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DFARS Business Systems Rule – Long Anticipated Proposal for Contractor Certifications and Independent Audits

By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

On July 15, 2014, the Federal Register published a proposed rule to amend DFARS 252.242-7005 to entrust contractors with the capability to demonstrate compliance with the existing DFARS business system criteria for contractors accounting, estimating and MMAS (material management and accounting system) based upon contractor's self-evaluations and audits by independent Certified Public Accountants (CPAs). The proposed rule has a 60 day period for public comments while also including the somewhat unusual provision for a three-hour public meeting on August 18, 2014 (registration closes on August 11). Although it is never stated in the proposed rule, the reason for the rule and its applicability to three of six DFARS business systems is DCAA's inability to audit those three systems.

It is somewhat ironic that the July 15, 2014 proposal bears-out public comments in the May 18, 2011 interim rule expressing concerns with DCAA or DCMA resources/abilities to timely audit for compliance to which the DAR Council retorted that "the need to have effective oversight mechanisms is unrelated to resources". At least with respect to DCAA, "effective oversight" of contractor compliance with three business systems is absolutely related to resources; hence, the proposed rule is effectively shifting the DCAA (alleged) lack of resources to DoD contractors. (Editor's comment: don't expect the DAR Council to ever acknowledge that the May 2011 public comment was accurate).

The more significant details of the proposed rule (repeated in each of the DFARS system specific clauses; 252.215-7002--Estimating Systems, 252.242-7006—Accounting Systems, 252.242-7004—MMAS):

- Annual reporting requirement within six months after the end of the contractor fiscal year, a report regarding compliance with the system criteria at the end of the Contractor fiscal year. The report shall be provided to the Contracting Officer and the Government auditor and include a statement that the contractor has evaluated the system

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for compliance with the system criteria, and the contractor's assessment of system compliance including a statement as to whether or not the system complies in all material respects and if not compliant, disclosure of any significant deficiencies.

- The status of any significant deficiencies or if applicable, in the contractor's CPA Report a corrective action plan with milestones and actions to eliminate any significant deficiencies that have not been corrected as of the date of the contractor's report.
- Triennial CPA audit requirement in the first year in which the contractor is required to provide the annual report and every three years thereafter, or more frequently if directed by the Contracting officer. The CPA audit shall be in accordance with GAGAS (Government Auditing Standards) for attestation engagements. The contractor shall reasonably ensure that the CPA: i) is independent and objective, supported by a written representation from the CPA firm that the firm is independent and objective, will remain independent, has not performed any nonaudit services for the contractor and will disclose any independence issues discovered, ii) is qualified to perform the audit by obtaining information about the key engagement members including professional standing and knowledge/experience in the type of work done, and iii) disclose the firm's most recent peer review.
- The contractor shall provide the contractor's CPA audit strategy, risk assessment, and audit plan and, upon completion, the CPA report and working papers.

It should be noted that the documentation requirements extend to everything required including the documentation supporting the contractor's self-evaluation, the contractor selection of the CPA firm, and the report and working papers of the CPA firm. It should be further noted that the sources for "significant deficiencies" (which would trigger system disapproval and payment withholds) are now the contractor, the contractor CPA, and/ or the Government.

The August 18, 2014 public meeting should make for a lively discussion, but it remains to be seen if the final rule will be significantly changed or more likely, virtually the same as proposed because the Directors of Defense Pricing and of Defense Procurement and Acquisition Policy (DDP and DPAP, respectively), have shown a tendency to summarily disagree with public comments (without any explanation).

DCAA Guidance Memos: Revised Approach and Reporting Guidelines for Audits of CAS DS, Billing Rates, and Accounting Business Systems

By Darryl Walker, CPA, CFE, CGFM Senior Director at Redstone Government Consulting, Inc.

The Defense Contract Audit Agency (DCAA) made public four audit guidance memorandums in late June 2014 clarifying how auditors will undertake audits and report the results of CASB Disclosure Statements (DS), accounting administration business systems, and provisional billing rates.

Accounting System Audits

In two June 26th memorandums, DCAA addressed changes to the audit and reporting approach of accounting administration business systems.

In its 14-PAS-011(R) memorandum DCAA announced that its existing audit program steps for post-award audits of non-major contractor accounting systems (activity code 17741) would be modified to align the audit steps with the systems criteria set forth in DFARS 252.242-7006 (Accounting System Administration), and audit procedures will be tailored toward reviews of smaller contractors.

Additionally, the previous report template for post-award accounting systems audits has been discontinued because i) that verbiage expressed an opinion on adequacy or inadequacy in conflict with the fact that only contracting officers (COs) make that determination and ii) the report structure did not provide sufficient information for the CO to make a final adequacy/inadequacy determination. Further, deficiencies found during the post-award audit are to be reported separately using the guidelines in audit program activity code 11090, and deficiencies segregated between those that are "significant/material" and those that are deemed "less severe" are to be reported consistent with updated

guidance discussed in the June 26th 14-PAS-009 (R) memo (see below).

In the 14-PAS-009(R) memo, DCAA clarifies guidance released in 2012 (12-PAS-012) regarding the reporting of accounting system business systems deficiencies for significant deficiencies versus those that do not rise to the level of being significant under GAGAS (Government Auditing Standards). The 2012 guidance apparently was not clear in how to report deficiencies deemed "less severe" which are found during a business system audit. When the only non-compliance issues are those considered less severe than significant deficiencies, but those issues still warrant the attention of the contracting officer, the auditor will issue a memorandum to the ACO (Administrative Contracting Officer), with a Statement of Condition and Recommendation of the finding so the ACO can ascertain the significance of the findings.

However, if findings are identified in "other than a business system audit", where both significant and less severe findings are found, issues deemed less severe will be clearly separated from those considered significant, and each type will be grouped in separate exhibits. Where a full business system audit yields only less severe findings requiring attention of the government, a report with a qualified opinion will be issued with those less severe problems described in an exhibit.

It remains to be seen if ACO's or anyone else will do anything with reported findings which do not rise to the level of a "significant deficiency" and/or if this is something of a moot point because DCAA auditors seemingly categorize all business systems audit findings as a "significant deficiency" in part because the deficiency only has to result in a "risk" to the Government without any evidence of actual harm. However, the fact that DCAA policies are locked in this detailed level of dissecting and categorizing facts is continuing evidence that DCAA's focus is solely on the very literal and conservative interpretations of compliance with government auditing standards with no focus on practical implications or utility.

Adequacy of Cost Accounting Standards Disclosure Statements

DCAA will no longer evaluate the adequacy of CAS Disclosure Statements (DS) as a stand-alone audit, with a separate audit report describing adequacy issues; instead, DCAA will blend in an adequacy assessment as a planning component of the audit whose purpose is to determine if the DS practices are compliant with CAS. If the CAS DS is adequate, DCAA will then perform the compliance audit and will issue a single report under activity code 19100 (or for separate standards under code 194XX), in which only CAS noncompliance issues will be identified. Use of the DCAA activity code of 19200 formerly used to identify DS inadequacies will be discontinued. DCAA's reason for this "new" approach is to allow for more efficient use of DCAA's limited resources—meaning to reduce actual audit time and expedite government process of awarding and administrating CAS covered contracts.

Based upon this recent audit policy, a CAS DS adequacy assessment will encompass determining if the DS is prepared according to regulatory instructions, is complete and consistent among the various Parts, and generally consistent with existing practices—it does not encompass a review of disclosed cost accounting practices for compliance with the individual standards.

Completing an adequacy assessment of an initial DS, followed by a memorandum to the CFAO (Cognizant Federal Agency Official) summarizing the final assessment before beginning the compliance audit, is a DCAA condition for accepting the engagement (i.e. performing the actual compliance review). The CFAO is to affirm that the DS is adequate before the audit begins, but in some cases, this affirmation may not be necessary. Nonetheless, if the CFAO deems the DS inadequate, DCAA may or more likely will choose to refrain from beginning the audit until the CAS DS is adequate.

When audits are required of revised DS practices, DCAA will establish one assignment for the audit; but before accepting the engagement, DCAA will document its assessment of the adequacy of the requested practice changes and attempt to resolve with the CFAO any inadequacies in the DS before DCAA accepts the engagement. The final audit report will be limited to expressing an opinion on compliance with CAS.

Where DCAA is requested to review a company's initial DS submission, the audit completion and outcome of which may be a condition for a forthcoming contract award, government COs and contractors are probably questioning whether the "new and improved" consolidated DS audit process may actually bottleneck an award, rather than expedite the procurement process. Where a DCAA audit is requested by

the procurement command before contract award, there are potentially two DCAA roadblocks within the single CAS audit—the DS adequacy assessment, a condition for DCAA to continue the audit, and then the audit for compliance with CAS.

The adequacy assessment verbiage in the updated audit program (Section B-1) does not provide sufficient insight as to whether the "adequacy" analysis will represent an abbreviated version of what was formerly a several page audit program. An optimistic first impression is that DCAA will not dwell so much on adequacy, will resolve adequacy issues quickly, and will then focus on compliance analysis and reporting. Although DCAA never mentions this in its audit policy, for years DCAA CAS DS audit reports have only addressed adequacy and DCAA has effectively disclaimed an opinion on compliance (only reporting alleged noncompliances, but never affirmatively expressing an opinion as to the contractor's DS compliance with CAS).

Whenever a DCAA "adequacy" analysis is invoked as a prerequisite for even starting an audit, contractors often face an endless and exasperating process of dealing with and overcoming trivial DCAA "adequacy" issues. In that context, should DCAA conduct the initial DS adequacy reviews at the same level of detail and utilize excessive subjective judgment as with other audits, contractors may find that the path to attaining a contracting officer approved DS will be a long and sometimes never-ending journey.

Provisional Billing Rates

The agency has released a new standard audit program identifying DCAA's responsibilities and audit procedures in establishing provisional billing rates (DCAA Memo 14-PPS-012(R) June 27th 2014).

The purpose, scope and procedures of the audit program encapsulate guidelines and regulations including the basic requirements of FAR 42.704.. In particular, the audit policy correctly state that FAR 42.704 does not require or even reference a contractor submission or proposal although the auditors are encouraged to ask for a contractor provisional billing rate proposal. FAR 42.704 clearly states that the Government (CO or Auditor) will establish provisional billing rates; hence, the audit policy and new audit program are based upon an accurate reading of regulatory roles and responsibilities. Activity code 15500 includes very general guidelines for auditors to unilaterally establish rates where contractors choose not to prepare a formal budgetary forecast, or to review contractor proposals delineating detail supporting projected billing rates for a particular billing year.

FAR Rule on Allowability of Legal Costs Whistleblower Proceedings

By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

On July 25, the Federal Register published the final rule regarding the allowablity of contractor legal costs related to a whistleblower proceeding (complaint of reprisal or retaliation). The rule which already applied to DOD, NASA, and GSA contracts as an interim rule dated September 13, 2013, had amended FAR 31.205-47(b) to make unallowable certain costs incurred by a contractor or a subcontractor for legal costs related to a complaint by a contractor or subcontractor employee. In large part, the revision to FAR merely attached whistleblower legal costs to the existing unallowablity provisions; in particular, those involving a civil proceeding where the disposition involves a monetary penalty or an order issued by the agency head to the contractor or subcontractor to take corrective action.

The final rule did include one revision from the interim rule which was in response to a public comment concerning FAR 31.205-47(b)(4) regarding disposition of the matter by consent or compromise if the proceeding "could have led" to any of the outcomes in (b)(1)-(b)(3). The public comment noted that the verbiage "could have led" was inconsistent with the interim rule which stated that the rule would only affect a contractor or subcontractor if the proceeding resulted in a monetary penalty or order to take corrective action. Unfortunately, the FAR Councils merely added the following subparagraph (extracts from 31.205-47(c)(2)(ii):

> In the event of disposition by consent or compromise of a proceeding brought by a whistleblower for alleged reprisal…reasonable costs incurred by the contractor or subcontractor that are not otherwise unallowable by regulation or by agreement with the

> United States "may be allowable" if the contracting officer, in consultation with his or her legal advisor, determined that there was very little likelihood that the claimant (contractor or subcontractor employee) would have been successful on the merits (emphasis added).

The source for this terminology, which is already in the FAR (31.205-47(c)(2)(i)), is the May 19, 2009 Federal Circuit decision, Secretary of the Army v. Tecom, wherein the Government prevailed because Tecom had made no demonstration that "very little likelihood of success existed" (in a third party lawsuit involving allegations of sexual harassment and retaliation under Title VII). Hence, the FAR Council has already utilized this terminology ignoring the fact that the Tecom decision was case specific; notably that Tecom had no idea until after-the-fact that it was expected to document its likelihood for success before settling out of court.

Coincidentally, the DoD-IG just issued a statement expressing concern for the lack of awareness of the "new protections" for whistleblowers. In particular, the IG expressed concerns that, "subcontractors, which do the bulk of the work and see a lot of things, may be afraid to come forward for fear of losing their subcontractor work". Apparently the IG believes that subcontractors are aware of prime contractor fraud, waste or abuse; however, prime contractors somehow muzzle subcontractors from contacting the DoD-IG hotline. As with virtually every other IG "belief", it provides no evidence or facts supporting its belief and even contradicts its belief in a statement (by the DoD Hotline Ombudsman) that he had been receiving four to six contacts per month, but has received 270 so far this year.

It should be obvious that the DoD-IG is primarily interested in getting the word out for the purpose of encouraging prime contractor employees, subcontractors and subcontractor employees to make hotline referrals. That has already been reinforced by a 2013 change to FAR 52.203-14 which required DoD contractors to post the DoD-IG hotline poster (previously DoD contractors were only required to post a company hotline poster and had the discretion of posting the DoD-IG hotline poster). As the Government continues to change regulations in hopes of increasing hotline referrals into IGs, a reminder that FAR 52.203-13 requires contractors to have a "Standards of Conduct" and to make certain disclosures to an IG (e.g. fraud, gratuities, bribes, overpayments). However, FAR 52.203-13 clearly permits the contractor to have its own hotline posters and to conduct its own investigations before reporting to an IG. That said, in order to succeed (or survive) as a Government contractor, having an active, responsive internal hotline reporting and internal investigative process is as critical as any other corporate asset.

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December 9-10, 2014 – Accounting Compliance for Government Contractors
Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
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In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

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Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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