GAO audits resolution requires an agency response to Congress.
- For other defective pricing audits, resolution occurs when:
  - The audit organization and agency management or contracting officials agree on the Government's prenegotiation objective, or,
  - If the parties cannot agree, when the audit follow-up official determines the matter to be resolved.

Contractor agreement is not required to achieve audit resolution. A defective pricing audit report is considered resolved when the prenegotiation objective is approved even though the contractor still has the right to negotiate, appeal, or litigate the resolution.

Process for Developing a Prenegotiation Position (DODD 7640.2). Agency directives (e.g., Department of Defense Directive (DODD) 7640.2, Policy for Follow-up on Contract Audit Reports) provide detailed policy and procedural guidance for the resolution and disposition of specified audit reports. However, the table below delineates typical steps in a negotiated settlement of an alleged case of defective pricing. If a negotiated settlement cannot be reached, the process can take much longer.

Typical Schedule for a Negotiated Settlement		
Step	**Contracting Officer Action**	**Complete by Day**
1	Receive audit and initiate tracking.	5
2	Review the audit report and develop action plan.	10
3	Assemble related facts: • Request contractor comments and rebuttal, if any, to defective pricing allegations. • Review the PNM and other documents	75

	related to cost or pricing data submission and contract negotiation. • Consult with Government personnel involved in the negotiation process.	
4	Review the contractor's response: • Request audit comments on the contractor's rebuttal and any additional information uncovered during your review. • Request legal comments on the audit and the contractor's rebuttal. Include copies of all relevant documents in your request. • If new information is uncovered during your review, request additional contractor comments and rebuttal, if any.	135
5	Develop, Document, and Obtain Approval of Prenegotiation Objective (Agency Decision)	180
6	Conduct settlement discussions with the contractor.	240
7	Complete the adjustment: (Completion of Action) • Prepare the following documents: • Price negotiation memorandum. • Contract modification - if the contractor owes the Government money. (Make modification bilateral if agreement was reached, unilateral if agreement was not reached.) • Final decision if agreement was not reached. • Demand for payment. • Obtain necessary clearance reviews. • Distribute the appropriate documents to the parties involved.	300

Review the Audit Report. Assure that the audit report:

- References the correct cost or pricing data cutoff date for receipt of updated cost or pricing data. The "as of" date is crucial, not date of certificate execution.
- Reflects the use of the contractor's latest certified cost or pricing data as reconciled with the PNM, and that the auditor considered all cost or pricing data and updated proposals.
- Clearly demonstrates a causal relationship between the cost or pricing data defect and the increase in contract price.
- Specifically references the exact cost category of the contractor's proposal deemed defective.
- Considers any prime contract special provisions that control the method of pricing contract modifications (when applicable).
- Findings are not affected by:
    - Incomplete or undefined contractor nomenclature;
    - Information outside the scope of certified cost or pricing data (e.g., judgments that had been made by contractor personnel);
    - An unclear audit scope; or
    - Unsubstantiated statements or conclusions that are not specifically supported by the audit findings.

Immediately consult your legal counsel for assistance and direction if a defective pricing case appears to involve fraud. Hold all actions involving suspected fraud in abeyance pending receipt of legal advice and any required coordination with the Department of Justice.

Request Contractor Comments (FAR 15.407-1(d), DCAM 4-303.1, 4-304.3, and 14-122). DCAA and most other Government audit organizations discuss factual matters with contractors throughout the post-award audit process. They also generally request contractor comments on a draft copy of the audit report exhibits, explanatory notes, disputed documents, and other significant audit information prior to final audit release. If the contractor refuses to provide comments on a draft report, the auditor may even ask for contracting officer assistance in obtaining a response. Generally, the contractor's responses to audit findings and the auditor's comments on those responses are included in the final audit report.

Still, you should give the contractor one final opportunity to comment on the audit findings before you develop your prenegotiation objectives. Limit the data released to that used as a basis for the prime contract price reduction.

- If there is some reason that you are unable to release the entire audit report, provide the contractor with a detailed summary of key elements.
- If the defective pricing allegations relate to subcontractor data, provide information necessary to support a prime contract price reduction available to the prime contractor. Assure that you do not disclose subcontractor trade secrets or confidential business information.
- If the contractor requests a copy of the price negotiation memorandum (PNM), most agencies authorize contracting officer release of pertinent portions. However, you should consult your agency legal counsel to determine your authority for release and any conditions required for release.

Establish a reasonable date for contractor response (normally 30 days). The period for response may be extended if necessary, but you should always emphasize to the contractor that a timely and complete response is essential to timely disposition of the defective pricing allegations.

Review Information Available Within Government Resources. Review the PNM and other information available within Government resources related to cost or pricing data submission and contract negotiation. Weigh the audit findings against any other information identified.

- In particular, you should consider the documentation in the PNM. The PNM should provide essential information concerning the cost or pricing data submitted by the contractor and the reliance placed on that data in contract pricing.
- You may find documents that clearly support the position that the data were defective and significantly affected the negotiated price.
- You may find other documents with information indicating that the data were not defective, such as:
    - Additional proposal updates provided by the contractor during the course of negotiations (e.g., later purchase orders, more current labor

and overhead rates, or production techniques proposed by the contractor during negotiations).
    - Evidence indicating that the defective data did not have a significant effect on contract price because the contracting officer did not rely on it.
- Collect factual information and documentation from engineers, price analysts, production specialists, and others who may possess information on the preaward negotiation process that is not included in the contract file.

Review the Contractor's Response (FAR 15.407-1(b)(3), 15.407-1(d), Univ. of Cal., San Francisco, 97-1 BCA ¶28,642, and M-R-S Mfg. Co. v. U.S., 203 Ct.Cl. 551, 492 F.2d 35).

Review the contractor's response to identify areas of agreement and the contractor's rationale for any disagreement. If the contractor agrees with the audit findings, your task is easy. Occasionally, a contractor will even submit a check with its audit response. However, more often, the contractor will submit a rebuttal to the audit findings.

Obtain support as necessary from other members of the negotiation team. Support from the cognizant auditor and legal counsel can be particularly valuable.

Remember that the Government's right to a price adjustment is not affected by any of the following circumstances:

- The contractor or subcontractor was a sole-source supplier or otherwise was in a superior bargaining position.
- The contracting officer should have known that the cost or pricing data at issue were defective even though the contractor or subcontractor took no affirmative action to bring the character of the data to the attention of the contracting officer.
- The contract was based on an agreement about the total cost of the contract and there was no agreement about the cost of each item procured under the contract.
- The prime contractor or subcontractor did not submit a Certificate of Current Cost or Pricing Data relating to the contract.

Your review may raise additional questions concerning the contractor's position and related information that must be answered before you can begin to prepare your prenegotiation objectives. In fact, you may find it necessary to exchange questions and answers with the contractor several times before the true differences between the audit position and the contractor's position are clear. If all parties can agree on the facts, it should be much easier to dispose of the audit.

Price Adjustment Prenegotiation Objective (FAR 15.407-1(b), FAR Table 15-2, DCAM 14-116.2, Kaiser Aerospace & Electronics, 90-2 BCA ¶ 22,965, Sperry Corp. Computer Systems, 88-3 BCA ¶ 21,623, and McDonnell-Douglas Corp., 69-2 BCA ¶ 7897).

The cognizant contracting officer is responsible for determining the price adjustment, if any, due the Government as the result of the alleged defective pricing. If your position differs from the final position of the cognizant auditor, assure that you comply with your agency and local procedures for documentation and review procedures to achieve audit resolution.

If you believe that the data provided by the contractor were defective, you must determine what the price would have been if the data had not been defective. The difference is the price adjustment due the Government as a result of the defective pricing.

- **Establish A Price-Adjustment Baseline.** Your price-adjustment baseline should be the price supported by the defective cost or pricing data submitted by the offeror before the close of negotiation or another agreed-upon date. Draw information on the data submitted from the PNM and the last cost or pricing data index submitted by the contractor.
  - Normally, you should use the baseline calculated by the auditor and reported in the defective pricing audit. This audit should have been adjusted for any additional cost or pricing data submitted by the contractor up to the time of price agreement and any sweeps data submitted after price agreement but before contract award.
  - You may modify the audit baseline if you identify new data or interpret existing data in a manner other than that used by the auditor in preparing

the report. Normally, you should coordinate with the auditor before adopting an adjusted baseline to identify any pitfalls associated with your approach.
    - BCA decisions (e.g., Sylvania Elect. Products, 70-2 BCA ¶ 8387, affirmed 202 Ct. Cl. 16,479 F.2d 1342) have accepted baselines based on the amount negotiated when the facts of the case clearly demonstrated that the specific cost element was reduced from the proposed amount to the amount negotiated. However, you should not adjust a baseline based on general across-the-board price reductions because there is no way to determine if those adjustments were related to the specific costs involved.
- **Calculate A Dollar-for-Dollar Reduction.** Normally, you should calculate the price reduction amount using the difference between the analysis baseline and a comparable price based on accurate, complete, and current data for the negotiation period.
    - That dollar-for-dollar reduction assumes that the **natural and probable consequence** of defective pricing is a price increase equal to the amount of the data defect plus applicable overhead and profit/fee.
    - The contractor may question the dollar-for-dollar reduction alleging that the defective data did not create a dollar-for-dollar change in contract price. For example, the firm could present evidence indicating that the contracting officer used a method (e.g., a pricing formula) that was not affected by the defective data. If that happens and the case goes to a BCA or Court, you:
    - Must provide evidence that defective data led to a price increase and the amount of that increase.
- **Consider Special Rules For Reductions Related To Unused Subcontract Quotes** (FAR 15.407-1(f)(1)). Special treatment is required for situations where a prime contractor uses defective subcontractor data in its pricing proposal but does not award a subcontract to the proposed subcontractor.
    - If the prime contractor awards the subcontract to a lower priced subcontractor, any adjustment in the prime contract price due to defective subcontract data is limited to the difference (plus applicable indirect cost and profit/fee) between the subcontract quote used for pricing

the prime contract and the actual subcontract price (provided the data on which the actual subcontract price is based is not defective).
    - If the prime contractor performs the work in-house, any adjustment in the prime contract price due to defective subcontract data is limited to the difference (plus applicable indirect cost and profit/fee) between the subcontract quote used for pricing the prime contract and actual cost to the prime contractor.
- **Consider Offsets.** When one element of proposed cost is overstated because a firm based its proposal on defective data, another cost in the same proposal may be understated because the firm based its proposal on defective data. If a contractor claims an offset, you should request support from the cognizant auditor in evaluating that claim.
    - Allow an offset for any proposed costs that were understated because the firm based its cost proposal on defective data, up to the amount of the Government's defective pricing claim. In other words, the overall contract price must not increase because the contractor provided defective cost or pricing data.
    - Only allow an offset in an amount supported by the facts if the contractor:
    - Certifies that, to the best of the contractor's knowledge and belief, the contractor is entitled to the offset in the amount requested; and
    - Proves that the cost or pricing data were available before the date of agreement on price, but were not submitted.
    - Only allow an offset for understated cost elements in the same pricing action. The understated cost need not come from the same cost grouping (e.g., material, direct labor, or indirect cost).
    - Do not allow an offset if the:
    - Understated data were known by the contractor to be understated when the Certificate of Current Cost or Pricing Data was signed; or
    - The facts demonstrate that the price would not have increased in the amount proposed for offset even if the available data had been submitted before the date of price agreement or another agreed-upon date.

Interest Adjustment Prenegotiation Objective (FAR 15.407-1(b)(7)). In calculating the interest due:

- Determine the defective pricing amounts that have been overpaid to the contractor by the Government.
- Consider the date of each overpayment.
  - For subcontract defective pricing, use the date that payment was made by the Government to the prime contractor, based on the prime contract progress billings or deliveries, which included payments for a completed and accepted subcontract item.
  - For other defective pricing, use the date that payment was made by the Government to the prime contractor for the related completed and accepted contract items.
- Apply the underpayment interest rate(s) in effect for each quarter from the time of overpayment to the time of repayment, utilizing rate(s) prescribed by the Secretary of the Treasury. Remember that interest continues to accrue until repayment is made.

Penalty Prenegotiation Objective (FAR 15.407-1(b)(7)). The current contract clauses on price reduction for defective pricing require the contracting officer to assess a penalty for any overpayment that resulted from knowing submission of defective cost or pricing data under any Government contract. Prior to 1 October 1995, the penalty provision only applied to DoD contracts.

The contract clauses require you to set the penalty at an amount equal to the amount of the overpayment.

Obtain Objective Review and Approval (DODD 7640.2 and OMB Circular A-50). Before entering into discussions with the contractor, obtain all reviews and approvals required by FAR, agency, or contracting activity guidance. This action will normally meet the requirement for audit resolution.

Even if it is not specifically required, consider obtaining legal review before entering into discussions with the contractor on a defective pricing case.

5.3 Completing Settlement Action

Process for Completing the Settlement Action. After all the necessary reviews and approvals have been completed, you will be in a position to complete settlement action, including the following.

- Conduct settlement discussions with the contractor;
- Complete settlement documentation;
- Obtain necessary clearance reviews and approvals; and
- Distribute the appropriate documents to the parties involved.

Conduct Settlement Discussions (FAR 33.210). Conduct settlement discussions with the contractor to reach a bilateral agreement. If you believe it would benefit discussions, invite the cognizant auditor to participate in discussions.

In attempting to reach a settlement, do not:

- Make an agreement that precludes further defective pricing audit reviews on the same or other contracts.
- Make an agreement that is contingent upon settling defective pricing found in other contracts.
- Accept contractual goods or services on the same or other contracts as compensation for, or disposition of, a defective pricing case.
- Credit the amount of defective pricing in negotiating a concurrent or subsequent contract, including a follow-on contract.
- Adjust only one contract for defective pricing when the same defective pricing was cited on multiple contracts with the same contractor.
- Settle, compromise, pay, or otherwise adjust any claim involving fraud, or any claim or dispute for penalties or forfeitures prescribed by statute or regulation that another Federal agency is specifically authorized to administer, settle, or determine.

If you cannot reach agreement with the contractor, issue a contracting officer's final decision under the contract Disputes clause.

Complete Settlement Documentation (FAR 15.407-1(d) and 33.211). Documentation is required, no matter how successful you are in reaching a negotiated settlement. In addition to a copy of the defective pricing audit, any comments obtained from the contractor, other documents used

in preparing prenegotiation objectives, and prenegotiation objectives, assure that the contract file documentation includes, the price negotiation memorandum, a final decision (if necessary), a contract modification, and the demand for payment (if needed).

- **Defective Pricing Memorandum.** The pricing memorandum must include the following:
  - Your determination as to whether or not the submitted data were accurate, complete, and current as of the date certified and whether or not the Government relied on the data; and
  - The results of any contractual action taken.
- **Contracting Officer's Final Decision (if required).** The final decision must:
  - Describe the claim for defective pricing.
  - Reference the pertinent contract clause.
  - State the factual areas of agreement and disagreement.
  - State your decision with supporting rationale.
  - Include the paragraph at FAR 33.211(a)(4)(v) delineating the contractor's right to appeal.
  - Demand payment whenever the decision results in a finding that the contractor is indebted to the Government.
- **Price Reduction Contract Modification and Demand Letter.** If the contract price is reduced as a result of the alleged defective pricing, document the price reduction in a contract modification. If the amount due the Government exceeds the amount remaining on the contract, issue a demand letter to obtain the difference. Assure that the contract modification and any demand letter include the following information:
  - The repayment amount.
  - The penalty amount (if any).
  - The interest amount through a specified date.
  - A statement that interest will continue to accrue until the date repayment is made.

Obtain Clearance Reviews and Approvals. Before distributing documents related to the settlement, obtain any approvals required by agency or local guidance.

Distribute Documents (FAR 15.407-1(d)). Distribute the defective pricing memorandum as follows:

- Send one copy to the cognizant auditor.

- If the contract has been assigned for administration, send one copy to the ACO.
- Notify the contractor of your determination by providing the contractor a copy of the defective pricing memorandum, or by some other means.

Distribute other contractual documents as required by FAR and agency procedures.