RESPONSE TO REPORT DODIG-2024-092 PURSUANT TO THE
JAMES M. INHOFE NATIONAL DEFENSE AUTHORIZATION ACT FOR
FISCAL YEAR 2023, PUB. L. NO. 117-263, SECTION 5274

The Department of Defense Office of Inspector General (DoD OIG) attaches the following response received from specifically identified non-governmental organization or business entity as required by the James M. Inhofe National Defense Authorization Act for Fiscal Year 2023, Public Law No. 117-263 SS 5274.

The DoD OIG offers no comment and makes no representation, express or implied, of any nature with respect to the matters stated in the attached responses.

TRANSDIGM GROUP INC.

June 24, 2024

U.S. Department of Defense
Office of Inspector General
4800 Mark Center Drive
Alexandria, VA 22350-1500

Subject: Response of TransDigm Group Inc. to the Inspector General Special Report: Summary of Prior DoD Office of Inspector General Contract Pricing Audits and Other Reviews, Report No. DODIG-2024-092.

To Whom it May Concern:

Pursuant to Section 5274 of Public Law 117-263, TransDigm Group Incorporated (TransDigm) provides this response to the subject Special Report issued by the U.S. Department of Defense, Office of Inspector General (DoD IG) on June 4, 2024 (Special Report). The Special Report is a summary of prior reports from DoD IG archives and does not contain new data or analysis. The references to TransDigm throughout the report are based on prior IG audit reports, each of which concluded TransDigm businesses followed all laws and regulations. Also notable is that of the multitude of contractor audits referenced by the Special Report, TransDigm is the only company that is repeatedly referenced by name. Audits of TransDigm businesses focused on select Defense Logistics Agency (DLA) contracts and although DLA represent less than approximately 0.5% of TransDigm's annual revenue, and procurements from TransDigm businesses combined represents less than approximately 0.3% of DLA's annual procurements, other companies that represent significantly larger portions of DLA spend were anonymized and simply referred to as "company" or "contractor".

More importantly, the Special Report fails to recite or reference the many concerning qualifications and caveats asserted in the original audit reports referenced. As detailed in this letter, the Special Report fails to explain that the referenced reports:

- **Contained highly qualified conclusions.**
- **Applied arbitrary standards and measures not consistent with the law.**
- **Incorrectly counted real costs as profit.**
- **Created policy that disincentivizes firm-fixed price contracting.**

A. The Audits Did Not Apply the Correct Law

The Special Report references DODIG-2022-043 (the Report) which audited select contracts awarded by the DLA to TransDigm businesses. The Report expressly acknowledges that the auditors applied arbitrary standards and then measured the contracts against these standards that have no basis in law, rules, or regulation. This resulted in flawed conclusions. The Report violated the basic principle of IG audits which tasks the auditors with finding the applicable law, policies, and standards and then

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determining whether a violation of *those* laws, policies, or standards has occurred.[1] Although the audit reports each concluded that TransDigm businesses followed all applicable laws and regulations, the auditors went beyond that assessment to apply measures and standards not applicable to the audited contracts to force a conclusion of "excess profits" and recommend voluntary refunds. The methodology used in the Report was contrary to law and resulted in a false and misleading conclusion. Examples are provided below.

1. **The Report Acknowledged Using Standards Not Applicable to the Audited Contracts.**

> ***"The FAR identifies profit percentages for three contract types,*** **none of which were in our sample….** ***We are not stating that 15 percent should be used as a benchmark when negotiating firm-fixed-price contracts; rather, this is the percentage we decided to use for the purposes of our audit analysis. In addition, this should not be interpreted to mean that any special profit ceiling applies solely to TransDigm contracts."***
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> ***~ DoD IG Report DODIG-2022-043 at pages 14 and 44.***

The Report acknowledged that it applied arbitrary profit standards to the audited contracts to arrive at the conclusion of "excess profit". It states that the legal standard applied by the auditors—a 15% mark up on costs as a benchmark for profitability—is not applicable to the TransDigm contracts audited. A fixed percentage mark up on costs is applicable only to *cost-reimbursement* contracts where the government bears all costs, and the contractor bears no risk of cost overruns. *None* of the audited TransDigm contracts were cost-reimbursement contracts. The audited contracts were *all* firm-fixed price contracts in which the TransDigm businesses bore all risks of performance and cost overruns. This is important because profitability on firm-fixed price contracts is realized *after* the contractor performs—*and* controls its costs during performance. The report inexplicably applies the incorrect standard to the audited contracts but then remarkably goes on to acknowledge that doing so conflicts with law and policy and warns contracting officials against use of the arbitrary standard in the future.

2. **The Report Ignored Significant Real Costs Incurred by the Business and Incorrectly Reported These Costs as Excess Profit.**

> ***"For our cost analysis, although we did determine the reasonableness of all costs, we did not determine the allowability of all costs... Our exclusion [of costs] should, in no way, be interpreted to mean that, in all instances, offerors are or should be precluded from including interest and taxes in price calculations for fixed-price contracts."***
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> ***~ DoD IG Report DODIG-2022-043 at page 43.***

The Report did not count all the real costs incurred by TransDigm businesses in performing the contracts audited. The Report ignored significant costs (such as federal taxes) and in doing so, counted those costs as profit and thus overstated the profit for the contracts audited. Establishing the correct cost base is required to determine profit. Despite having all necessary cost data which were independently

[1] Department of Defense Inspector General, *Department of Defense Inspector General Administrative Investigations Manual* (May 2021), at 3.1.2.2 ("*Investigators need to thoroughly research and understand the applicable laws, rules, or regulations early in their investigation planning. This means not only understanding which particular standard applies, but also understanding the applicable language in the standard that needs to be proved or disproved for a violation to have occurred.*")

verified by a third-party government cost accounting firm (BDO USA LLP), the report removes certain sts, like federal taxes, by again auditing the fixed-price contracts using cost-reimbursable contract standards. This further renders the assertion of "excess profit" inaccurate. In ignoring real costs, the report expressly makes clear that the exclusion should not be applied in future firm-fixed price contracts but fails to explain why it is appropriate to count costs as profit for the audited TransDigm contracts.

3. **The Report confuses price with profit and creates new policy that disincentivizes firm-fixed price contracting.**

The audits of contracts awarded to TransDigm companies only focused on profitability as a measure of price reasonableness, ignoring completely all other costs or any measure of cost controls by the companies. After incorrectly counting costs such as federal taxes as profit, the Report incorrectly applied a 15 percent profit standard used for cost-reimbursable contracts and improperly declared anything more than 15 percent for fixed-price contracts as "excess profits". The Report then arbitrarily concludes that anything more than 15 percent *profit* results in an excess *price* to the government. This assertion falsely assumes that a profitable contract must result in an unreasonable price regardless of what costs are incurred or saved by the contractor. This reasoning is inconsistent with the FAR and is logically flawed.

The report ignores the fact that cost is a major driver of profitability and evaluating *all* costs is important for any cost analysis. As illustrated by the table below, under a firm-fixed price contract, it is entirely possible for a contractor to earn more profit than a competitor with a higher price.

Contractor	Price	Cost	Fee	Profit %
A	**$100**	$85	$15	15%
B	**$96**	$65	$31	32%

In this example, Contractor B represents a better price for the buyer and is also more profitable for the contractor. The two concepts are not mutually exclusive, and in a firm-fixed price contract, the contractor is incentivized to reduce costs after award and increase efficiency to maximize its profit. By reviewing a firm-fixed price contract after it is complete and labeling profit above 15 percent as "excess profit" and from that drawing a conclusion of "excess price", the Report confuses the point of cost analysis. More importantly, the Report's approach creates policy that disincentivizes companies from pursuing cost-saving efficiencies in their performance because they would then be accused of charging an excessive price for their product. This policy setting by the Report undermines the FAR and could result in the Government overpaying for products and services and dissuading companies from engaging.

In a firm-fixed price contract, the government shifts the risk of cost overruns to the contractor. This is why the procurement regulations are concerned with the reasonableness of the *total price* and not the *profitability* of the contractor. If after award, the costs of the contractor go above the agreed upon price, the contractor is *not* entitled to a price increase. On the other hand, in a cost-reimbursable contract, the contractor is protected because it can simply pass on cost increases to the government. It is precisely for this reason that the only regulations identified by the DoD IG in the Report relating to contract fee

caps are related to cost-reimbursable type contracts and not firm-fixed price contracts like the ones audited.[2] The Report applied the wrong standards to the audit.

As the Report acknowledges, the FAR specifically recognizes that it is in the government's interest "*to offer contractors opportunities for financial rewards sufficient to stimulate efficient contract performance, attract the best capabilities of qualified large and small business concerns to U.S. Government contracts, and maintain a viable industrial base*."[3] This is precisely what is achieved under a firm-fixed price contract when a contractor reduces cost and an audit after award should not penalize the effort.

B. The Audits Ignored Price Analysis Tools Used by the Government

The *FAR*, *DFARS*, and the *DoD Procedures, Guidance, and Information (PGI)* all favor price analysis for assessing the reasonableness of firm-fixed price proposals where adequate price data is available. This is also true in cases where the procurement is considered a "sole-source" due to platform qualification requirements but where nearly identical products sold by multiple companies exist in the marketplace for price analysis purposes. This methodology is often used by contracting officers to assess whether prices of sole-source products are fair and reasonable and the regulations task contractors with supporting their proposed prices with this data. Yet, contrary to the regulations, the Report completely ignores the possibility of price analysis as a sound method for determining price reasonableness and instead concludes that because the audited contracts were sole-source, price analysis was completely unavailable. This conclusion is flawed and inaccurate.

The audit reports failed to describe any of the price reasonableness analysis and conclusions by the government contracting officers for the contracts audited and ignored years of price negotiations that resulted in the determination of price reasonableness and award of the audited contracts. The audit team was provided detailed market data for nearly all the parts audited, showing that these parts can, and should be compared to equivalents sold in the commercial marketplace. Unfortunately, the Report failed to consider this data or even acknowledge its existence or relevance.

Conclusion

Any summary report such as the Special Report which references prior audit reports should restate the methodology and qualifications provided in those reports. The use of inapplicable standards contrary to the law lead to misleading reports as evidenced by the report's own statements and acknowledgements. The Special Report only reiterates the qualified conclusions but fails to provide any of the clarifications and caveats present in the original reports or restate the report findings that TransDigm companies followed all applicable laws and regulations. Also notable is that of the multitude of contractor audits referenced by the Special Report, TransDigm is the only company that is continually featured by name despite prior IG audits of many other companies. Nearly all other audits referenced in the Special Report refer to the subject companies as simply "company" or "contractor".

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[2] *See* FAR 15.404-4 (Profit) ("The contractor assumes the greatest cost risk in a closely priced firm-fixed-price contract under which it agrees to perform a complex undertaking on time and at a predetermined price…The contractor assumes the least cost risk in a cost-plus-fixed-fee level-of-effort contract, under which it is reimbursed those costs determined to be allocable and allowable, plus the fixed fee.")

[3] DoD IG Report DODIG-2022-043 at page 14.