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Chief Review Services Chef - Service d'examen

CRS  CS Ex

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Internal Audit: Subcontract Visibility

July 2010

7050-49 (CRS)



Canada 

## **Caveat**

Contractors have not been included in the scope of this audit as the focus is on Department of National Defence (DND) contract management processes. This audit represents a high level of assurance.



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## Acronyms and Abbreviations

ADM(Mat)	Assistant Deputy Minister (Materiel)
ADM(Fin CS)	Assistant Deputy Minister (Finance and Corporate Services)
CA	Contracting Authority
CFLA	Canadian Forces Legal Advisor
CRN	Client Reference Number
CRS	Chief Review Services
DAPPP	Director Accounts Processing, Pay and Pensions
DCC	Defence Construction Canada
DGMSSC	Director General Materiel Systems and Supply Chain
DMPP	Director Materiel Policy and Procedures
DND	Department of National Defence
DoD	Department of Defense
FAA	<i>Financial Administration Act</i>
GFE	Government Furnished Equipment
Gov	Government
GSM	Government Supplied Material
GST	Goods and Services Tax
HST	Harmonized Sales Tax
OPI	Office of Primary Interest
PAM	Procurement Administration Manual
PBN	Procurement Business Number
PWGSC	Public Works and Government Services Canada
QAR	Quality Assurance Representative
RA	Requisitioning Authorities
SACC	Standard Acquisition Clauses and Conditions
T&C	Terms and Conditions
T&M	Time and Material
US	United States
WBS	Work Breakdown Structure



## Synopsis

Observations regarding billings and having sufficient supporting documentation to certify payments for subcontract-related work were made in prior Chief Review Services (CRS) contract management audits. As a result, CRS undertook an audit of subcontract visibility to assess the adequacy of controls to manage contracts with significant subcontract work.

Government-wide procurement policy for subcontract invoice submission and payment certification requires greater clarification with respect to the visibility of subcontract-related work. As a result, instances were observed where supporting documentation provided to DND was not sufficient to support subcontract-related charges. This shortfall is partly due to many contracts not having invoicing terms and conditions that require the vendor to provide DND with subcontract-related supporting documentation.

Although DND may provide input on invoicing terms and conditions for subcontract-related work, it is the mandate of Public Works and Government Services Canada (PWGSC) to specify in the contracts what supporting documentation is to be provided. Otherwise, the contractor is under no obligation to provide this supporting documentation if it is not specified in the contract. Regarding the post-verification of payments, standard acquisition clauses provide access to vendor information which is not specified in the invoicing instructions. However, these clauses only permit the PWGSC contracting authority to request this information on behalf of DND.

The management action plans provided by the Assistant Deputy Minister (Materiel) (ADM(Mat)) are sound. Increased communication between DND and PWGSC will facilitate changes in the PWGSC supply manual needed to ensure increased visibility of subcontract costs.

Plans to include subcontractor visibility in contract management certification training will improve the rigor of the payment verification process. As well, in the long term there will be more firm fee performance based payments for in-service support contracts. This new basis of payment will reduce the need for visibility of subcontract costs. CRS will monitor progress made in implementing the management action plans and will undertake an audit follow-up if warranted.



## Results in Brief

Since 2005, several CRS contract management audits have raised concerns regarding billings for subcontract work. An analysis<sup>1</sup> of 8,932 active contracts was conducted to identify other DND contracts tendered by PWGSC with significant subcontract work.

Sixty-two contracts worth \$19.2 billion were identified that represented 75 percent of the Department's contract obligations. On average the subcontract value represented as much as 35 percent of the prime contract value.<sup>2</sup> Approximately 69 percent of these contract obligations were unspent at the time of audit.

### Overall Assessment

Improvements in the policy for subcontract terms and conditions (T&C) and its application are needed as a framework for payment certification controls.

The audit objective was to assess the adequacy of controls in place to manage contracts with subcontract work.

## Findings and Recommendations

### Policy on Subcontract Visibility

Government contracting policy does not specify the level of visibility and accessibility of supporting documentation needed to substantiate amounts claimed by prime contractors for subcontract work. Because no policy requires the vendor to submit supporting documentation for subcontract-related work, other than what is clearly specified in the contract, DND does not always have visibility of subcontract-related charges when certifying invoices for payments.

The T&Cs for nearly one-third of the 62 contracts reviewed do not provide DND access to sufficient supporting documentation for subcontract-related work. It is at the discretion of the PWGSC contracting authorities (CA) as to whether or not the contract specifies what supporting documentation will be required prior to DND's certifying that a payment is in accordance with Section 34 of the *Financial Administration Act* (FAA). If such a requirement is not clearly stated, the contractor is under no obligation to submit supporting documentation for subcontracted work. The PWGSC CA's inclusion of specific T&Cs for subcontract work would maximize the likelihood of DND's receiving value for subcontract-related work.

<sup>1</sup> CRS Analysis of Contracts, October 2009.

<sup>2</sup> Estimated total subcontract values range between 30 percent and 49 percent: 30 percent based on the median value of a sample of contracts with available subcontract information, and 49 percent based on the median of the United States (US) Department of Defense (DoD) subcontract values from 2003 to 2008.



Standard acquisition clauses and conditions (SACC) for audit, inspection and examination of vendor records state that examination can only be performed by a representative approved by the Minister of PWGSC.<sup>3</sup> These SACCs, and the absence of subcontract invoicing T&Cs, limit DND's ability to obtain sufficient subcontract documentation necessary to support payment certification prescribed by Section 34 of the FAA.

It is recommended that a risk-based invoicing T&Cs policy be proposed to PWGSC for inclusion in the PWGSC supply manual to ensure that subcontractor costs can be clearly substantiated.

### **Invoicing Terms and Conditions**

Not all DND contracts tendered by PWGSC included invoicing instructions with specific supporting documentation to support subcontract work. For the most part, 23 sole-source contracts were necessary to respect the intellectual property rights associated with in-service support of combat systems. Of the sole-source or time and material (T&M) contracts included in our sample size of 62, 17 did not require sufficient and relevant supporting documentation in order to certify payments for subcontract work.

It is recommended, where cost effective, that DND requisitioning authorities (RA) request PWGSC to amend invoicing T&Cs for contracts that require more visibility of subcontract costs.

In the future, major combat system in-service support contracts will be performance based with firm fee payments. As a result, most payments will not require the same degree of subcontract visibility.

### **Payment Certification**

For eight contracts that did specify sufficient documentation to substantiate subcontract costs, more documentation should have been obtained to properly certify whether prices charged were in accordance with the contract.

It is recommended that for contracts with invoicing instructions for subcontract work, DND contract managers improve the rigor of payment certification with risk-based sampling of subcontract costs.

### **Application of Subcontract Management Terms and Conditions**

T&Cs relating to subcontract management by the prime contractor to mitigate risks to the Crown were not consistently included in DND contracts tendered by PWGSC. For example, 14 task authorization contracts did not include a requirement for the prime to launch a competitive process to obtain the best value for future subcontracts. To assess issues such as security clearance requirements, affiliated vendors, and intellectual

<sup>3</sup> For PWGSC-tendered contracts, the CA is a member of PWGSC.



property rights, subcontractors need to be identified. However, only 21 prime contracts included a requirement for a work breakdown structure (WBS) in the principal subcontracts.

It is recommended that the DND Procurement Administration Manual (PAM) be augmented to enhance subcontract management guidance for DND, that T&Cs input be provided into contracts tendered by PWGSC, and that a subcontract T&Cs checklist be included in the PWGSC supply manual.

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**Note:** For a more detailed list of CRS recommendations and management response, please refer to [Annex A](#)—Management Action Plan.

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## Introduction

### Background

Since 2005, CRS has completed eight contract management audits. On average, the subcontract charges for these eight prime contracts amounted to 28 percent of the contract value. There were several audit observations regarding the sufficiency of supporting documentation to certify payments for subcontract-related work. To address this concern, the Assistant Deputy Minister (Finance and Corporate Services) (ADM(Fin CS)) issued direction in 2005 regarding the examination of subcontract invoices prior to payments.<sup>4</sup>

#### Review of Subcontract Invoices

In February 2005, ADM(Fin CS) directed the review of all subcontract invoices for payments in excess of \$250,000.

CRS recently completed an analysis of contracts in 2009 that identified PWGSC-tendered contracts that included a significant amount of subcontract work. These contracts represented approximately 75 percent of all DND contract obligations.

### Objective

To assess the adequacy of controls in place to manage contracts with significant subcontract-related work.

### Scope

- 62 DND contracts worth \$19.2 billion tendered by PWGSC with significant subcontract work.
- On average, the value of subcontract work was approximately 35 percent.
- 80 percent of the sampled contracts were awarded to firms located in Canada.
- Contracts tendered by Defence Construction Canada (DCC) were not included.

### Methodology

- CRS survey of 62 contracts RAs;
- Review of 62 contracts, progress claims, supporting documentation and progress reports;

<sup>4</sup> 7000-1 (DAPPP/Accounts Processing), 15 February 2005 memo to ADM(Mat).



- Categorization of the audit sample, based on:
  - Tendering process—competitive or sole source,
  - Type of payment—firm price or T&M,<sup>5</sup>
  - Type of deliverable—goods or services;
- Interview of 16 RAs based on subcontract risk.

### **Criteria**

- The audit criteria are outlined in [Annex B](#).

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<sup>5</sup> The T&M category was used for fixed-time rate and cost-reimbursable contracts. No contracts in the audit sample were cost reimbursable with a ceiling price.



## Findings and Recommendations

### Procurement Policy for Subcontract Visibility

Government-wide contracting policies could be strengthened to increase the level of visibility and accessibility of supporting documentation needed to substantiate payments for subcontract work.

**Visibility of Subcontracts.** There is no government-wide contracting policy that provides guidance on the need for subcontract terms of payment in a prime contract or the level of supporting documentation necessary for DND to certify payments under FAA Section 34 for subcontract work. Even though the Crown allows for a subcontract markup, current policy does not specify the necessary supporting documentation to break out subcontract charges for items such as labour, materiel, and taxes.

Although DND may provide input on invoicing T&Cs for subcontract-related work<sup>6</sup> it is the mandate of the PWGSC CA to specify subcontract T&Cs in the contract and what documentation is needed to satisfy the FAA Section 34 requirement that “the price is according to the contract.” Most contracts in the audit sample included the 15-day limitation to notify the vendor that more information would be necessary to support a payment. However, for 15 percent of the contract sample the invoice instruction was to only provide a copy to the PWGSC CA. This reduces the amount of time DND has to assess whether charges are supportable to certify a payment.

**PWGSC Procurement Policy.** Government-wide procurement policy is a mandate of PWGSC. The PWGSC policy regarding subcontract visibility is focused on the contract award process to address price justification,<sup>7</sup> exchange rates,<sup>8</sup> vendor affiliations,<sup>9</sup> subcontract value and profits.<sup>10</sup>

Since January 2010, CAs are no longer required to have copies of prime contractor’s subcontract.<sup>11</sup> This will make it more difficult for CAs to assist in subcontract invoice verification to certify that progress claims are in accordance with the contract. Although a DND signature is necessary for Section 34 FAA certification, the PWGSC policy still considers it a dual responsibility.<sup>12</sup> The need to clarify the accountability for payment certification still exists.<sup>13</sup>

<sup>6</sup> PWGSC Supply Manual, Chapter 1, Annex 1.2, code 4.3.1.

<sup>7</sup> SACC 2004, 2003.

<sup>8</sup> PWGSC Supply Manual, Chapter 7, Article 7E.574.

<sup>9</sup> PWGSC Supply Manual, Chapter 7, Article 10:131-132.

<sup>10</sup> SACC 9601, 2030, 2035.

<sup>11</sup> PWGSC Supply Manual, Chapter 11, Article 11.068 (12 December 2008); omitted from PWGSC Supply Manual (4 January 2010).

<sup>12</sup> PWGSC Supply Manual, Chapter 1, Annex 1.2, code 5.8.6.

<sup>13</sup> CRS Internal Audit, Light Armoured Vehicles Life Cycle Support Contract, January 2006.



To enable DND to obtain information needed to support payments, procurement policy needs to provide risk-based guidance on subcontract terms of payment and the type of supporting documentation needed in higher-risk obligations such as sole-source or T&M contracts. The risk-based logic used in this audit is demonstrated in Annex C and could be used as a guide to determine necessary supporting documentation for subcontract work.

**Accessibility of Supporting Documentation.** The invoicing T&Cs for one quarter of sample contracts reviewed in this audit did not provide DND access to sufficient subcontract supporting documentation needed to perform payment certification. The most common SACCs in the audit sample, SACC 9601, now superseded by SACC 2030 and 2035, do not clearly address access to subcontractor supporting documentation necessary for invoicing.

- As shown at Annex D SACC 9601, 2030 and 2035, the invoice payment instruction only requires supporting documentation that is specified in the contract. If the specified supporting documentation is not provided, the vendor should be notified within 15 days of the receipt of the invoice.
- These three SACCs contain the “Accounts and Audit” clause requiring the contractor to keep accounts and records for all expenditures under the contract for a period of six years. This clause is applied after payments have been made, and overcharges identified through post-verifications may be received as a credit in subsequent invoices. <sup>14</sup>
- SACC 2030 and 2035 invoicing instructions are more restrictive than SACC 9601 regarding access to supporting documentation.<sup>15</sup> As well, two other optional SACCs that are used to specify supporting documentation do not include subcontract invoices.<sup>16</sup>
- Similar to these three SACCs, the DND PAM also requires that supporting documents be provided as specified in the contract.<sup>18</sup>

<sup>14</sup> |

<sup>15</sup> The reference to subcontract expenditures does not require individual subcontract invoices.

<sup>16</sup> PWGSC Supply Manual 4.70.50 SACC H3022C, H3020C. Invoices for direct costs do not include subcontract labour according to SACC 1031-2.

<sup>17</sup> |

<sup>18</sup> DND PAM, Chapter 5—Control Procurement, 5.6.3 (d).



- According to PWGSC procurement policy, SACCs are not usually included in major Crown contracts.<sup>19</sup> For two major Crown contracts in the audit sample, the audit clause stipulated that only Audit Services Canada would be considered as a representative of Canada to perform audits, inspections and examinations.<sup>20</sup> This clause limits access by DND and PWGSC to only those supporting documents specified in the contract.
- |||||  
 |||||  
 |||||<sup>21</sup>

These SACCs do not enable DND to obtain sufficient subcontractor related supporting documentation to certify that payments are in accordance with the contract without the cooperation of the PWGSC CA and the vendor. The DND responsibility for payment certification can be carried out only if the contract specifies the necessary supporting documentation, or the Minister of PWGSC appoints DND as a representative to exercise the SACC audit clause.

**Recommendation**

To ensure visibility of subcontract costs, it is recommended that DND propose a supplementary risk-based invoicing T&Cs policy to PWGSC for inclusion in the PWGSC supply manual and a standard clause for T&M subcontractor supporting documentation.  
**OPI:** ADM(Mat)/DGMSSC/DMPP

<sup>19</sup> Procedures for Using the Departmental Standard Procurement Templates (2T-PROC 1), Higher Complexity Goods.

<sup>20</sup> |||||

<sup>21</sup> |||||

## Invoicing Terms and Conditions

At the discretion of PWGSC, DND contracts tendered by PWGSC do not always include subcontract-related T&Cs and specific invoicing instruction for vendors to provide supporting documentation sufficient to certify payments for subcontract work.

Although DND may provide input to PWGSC-tendered contracts as part of the requisition process, the final content of the contract, with respect to subcontract basis of payment and invoicing instructions, is at the discretion of the PWGSC CA. Not all of the sole-source and T&M contracts highlighted in Table 1 included T&Cs requiring visibility of subcontract costs. Seventeen of these contracts did not specify the supporting documentation needed to sufficiently support payment certification. It was observed that contract awards for in-service support are often sole-source to respect the intellectual property rights of the original equipment manufacturer of combat systems. There are inherent risks associated with payments that involve subcontract cost for sole-source and T&M contracts that have been addressed in recent CRS contract management audits.

### Supporting Documents

In spite of the absence of invoicing T&Cs for subcontract work, DND contract managers were successful in obtaining supporting documents for one contract.

Basis of Payment	Sourcing Strategy	Nature of Contract	Count	Percent Subcontract Value
Firm Price	Competitive	Goods	10	9%
		Service	4	25%
	Sole Source	Goods	2	25%
		Service	3	50%
T&M	Competitive	Goods	-	-
		Service	20	45%
	Sole Source	Goods	2	54%
		Service	16	22%
<b>Total</b>			57 <sup>22</sup>	

**Table 1. Audit Sample.** The highlighted rows illustrate that 43 of the 57 contracts are either sole-sourced (5 firm price, 18 T&M) or T&M competitive bid contracts (20). The estimated subcontract value was based on information provided by DND contract managers—a conservative estimate compared to the past five years of subcontract values for US defence contracts that averaged 49 percent of total contract obligations.<sup>23</sup> Contract awards for in-service support are often sole-source to respect the intellectual property rights of the original equipment manufacturer of combat systems.

<sup>22</sup> Five contracts with no subcontracting work were excluded from further analysis, as portrayed in [Annex C](#).

<sup>23</sup> DoD Program Goals and Statistics, Fiscal Year 2003-2008, accessed on 26 November 2009.



**Obtaining Supporting Documentation.** Contracting policy requires that procurement files be established and structured to facilitate management oversight with a complete audit trail.<sup>24</sup> DND procurement authorities indicated that they made several requests to the PWGSC CAs and/or the contractor(s) for subcontract supporting documentation. Although this documentation was necessary for payment certification, as well as contract oversight, the contract T&Cs did not specify the required supporting documents. Accordingly, in some cases, certain defence contractors did not provide the additional information.

Although current contract invoicing instructions may not be sufficient, DND's PAM states that DND procurement officers are responsible, on receipt of a PWGSC contract, for ensuring there are no errors or omissions and that appropriate clauses are included.<sup>25</sup> When requesting the PWGSC CA to consider contract amendments, the costs associated with the request for more supporting documentation can be considered excessive. A request for more vendor documentation, however, should not generate any additional significant costs to the Crown as invoices are simply a summary of the subcontract cost records held by the prime contractor.

**Performance Based Contracts.** In the future, in-service support contracts for combat systems will be performance based. Most payments will be negotiated or competitively tendered firm fees linked to the usage of the combat system. Performance incentives will be based on the availability of the combat system. Therefore, there will be much fewer T&M payments that require subcontract visibility.

### Recommendation

Where cost effective, it is recommended that DND RAs request PWGSC to amend invoicing T&Cs for contracts that require more visibility of subcontract costs. For future contracts, such as sole-source and T&M, contracts should require greater subcontract visibility.

**OPI:** ADM(Mat)/DGMSSC/DMPP

<sup>24</sup> PWGSC Supply Manual, Chapter 8—Contract Management, Section 8.5 (c).

<sup>25</sup> PAM, Chapter 4—Execute Procurement, Section 4.2.3.2—PWGSC Contracts Award Process, 4.2.3.2.1.



### Payment Certification

For some contracts with specific invoicing instructions to substantiate subcontract costs, more supporting documentation is required.

**Supporting Documentation.** DND finance<sup>26</sup> and procurement<sup>27</sup> policy requires procurement authorities to ensure that all documentation specified in the contract to support the payment is included with the payment request, such as timesheets, progress reports, and invoices. This supporting documentation is to be reviewed prior to payment certification.

For some contracts with specific instructions to substantiate subcontract costs, the DND RAs did not ensure that all invoicing instructions were satisfied prior to payment. In a review of the 26 contracts that specified a requirement for subcontract supporting documentation, eight contracts did not have the required supporting documentation as outlined in the invoicing instructions.

**Missing Information.** Analysis of the sample contracts showed the following information was not available for the eight contracts where payments did not have sufficient supporting documentation:

- Monthly progress reports to verify that services or goods have been delivered;
- Copies of subcontractor invoices; and
- Copies of subcontracts (for the contracts with subcontract work in the audit sample, CAs were in possession of only two subcontracts).

|||||<sup>28</sup> Although DND certifies the payment of progress claims, this cannot be done for PWGSC-tendered contracts without the assistance of the PWGSC CA.

**Contracts Requiring Subcontract Supporting Documentation.** Although it was observed that 29 contracts specified supporting documentation for subcontract costs, four were relatively low risk:

- Two contracts were competitively tendered firm-price goods; and
- Two contracts were competitively tendered firm-price service contract.

### Recommendation

For contracts with subcontract visibility T&Cs, DND contract managers should improve the rigour of payment certification with risk-based sampling of subcontract costs.

**OPI:** ADM(Mat)/DGMSSC/DMPP

<sup>26</sup> Financial Administration Manual, Chapter 1016-3—Account Verification—FAA Section 34, page 4.

<sup>27</sup> PAM, Chapter 5—Control Procurement, Invoice/Process Claim Review—Process, Section 5.6.3 (e).

<sup>28</sup> |||||



## Application of Subcontract Management Terms and Conditions

Consistent application by PWGSC, of subcontract management T&Cs in prime contracts would minimize risks to the Crown.

Prime contract T&Cs relating to subcontractor management were not consistently included in the audit sample of DND contracts tendered by PWGSC. For major Crown projects with a co-located PWGSC CA, DND input on contract T&Cs is given greater consideration. Although many contracts had a similar sourcing and deliverable strategy, they differed significantly with respect to the T&Cs applicable to subcontract management.

There are several significant subcontract T&Cs identified in the audit sample that would have reduced risk exposure and helped ensure better value for money for the Crown if they had been included in all applicable contracts. A T&Cs benchmark of contracting practices in other governments and industry found that DND subcontract T&Cs, when applied, were more stringent than the private sector and the allies, with the exception of the US (see [Annex E](#)).

**Competitive Subcontracting.** Where applicable, incorporating T&Cs that require the competitive tender of subcontracts provides a higher level of assurance that the Crown receives good value. Of the 62 contracts in the audit sample, 26 did not have a competitive process requirement for subcontract work that would evolve from tasks within the contract scope. This is of particular concern for those contracts that have a T&M basis of payment. New tasks that are defined during the life of the contract will not benefit from the competitive tendering process performed at the time of the original contract award.

**Breakdown of Work by Subcontract.** For T&M contracts, increased awareness of subcontractor work by task or WBS would enhance the oversight of the prime contract. A requirement to have the prime contractor identify subcontractors allows the Crown to identify security requirements, intellectual property issues, vendor affiliations, foreign exchange adjustments and subcontractors with a history of poor performance. WBS estimates would also identify those subcontractors who perform more than the 40 percent limitation of the prime contract value, a mandatory requirement for all contracts.<sup>29</sup> Sixty-three percent of the applicable contracts in the audit sample did not include this clause that requires WBS to include subcontract work.

### Subcontract Management Best Practices Observed

- Subcontractor Management Plan required from the contractor.
- An intracompany/intercompany subcontract profit limitation.
- Subcontract breakdown with estimated expenditure and responsible subcontractor listing.
- Subcontractor value threshold for CA notification.
- Mark-up on subcontract work laid-down cost for tasks arising during the contract period.

<sup>29</sup> SACC 2030, 2035, 9601.



**Subcontract Terms of Payment.** Ensuring T&Cs that require subcontractor basis of payment allows DND to verify that subcontractor prices are in accordance with the contract. FAA Section 34 payment certification requires prices not specified in the contract to be fair and reasonable. There were seven contracts in the audit sample that did not incorporate subcontract terms of payment.

**Annual Cost Submission.** To ensure that the final price paid for contracted goods or services represents a reasonable price for cost reimbursable portions of work,<sup>30</sup> the PWGSC supply manual requires that the contractor submit an annual cost submission that includes a breakdown of subcontractor costs.<sup>31</sup> For repair and overhaul contracts, the cost submission clause is mandatory but the CA or audit agency may determine whether a cost submission must be provided.<sup>32</sup> It was observed that 25 contracts in the audit sample did not require a cost submission report from the contractor to provide costing details at the subcontractor level. This subcontract information can assist the CA in planning for an audit of the contract.

**Earned Value Reporting.** Earned value reports provide a contract manager insight into the cost and progress of the overall work and each element of the WBS. A Cost Performance Index report is particularly useful for sole-source contracts or sole-sourced subcontract work to ensure actual costs to the vendor are not so low that profits may exceed the negotiated profit margins. Although most defence contractors use an earned value system for cost schedule control, only three contracts in the audit sample required earned value reporting.

### Recommendation

It is recommended that the DND PAM be augmented to enhance subcontract management guidance for DND, that T&Cs input be provided into contracts tendered by PWGSC, and that a subcontract T&Cs checklist be included in the PWGSC supply manual.

**OPI:** ADM(Mat)/DGMSSC/DMPP

<sup>30</sup> PWGSC Supply Manual, Chapter 4, 4.70.20.35 (e).

<sup>31</sup> SACC C0300C and PWGSC Form 7953.

<sup>32</sup> PWGSC Supply Manual, Chapter 4, 4.70.20.35 (f).



## Annex A—Management Action Plan

### Policy

#### CRS Recommendation

1. To ensure visibility of subcontract costs, it is recommended that DND propose a supplementary risk-based invoicing T&Cs policy to PWGSC for inclusion in the PWGSC supply manual and a standard clause for T&M subcontractor supporting documentation.

#### Management Action

A copy of the audit report and a request for PWGSC to develop appropriate policies and clauses will be sent to PWGSC. The letter will highlight the need for visibility of subcontract costs in T&M type contracts to permit certification of invoices and progress claims, as well as providing suggestions for changes to their Supply Manual. Internally, the PAM will be amended to include the requirement for requisitions to PWGSC to identify the need for subcontract data where appropriate.

Draft changes to the PAM and send correspondence to PWGSC by 30 October 2010.  
Promulgation of changes to the PAM by 31 March 2011.

**OPI:** ADM(Mat)/DGMSSC/DMPP

**Target Date:** 31 March 2011

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### Invoicing Terms and Conditions

#### CRS Recommendation

2. Where cost effective, it is recommended that DND RAs request PWGSC to amend invoicing T&Cs for contracts that require more visibility of subcontract costs. For future contracts, such as sole-source and T&M, contracts should require greater subcontract visibility.

#### Management Action

The correspondence associated with Recommendation # 1 will advise that amendments to current contracts may be requested following an in-house review. Additionally, the divisions will be requested to review these files to determine if it is cost effective to request an amendment asking for subcontract data. Future contracts will be addressed as part of the action associated with Recommendation # 1.

**OPI:** ADM(Mat)/DGMSSC/DMPP

**Target Date:** 30 August 2010

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## **Payment Certification**

### **CRS Recommendation**

3. For contracts with subcontract visibility T&Cs, DND contract managers should improve the rigour of payment certification with risk-based sampling of subcontract costs.

### **Management Action**

The divisions responsible for the eight contracts already in place that identify the need for supporting subcontracting data will be reminded that invoices should not be certified without such information being provided. The overall rigour of payment certifications where subcontracting activities apply will be addressed in changes to the PAM particularly as they apply to high value, non-competitive, non-firm fixed price contracts.

A listing of the eight contracts of concern will be provided to the divisions concurrent with the distribution of the final audit report (estimated 30 August 2010). The recommended changes to the PAM will be drafted and translated.

**OPI:** ADM(Mat)/DGMSSC/DMPP

**Target Date:** 31 March 2011

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## **Application of Subcontract Management Terms and Conditions**

### **CRS Recommendation**

4. It is recommended that the DND PAM be augmented to enhance subcontract management guidance for DND, that T&Cs input be provided into contracts tendered by PWGSC, and that a subcontract T&Cs checklist be included in the PWGSC supply manual.

### **Management Action**

Changes to the PAM, including a possible new T&C, will be drafted. The focus will be on those contracts that involve an anticipated large subcontract role and where the pricing is not firm fixed price. The possible development of a T&C checklist for PWGSC is part of the correspondence mentioned in Recommendation # 1.

Draft changes to the PAM with a follow-on translation.

**OPI:** ADM(Mat)/DGMSSC/DMPP

**Target Date:** 31 March 2011

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## Annex B—Audit Criteria

### Objective

To assess the adequacy of controls in place to manage contracts with significant subcontract work.

### Criteria Assessment

Level 1 (Satisfactory); Level 2 (Needs Minor Improvement); Level 3 (Needs Moderate Improvement); Level 4 (Needs Significant Improvement); Level 5 (Unsatisfactory)

### Governance

1. **Criteria.** Roles and responsibilities with regards to subcontract oversight are articulated in policies and followed (Core Management Controls: AC1, AC3, AC4, ST5).

**Assessment. Level 4**—Guidance and policy for subcontracting invoice submission for Section 34 certification is not clear with respect to visibility necessary for subcontract billings and DND access to supporting documentation.

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### Control

2. **Criteria.** Controls with appropriate contract terms and conditions are in place to minimize risks to the Crown associated with subcontracts (Core Management Controls: AC1, ST13, ST10, ST5).

**Assessment. Level 4**—Subcontracting T&Cs have not been used consistently for applicable contracts to minimize risks to the Crown.

3. **Criteria.** Value for money controls are in place for subcontracting in sole-source contract or competitive T&M contract.

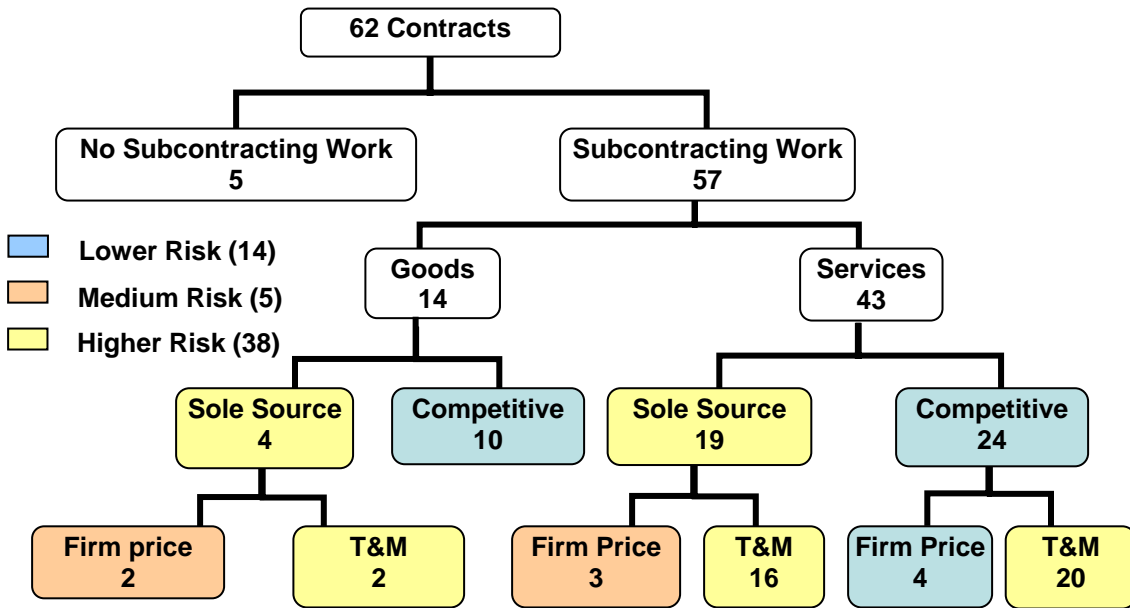
**Assessment. Level 3**—Competitive tendering for arising subcontract work, discretionary audit clauses, inclusion of subcontract rates and basis of payment were not commonly applied to higher risk contracts such as sole-source and T&M contract.

4. **Criteria.** Sufficient reporting on subcontract work is available to assess the project actual and reasonable costs.

**Assessment. Level 4**—Insufficient supporting documentation for subcontract cost verification for subcontract work worth \$180 million; lack of subcontract work reporting due to insufficient subcontract management T&Cs and no linkage of subcontract work to contract WBS; key subcontract deliverables such as a copy of subcontract or subcontract management plan were not obtained from the prime vendor.



## Annex C—Risk Logic Chart



**Figure 1. Audit Risk Logic Chart.** Sixty-two contracts identified in the CRS *Analysis of Contracts* were broken down into two categories based on whether or not they contained subcontracting work. Those with subcontract work were then classified based on nature of the product being procured (good or service). Each classification was analyzed and risk-rated based firstly on their sourcing strategy and secondly on the associated basis of payment.

This flowchart outlines the 62 contracts that were identified in the CRS *Analysis of Contracts*. These contracts were broken down into two categories based on whether or not they contained subcontract work: No Subcontract Work = 5 and Subcontract Work = 57. Those with subcontract work were the focus of this audit.

The following list, based on the nature of product procured, outlines the associated contract risk category for each of the 57 contracts identified as having subcontract work. A risk level was initially assigned based on the sourcing strategy of the contract and then subsequently categorized based on the contract’s basis of payment.

1. **Nature of Contract:** Goods–14;
  - a. **Sourcing Strategy:** Sole-Source–4 (High Risk)
    - i. **Basis of Payment:** Firm Price–2 (Medium Risk)
    - ii. **Basis of Payment:** T&M–2 (High Risk)
  - b. **Sourcing Strategy:** Competitive–10 (Low Risk)



2. **Risk Category:** Services–43;
  - a. **Sourcing Strategy:** Sole-Source–19 (High Risk)
    - i. **Basis of Payment:** Firm Price–3 (Medium Risk)
    - ii. **Basis of Payment:** T&M–16
  - b. **Sourcing Strategy:** Competitive–24 (Low Risk)
    - i. **Basis of Payment:** Firm Price–4 (Low Risk)
    - ii. **Basis of Payment:** T&M–20 (High Risk)



## **Annex D—Excerpts from SACCs**

### **9601 14 (1994-01-04) Payment**

1. Notwithstanding any other provision of the Contract, no payment shall be made to the Contractor unless and until:
  - a. An invoice, inspection notes, certificates and any other documents required by the Contract have been submitted in accordance with the terms of the Contract and the instructions of the Minister;
2. The Minister shall notify the Contractor, within 15 days of receipt of an invoice, of any inadequacy of the invoice or of the supporting documentation, and where any such notice is given within that period the date for payment of the amount invoiced shall be postponed until the Contractor remedies the inadequacy to the satisfaction of the Minister.

### **9601 28 (1994-01-04) Accounts and Audit**

1. The Contractor shall keep proper accounts and records of the Cost to the Contractor of the Work and of all expenditures or commitments made by the Contractor in connection therewith, and shall keep all invoices, receipts and vouchers relating thereto. The Contractor shall not, without the prior written consent of the Minister, dispose of any such accounts, records, invoices, receipts or vouchers until the expiration of six (6) years after final payment under this Contract, or until the settlement of all outstanding claims and disputes, whichever is later.
2. All such accounts and records as well as any invoices, receipts and vouchers shall at all times during the retention period referred to in subsection 1 be open to audit, inspection and examination by the authorized representatives of the Minister, who may make copies and take extracts thereof.

### **9601 39 (2007-05-25) Invoice Submission**

Invoices must be submitted in the name of the Contractor. They must show the name and address of the client department, item/reference number, deliverable and/or description of Work, contract serial number, Client Reference Number (CRN), Procurement Business Number (PBN) and financial code(s). If applicable, the method of shipment together with date, case numbers and part or reference numbers, item, quantity, unit of issue, unit price, and additional charges will be shown on the invoice. If applicable, fixed time labour rates and level of effort and, the amount invoiced (exclusive of the GST or HST as appropriate), will be shown separately.





## **General Conditions—2030, 2035**

### **Invoice Submission**

1. Invoices must be submitted in the Contractor's name. The Contractor must submit invoices for each delivery or shipment; invoices must only apply to the Contract. Each invoice must indicate whether it covers partial or final delivery.
2. Invoices must show:
  - a. the date, the name and address of the client department, item or reference numbers, deliverable and/or description of the Work, contract number, Client Reference Number (CRN), Procurement Business Number (PBN), and financial code(s);
  - b. details of expenditures in accordance with the Basis of Payment, exclusive of Goods and Services Tax (GST) or Harmonized Sales Tax (HST) (such as item, quantity, unit of issue, unit price, fixed time labour rates and level of effort, subcontracts, as applicable);
  - c. deduction for holdback, if applicable;
  - d. the extension of the totals, if applicable; and
  - e. if applicable, the method of shipment together with date, case numbers and part or reference numbers, shipment charges and any other additional charges.

### **Payment Period**

If the content of the invoice and its substantiating documentation are not in accordance with the Contract or the Work is not in acceptable condition, Canada will notify the Contractor within fifteen (15) days of receipt. The 30-day payment period begins upon receipt of the revised invoice or the replacement or corrected Work. Failure by Canada to notify the Contractor within fifteen (15) days will only result in the date specified in subsection 1 to apply for the sole purpose of calculating interest on overdue accounts.

### **Accounts and Audit**

1. The Contractor must keep proper accounts and records of the cost of performing the Work and of all expenditures or commitments made by the Contractor in connection with the Work, including all invoices, receipts and vouchers. The Contractor must retain records, including bills of lading and other evidence of transportation or delivery, for all deliveries made under the Contract.



**Annex D**

2. If the Contract includes payment for time spent by the Contractor, its employees, representatives, agents or subcontractors performing the Work, the Contractor must keep a record of the actual time spent each day by each individual performing any part of the Work.
  
3. Unless Canada has consented in writing to its disposal, the Contractor must retain all the information described in this section for six (6) years after it receives the final payment under the Contract, or until the settlement of all outstanding claims and disputes, whichever is later. During this time, the Contractor must make this information available for audit, inspection and examination by the representatives of Canada, who may make copies and take extracts. The Contractor must provide all reasonably required facilities for any audit and inspection and must furnish all the information as the representatives of Canada may from time to time require to perform a complete audit of the Contract.



## Annex E—Subcontract Management T&Cs Benchmark

Subcontract Management	Audit Sample	US Gov	Australian Gov	Industry (review of 6 companies)
Competitive process requirement for subcontracts	37%	Yes	N/A	Yes
Breakdown of subcontract work in Task or WBS	37%	Yes	Yes	No
Inclusion of subcontract rate and payment method	84%	Yes	Yes	No
Security requirement for subcontracts	91%	Yes	N/A	Yes
Annual cost submission includes subcontract breakdown	46%	Yes	N/A	No
Reference to subcontract SACC/accountability	93%	Yes	N/A	Yes
Intellectual property rights	70%	Yes	Yes	Yes
Identification of major subcontractors or supplier	37%	Yes	Yes	Yes
QAR right of access to subcontractor's facilities	80%	Yes	N/A	Yes
Contractor to notify royalty payment	50%	Yes	Yes	No
Subcontract warranties will be exercised by Contractor	54%	Yes	Yes	No
GFE/GSM for contractor or subcontractor	68%	Yes	Yes	No
Time verification clause	94%	Yes	N/A	No
Discretionary audit clause	98%	Yes	N/A	No

**Table 2. Common Subcontract Management T&Cs.** Canadian government subcontract management contract clauses are more stringent than the private sector and the Australian government's. However, in the US government, an Electronic Subcontracting Reporting System is used to keep track of subcontract information, which contains key information such as subcontract value, subcontract duration, significance of subcontract, etc. The US subcontract management policy requires a vendor procurement system review every three years to ensure subcontracts are tendered or awarded for best value. Earned Value Management is also required for long-term or higher-value contracts.

