THE CAPITOL FORUM

TransDigm: A Closer Look at TransDigm's Corporate Training and Strategies to Avoid Government Scrutiny of Price and Cost Data

*Vol. 5 No. 103 - March 27, 2017 - **Click here** to access our library.*

Company Update

According to four former management level employees of TransDigm subsidiaries, TransDigm hosted quarterly meetings to review performance metrics for each subsidiary and to develop and implement procedures to help those subsidiaries hit their sales targets. We have **previously reported** on how these meetings place pressure on subsidiary managers to hit high revenue and profitability targets, which in turn has resulted in subsidiaries pushing excess inventory on distributors to hit sales targets—a practice known as channel stuffing.

Our sources indicated that in addition to reviewing each subsidiaries' financial performance, these quarterly meetings also include regular training sessions on the government procurement process and guidance on how best to navigate the procurement process to maximize price increases. None of the sources we spoke with are currently employed at TransDigm subsidiaries, so we do not know whether TransDigm currently employs the same training methodology. However, our sources were employed as recently as 2016, so we believe that the training program identified in this article is still relevant.

All four of our sources attended these meetings and have given similar accounts of the training process. Our sources formerly worked at three different TransDigm subsidiaries that have a range of different product offerings, and the subsidiaries they worked for sold products both to commercial customers and the government. Below, we detail accounts from the training sessions, as well as the methods the TransDigm subsidiaries were taught to avoid scrutiny of price increases.

"Very well-orchestrated indoctrination sessions." According to our sources, these quarterly compliance sessions focused on the rules and regulations of the federal acquisition process and were accompanied by some form of a PowerPoint presentation titled "Understanding How the Government Buys." One source noted these presentations were given by Halle Terrion, who is currently the general counsel and chief compliance officer TransDigm.

Regarding the nature of these sessions, one source stated that "it was not at all veiled, it was very repetitive. At our first meetings, we had been briefed on what the proceedings were going to be like, we were newbies but very quickly, at least to me, these were very well orchestrated indoctrination sessions." The other three sources who attended the meetings agreed with this characterization of the meetings, which focused on drilling home several key points, which we discuss below.

Seminars taught subsidiary leadership to deny the government's requests for cost and pricing information. These sessions, according to our sources, focused very specifically on how to get away with the bare minimum of compliance when conducting sales to the military, with one source stating, "the general rule is, we take a very strict, limited interpretation of what the regulation requires us to do," and that "it was stressed repeatedly, that our requirement was to comply with the letter of the regulations. It was not our responsibility to make the prime or procurement officer's job easier. We were to challenge every single request from a prime or an auditor if we did not think that we were required to provide the information they were requesting."

The same source went on to say that "we were told—it was never in writing—but we were told to do everything we possibly could do to avoid an audit. And if we had to succumb to an audit, we were to challenge every single request for data," with another source stating, "if the government says, well, I need all this cost data, well, that was always a no no."

This practice of TransDigm not providing cost data was detailed in the 2006 IG **audit** of TransDigm. That report listed a dozen different tactics used by TransDigm to deny procurement officers' requests for additional information.

Training also included guidance to stay under the TINA threshold. According to our sources, at these compliance meetings, there were discussions during the seminars, as well as general conversations among subsidiary heads, on how best to avoid pricing disclosures when selling to the government. Under the Truth in Negotiations Act (TINA), offerors are required to submit certified cost and pricing data for non-commercial items if a procurement exceeds $750,000. All of our sources stated that TransDigm expected subsidiaries to drive contract prices right up to that threshold without going over.

One source stated that during the compliance seminars, "TransDigm made sure that we were all aware of the TINA threshold and advised us to stay under the TINA threshold whenever possible. It was emphasized at every meeting/seminar I attended that it was TransDigm policy to avoid providing our cost data to any potential customer (Gov't or Private) whenever possible." A fifth former employee, who unlike the other sources interviewed for this article did not actually attend the training session but did attend the quarterly meetings, stated that during the quarterly meetings "we did talk amongst ourselves about how to get procurements with the government and how to not hit the targets to where they're looking at our books, so we could get the better margins on our parts."

By staying under the TINA threshold, TransDigm subsidiaries could significantly increase the price of their products to the government. According to one source, "the expectation was if you're going to be below the TINA threshold, you're going to get every penny you could get. So discrete purchases, end of the year purchases where DLA comes in and says 'I want 100 [XXXX]' and my OEM price on those is say, 8500 bucks, I should be getting 15, 16, 17 thousand a piece" from the government. We followed up by asking whether the tactic of charging the government double the price was something to boost sales at the end of a quarter or a constant practice, to which the source replied that it was "constant—They don't have a choice. They have to buy it from you, you're below the TINA threshold, you don't have to let them see your numbers, they can't audit you, get the most price you can."

When a contract was likely to exceed the $750,000 TINA cap, TransDigm subsidiaries employed other practices to avoid having to disclose cost information, including trying to break up the single larger contract that exceeded the TINA threshold into multiple smaller contracts that were all below the TINA threshold.

According to one source, passing the sale through several geographically dispersed distributors was one way to squeeze larger contracts under the TINA threshold and avoid pricing scrutiny: "But another part of that would be look for those opportunities to sell below the TINA threshold and find ways to justify it. For example, if the government comes to me for 2.1 million in spares, that's auditable right? Because it's above the 750,000 threshold, so it's going to limit my profitability. But if I'm working out of a North American distributor, a European distributor, and an Asian distributor, that 2.1 million now will only be 700,000 out of each one. Now generally speaking, according to the DFAR (Defense Federal Acquisition Regulation), I can't split a purchase order for the purpose of avoiding the TINA threshold unless I've got a compelling reason, and my compelling reason could be, look, it's geographically distributed, each of those markets has a different requirement, it's the best way for me to administrate and service the need, the interest of the government is best served with my working through these three distributors instead of doing it all out of one. And now I've avoided the TINA threshold, which means I get more profit."

Tactics during an audit. While TransDigm encouraged its subsidiaries to do everything in their power to avoid an audit, sometimes the subsidiaries were forced to submit to an audit by their prime contractor, which could include Boeing or Lockheed Martin. A subsidiary at which one of our sources worked was audited by a Boeing employee acting as an agent for the government procurement officer.

When audited by the prime contractor, the source stated that the guidance from TransDigm was to inflate the cost of production: "The guidance would be something like, if during an audit you're required to show an hourly rate for technicians, find the most expensive technicians that have to do with the specific product and if the auditor wants to include a wider pool of employees, you challenge that."

The source went on to state that if the subsidiary had an agreed upon profit basis on a contract with a prime contractor like Boeing that could be audited, it was also practice to inflate the production cost in order to increase the profit margin.

According to the former employee, "Well if you do an audit and you agree on the cost basis then cost is not part of the final negotiation, the only part of the final negotiation is what is a reasonable amount of profit. So I can drive my cost up by limiting the pool of employees that are the most expensive… If I can establish a high cost basis, right, when we get to negotiation on profit then 8% of a million is more money than 8% of 900,000. There you go."

According to the source, this practice is wholly-justified under the DFAR regulations, and relies on a very liberal interpretation of what is allowed under the regulations. The source stated that the DFAR regulations give a large amount of leeway as to what can be included when determining cost-basis, with prime contractors insisting on a narrow interpretation, and subcontractors like TransDigm insisting on wider interpretations. The source went on to state that TransDigm was very specific in instructing subsidiaries to push the envelope when calculating cost basis, but to never do anything to violate the DFAR regulations.

Closer look at federal procurement officers. According to our sources, by constantly challenging every request for pricing visibility, subsidiaries could wear down procurement officers into accepting high prices. Procurement officers can either work for the government or a prime contractor, and it is their responsibility to determine price-reasonableness. Contracting officers are, according to one source, the "final arbiter" of all procurement decisions, and TransDigm can appeal all requests for pricing information to a contracting officer. However, contracting officers are often overburdened and slow to resolve an issue, and it can take months for the contracting officer to make a determination.

According to the source, "often, the procurement agent could not wait 6 months and would then rule in favor of commerciality, or make a notation in the procurement file that they were unable to make a determination of a 'Fair and Reasonable' price, but had authorized the purchase due to an immediate operational need. We were not really concerned about the 'Fair and Reasonable' notation, because they had to come to us for the parts."

The extra burden placed on the procurement officer by constantly requesting appeals to demands for pricing information often made the officer roll-over and accept the high costs: “If you can make what sounds like a reasoned and logical argument to the actual purchasing agent, all they’re interested in is being able to put a checkmark on their folder that says ‘I’ve found it to be fair and reasonable.’ That’s what’s driving them.”

We asked the source how often they received pushback from procurement officers. According to the source, there is “a wide range of competency and due diligence across procurement officers. DLA rarely pushes back, while Hill Air Force Base is always asking for more information.” The source stated that during his time at TransDigm, he never actually had a case go to a contracting officer, as the mere threat of appeal and associated delay and extra work was enough to get the procurement officer sign off on the procurement.

Monopoly parts and use of distributors to “show cost basis.” TransDigm is very open that it seeks out proprietary aerospace parts with high aftermarket margins. According to the company’s SEC filings, 80% of its sales come from products for which it is the sole manufacturer. This heavy focus on proprietary parts leaves TransDigm confident when they negotiate with the government.

According to one source, “Yeah so the government’s going to ask for everything, they’re going to tell you I need to see your cost basis. And if it’s under 750,000 my answer is no. And if he says well I can’t buy it if you don’t do it I say fine well you can’t buy it any other place anyway. Here, buy it from my distributor instead of me. My distributor, he’s going to show his cost basis, it’s the invoice he gets from me. When you’re sole-source and the only IP, they’re going to have to come to you eventually.”

1233 20th St. NW
Washington, DC, 20036
202-601-2300