The CPSR’s Role in Corporate Governance Risk Management

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Overview

There are many advantages and disadvantages to both the Government and contractors relative to the establishment of a contractor-led self-assessment process focused on evaluating the Subcontracting function. This article explores challenges often associated with developing a set of meaningful Subcontracting metrics that can be used to not only evaluate the performance of the Subcontracting organization, but to enhance its performance.

Major process reviews or audits of the subcontracting function (such as CPSR's, DCAA Reviews, Audits, etc.) can be considered as opportunities for subcontracting organizations to benchmark and showcase its processes against customer and executive management expectations. Traditionally, subcontract managers have relied upon corporate internal audit groups to accomplish this task. But, are there opportunities for subcontract managers to not only conduct their own self-evaluations, but to have those audits serve as substitutes for other internal and external audits? Can subcontract managers and their customers truly benefit from “proactive” assessments, whereby the organization uses self-assessments as catalysts for re-engineering, establishing metrics, and conducting continuous process improvements? Let’s evaluate the challenges and opportunities associated with establishing a meaningful self-evaluation program.

Introduction

Every aspect of business carries some degree of risk—one key subcontract management professional’s responsibility is managing these risks so as to avoid situations that might jeopardize a firm’s operations. Risks can be pro-actively managed, anticipated, and controlled in many functional areas. It is difficult to pick up a newspaper today and not read about the financial scandals that have plagued many corporations.
Clearly, the focus of those headlines is on the conduct and behaviors of Chief Executive Officers and members of the Board of Directors. But what if you were to pick up tomorrow’s newspaper and discover that your Procurement Department has been accused of misappropriations of funds, violation of laws, and operating under poor business practices? As shocking as it sounds, this could be happening within your organization today, right under your nose.

The Government’s View of Subcontract Compliance Risk

The Government defines “Risk”, used in this context, as the Government’s financial, quality and delivery exposure posed by contractor’s operations. In order to determine the degree of risk associated with a particular contractor’s operations, the Administrative Contracting Officer (ACO) will typically conduct a risk assessment. The FAR states that ACO’s shall determine the need for a CPSR based on, but not limited to, the past performance of the contractor, and the volume, complexity and dollar value of subcontracts. Typically, the first step in conducting a risk assessment is to collect certain data pertaining to the contractor. The following factors have a significant impact on the risk that contractors' purchasing systems pose to the Government:

- Approval status history
- CPSR recommendations and repeat recommendations to the contractor
- Dates of previous CPSRs and other reviews
- Government contract mix: cost-type, firm fixed-price, etc
- Direct material and material overhead as a percentage of total sales
- Sales to the Government as a percent of the contractor's total sales
- Defense Contract Audit Agency (DCAA) audit reports
- Input from the contracting officers and members of their teams
- Education, training, and experience of the contractor's purchasing personnel
- The contractor's self assessment and internal auditing efforts
- The contractor's relative position in its industry
- Reorganizations, mergers, and divestitures
- Radical increases or decreases in sales

The Opportunity

As competition among U.S. Government contractors becomes increasingly fierce, each contractor must adopt strategies that can set itself apart from the pack. What better way of doing this then to obtain your top customer’s approval of your subcontracting processes and practices?

A multi-national, U.S. based high-technology firm employed a number of procurement professionals in its subcontracting function. As a major U.S. Government defense contractor, the firm is obligated to operate a subcontract management and subcontracting function that complies with all aspects of the Federal Acquisition Regulations (FAR). The ultimate measure of its compliance with the FAR is the process of obtaining a subcontracting function that is compliant with the requirements of the CPSR.

The objective of a CPSR is to evaluate the efficiency and effectiveness with which the contractor spends Government funds and complies with Government policy when subcontracting. While conducting a
CPSR, the Government’s CPSR analysts focus on identifying possible signs of a weak-subcontracting system. These signs include:

- Noncompliance with Public Laws
- Noncompliance with Regulations
- Noncompliance with Prime Contract Requirements
- Failing Establishment of Sound Policies and Procedures in Subcontracting
- Failing to implement Good Business Practices

The firm’s Manager of Subcontracts was contacted by a U.S. Government auditing agency and informed that his organization would be subjected to a two week CPSR within the next nine months. It had been almost five years since the firm had undergone such scrutiny of its operations. Because of this time span, several potential problems and considerations surfaced, such as:

- The implementation of new and revised regulations and laws
- The lose of knowledgeable personnel
- The lack of documented procedures
- The existence of out-of-date Corporate Policies

Furthermore, the firm was in the midst of undergoing audits from many other U.S. Government audit agencies. This put a drain on the firm’s vital resources. The Manager of Subcontract was truly concerned about the fate of his organization.

Failure Is Not An Option!

There are many negative consequences that are possible as a result of failing a CPSR. The primary and arguably the most important from an organization’s “bottom-line” prospective, is the negative customer perception of the organization. In U.S. Government procurement, many large defense firms routinely subcontract up to 90% of the work effort under a prime contract. The U.S. Government relies heavily upon these firms’ ability to control subcontractors. This is based on the fact that there is typically no legal privity of contract between the U.S. Government and subcontractors, as illustrated below:
The U.S. Government’s remedy for a prime contractor’s failure to pass a CPSR is the withholding or withdrawal of that firm’s subcontracting system. This would result in a prime contractor’s inability to issue a subcontract without first seeking the written approval of a U.S. Government Contracting Officer. This additional approval causes:

- Increased Cycle Time
- Increased Acquisition Costs
- Possible Prime Contract Performance Problems

In addition to these problems, a failed CPSR can have devastating effects on the future of the firm.

- Disqualification on Competitive Request for Proposals
- Losing a Competitive Proposal Based on Past Performances on Government Audits
- Loss of Revenue
- Increased Government Oversight – Other Audits Will Follow
- Increased Overhead Expenses
- Delayed Billings and Collections

In this defense prime contractor’s opinion, failure was not an option!

**The Solution**

Typically, the firm would have relied upon its internal audit staff to conduct an audit of the function in order to determine its strengths and weaknesses. However, the firm realized that its internal audit staff does not use the same set of metrics as the U.S. Government CPSR analysts. In addition, internal audit staffers tend to have Accounting or Financial related education and experience, not Subcontract Management experience. After careful examination of its internal resources, the firm made a strategic decision to seek the assistance of J.A. White & Associates, Inc. to implement, manage, and maintain the self-governance program.
The implementation involved the following:

1. Develop a defined Project Objective and Project Schedule
2. Conduct an Internal Risk Assessment as well as an Independent Risk Assessment to determine the firm’s strengths and weaknesses
3. Evaluate the results of the internal and external assessments
4. Conduct surveys of both suppliers and internal customers relative to the department’s effectiveness and overall compliance
5. Establish the firm’s ability to embrace and manage strategic change
6. Develop new processes, policies and procedures, desktop guides, and job aids
7. Conduct Business Process Re-engineering efforts
8. Develop and conduct training
9. Establish metrics
10. Motivate and energize the firm’s culture relative to the CPSR. Instead of seeing the process as an “audit”, the firm began to view it as an opportunity to have its client, the U.S. Government, conduct a benchmark of their process against the Government’s expectations.

The Benefits

As a result of its innovative processes, the firm was able to not only obtain a CPSR-Compliant subcontracting system, but it also obtained other benefits such as:

- Increased spending with socially and economically disadvantaged businesses.
- Increased the amount of competition in subcontracting.
- Realized cost savings and reductions in cycle times in the processing of Government “Red Tape” due to unnecessary processes based on outdated regulations.
- Implemented a web based subcontractor-rating system.
- Implemented an on-going training program.

This case study still serves as a world-class model within the industry.
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- Introduction to Federal Acquisition Regulations (FAR)
- Formation of Government Subcontracts
- Contractual Relationships
- Risk: Defining & Managing
- Subcontract Management
- File Documentation Compliance

**Introduction to Letter Subcontracts**

The objective of this training module is to help each participant understand the importance of their role while performing their duties as buyers, subcontract administrators, and contract managers. The contents of this module apply largely to supplies and services which are to be acquired under a U.S. Government prime or subcontract. After successful completion of this session, the participant will be able to:

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- Proper use of Letter Subcontracts
- When to issue a Letter Subcontract
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