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Prime Contractors Continue to Embrace DCAA's Mythological Theory of Subcontract Management

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

In late 2016 the ASBCA issued its decision (ASBCA Nos 59508, 59509) which wholly and absolutely rejected a DCAA legal theory (created by an auditor) which focused on a prime contractor's "contractual" responsibilities to manage its subcontracts. The legal theory (or more accurately the FAR reference) was 42.202(e)(2) which is in the context of differentiating a Government ACO responsibilities for prime contracts and the absence of ACO responsibilities for subcontracts. Of significance, FAR 42.202(e)(2) might be in FAR, but it isn't linked to any contractual clause; hence, it is guidance applicable to the Government, but nothing extends that FAR citation to prime contractors. Although the absence of the FAR clause as a contractual clause was enough for the ASBCA to wholly reject the Government claim (disallowing about $118 million in subcontract costs), the ASBCA went on to address and to reject DCAA's theory (or more accurately embellishment) of the specific requirements of "managing a subcontract"; these included DCAA expectations that the prime contractor would accomplish or coordinate the accomplishment of the following:

- Ensure that each subcontractor self-monitored in terms of provisional billing rates versus actual indirect rates, timely filed its final indirect cost rate proposal, and timely submitted adjustment vouchers (sometimes known as true-up vouchers) for differences between provisional rates and certified final rates.
- Issue subcontracts which required the subcontractor to allow the prime contractor to audit the subcontractor accounting records (claimed costs) or to allow the prime contractor to receive copies of DCAA subcontractor (assist) audits. Based upon its lack of any practical experience and its non-contractual legal theory, DCAA apparently believes that a prime contractor should have access to competitive sensitive subcontractor rates (either directly through a prime contractor audit of the subcontractor or indirectly through the prime contractor's access to an unredacted DCAA audit or the subcontractor rates (pool/base/rates) and subcontract direct costs.

THIS ISSUE:

The 2016 ASBCA decision seemingly neutralized all of DCAA's audit policies and interpretations as those audit policies expound upon prime contractor management of subcontracts. That said, one would expect prime contractors to revisit their subcontract terms and conditions to eliminate any of the requirements which were nothing more than a reflection of DCAA's creation of a legal theory which turns out to be non-contractual. Unfortunately, clients who are subcontractors continue to encounter subcontract terms and conditions which still contain some of the following terms and conditions:

- Subcontractor requirement to submit its annual final indirect cost rate proposal (not to the prime contractor, but to notify the prime of the submission)
- Subcontractor agreement to allow the prime contractor or in some cases, a "neutral" third party to audit the books and records of the subcontractor (books and records typically described as timecards/payroll, accounts payable/disbursements, etc….the "etc." should be a bit disconcerting because it is essentially open-ended.
- Subcontractor monthly invoices to include detailed supported documentation at the individual transaction level (translated: summary level invoices become voluminous submission). A rhetorical question, does this requirement negate any expectation for an after the fact audit…the rhetorical answer, not if the subcontract contains the clause permitting or requiring an audit. And an unanswered question, who pays for the third party after the fact (incurred cost) audit?

All of these requirements have evolved from DCAA audits of prime contractors where DCAA insisted that an adequate prime contractor accounting/billing system would include very specific administrative requirements for subcontractors; in many cases the "list" of requirements are almost identical to those effectively struck down by the ASBCA cases.

In addition, we routinely encounter subcontract terms such as one which permits a subcontractor to bill direct travel (if pre-approved in advance by the prime contractor point of contact) along with all detailed receipts supporting the travel costs and allowing the subcontractor to add allocable indirects (i.e. G&A) if the subcontractor happens to already have a Government approved accounting system. If the subcontractor does not have a government approved accounting system, it should be obvious that base upon FAR 42.202(e)(2) it isn't the government's responsibility to audit a subcontractor's accounting system…that responsibility resides with the prime contractor as a part of its procurement policies for certain contract types (e.g. cost type). Hence, for any subcontractor facing this challenge and not having a government approved accounting system, you should assume that any allocable G&A will not be reimbursed by the prime (unless the subcontractor subsequently obtains a government prime contract which requires an accounting system adequacy determination.

One other note of caution for subcontractors, that prime contractors are mixing and matching terms and conditions for different contract types all within the single subcontract. For example, a subcontract might be 98% fixed price, but the remaining 2% is for reimbursable travel in which case the subcontract terms include requirements for final indirect cost rates, audits, and cost allowability (FAR 31 cost principles); however, the subcontract never limits applicability to the cost type task or line item. In some cases, prime contractors insert the terminology, "to the extent applicable" as a lead-in statement before listing requirements which might not apply or might not apply to all line items/costs. Perhaps obvious, but a subcontractor should balk at subcontract terminology which mixes and matches requirements for fixed price work with requirements for cost type work and clarifies it with the addition of "to the extent applicable".

With respect to prime contractors who continue to include subcontract requirements which should have been eliminated based upon the late 2016 ASBCA decisions, those prime contractors are perhaps unwittingly reversing or negating the ASBCA decision. To the extent the subcontract has specific requirements that are not in the FAR (not in the prime contract), the prime contractor is now self-imposing subcontract administrative requirements (such as audits of subcontract costs, subcontractor indirect cost rate submissions, subcontractor submission of time sheets, etc.), for which the prime contractor must now "manage" those requirements. If the prime fails to manage explicit subcontract requirements (that the prime added on its own), a DCAA auditor will now be in a position to question subcontract costs based upon the contractor's failure to comply with the contractor's own policies.

At the very least, prime contractors should revisit their subcontract terms and conditions and consider eliminating

those which exist as a by-product of DCAA's expanded and contractually invalid interpretation of FAR 42.202-(e)(2). Or leave things alone and continue with administrative requirements which are non-value added.

DoD-IG gives DCAA's System for Audits a "Pass with Deficiencies"

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

The DOD-IG (Inspector General) just issued its "External Peer Review on the Defense Contract Audit Agency System Review Report" and the highlight (at least for DCAA) is that they "passed with deficiencies" which means that DCAA can continue to issue audit reports which assert compliance with GAS (Government Auditing Standards; apparently this criterion is no longer GAGAS or Generally Accept Government Auditing Standards). Of passing note, from 2009 through 2014, DCAA did not have an external peer review (which traces back to 2008-2009 GAO reports which concluded that DCAA was not performing audits in accordance with GAGAS); however, no one has ever determined if or how that impacts government contractors other than in a somewhat meaningless note in the DCAA audit reports. In other words, government contractors on the receiving end of DCAA audit reports have not gained any advantage during periods when DCAA did not have an external peer review.

In terms of the latest peer review, the cited deficiencies included: evidence, supervision, professional judgment and reporting and these were attributed to conditions observed within a statistical sample of 67 audits (from a universe of 4,251 audits issued by DCAA between July 1, 2015 and June 30, 2016).

In much the same fashion as a contractor (auditee) responds to a DCAA draft audit report, in this case DCAA provided its response to conditions (findings) identified by the IG. We found the following of interest if for no other reason it appears that for DCAA, dealing with the DoD-IG is much like defense contractors dealing with DCAA.

- DCAA observed that the DOD-IG overstated the number of findings, for example the same basic set of circumstances formed the based for the IG concluding that DCAA failed to comply with evidence, supervision and reporting. DCAA maintained that the fundamental issue was only one of the three and it should only have counted as failing to comply with that one. This is beyond amusing because that's exactly how DCAA approaches business systems deficiencies; specifically using one set of facts to assert that a contractor has failed to comply with more than one systems criteria. Both DCAA and the DoD-IG seem to adhere to the theory that more negative reporting is better even if that statement of facts is repeated and repeated and repeated.
- For 18 of 67 audits, the DOD-IG reported that DCAA had failed to obtain sufficient evidentiary matter to support the DCAA conclusion. Among the 18 audits, the DoD-IG found 25 instances where the auditors did not obtain sufficient evidence to support the auditor conclusion that the costs were allowable, allocable and reasonable. An example cited by the DOD-IG was DCAA's opinion that contractor compensation and software licensing costs were reasonable, allowable and allocable, but for 13 instances, DCAA did not have any documentation where it specifically tested for reasonableness. Thus, if DCAA did obtain sufficient evidentiary matter for all other cost accounts, it would not matter because two categories of costs were not tested (to the satisfaction of the DoD-IG). The similarity to DCAA audits of defense contractors is in the fact that a contractor might have thousands of opportunities for documenting costs, but overall (accounting system) failure can result from inadequate documentation on relatively few. The dissimilarity to DCAA audits is that an error rate of 27% (18 of 67 audits) was apparently not enough to give DCAA an overall rating of system failure. Noting that the IG used a statistical sample, the sampled results theoretically extrapolate to 1,148 audits (out of 4,251) for which the audit conclusions were based upon inadequate evidentiary matter.

Beyond the immediate DoD-IG report, the conclusion that DCAA had a high failure rate for obtaining sufficient evidentiary matter is more than disconcerting to anyone audited by DCAA because the consensus is that DCAA over-audits in terms of its demands for documentation supporting cost allowability, allocability and reasonableness. In the case of software licensing and cost reasonableness, this could present some significant

new challenges for contractors who may now find themselves having to demonstrate cost reasonableness for costs previously considered low risk (I.e. software licenses and renewals purchased from a known third party, most likely a commercial item for which cost reasonableness for any given year may track back to original software acquisition). If DCAA wants to avoid or minimize future (DoD-IG) second-guessing of "evidentiary matter", this will be bad news for contractors who already believe that DCAA's demands for documentation are excessive and unnecessary. We can see it now, DCAA demanding more and more and blaming it on compliance with GAS (as interpreted by the DoD-IG).

- In another example where the DoD-IG tactics and conclusions were eerily similar to DCAA in the context of contract audits, DCAA asserted that the DoD-IG failed to consider materiality in terms of costs which were audited (with sufficient evidence concerning cost reasonableness) and similar costs audited for allowability, but not for reasonableness. In the audit risk assessment (for legal and miscellaneous costs), the auditor specifically stated that he/she would audit for allowability, reasonableness and allocability. In fact, that auditor only focused on allowability (which is the focus when auditing legal costs); however, the auditor's failure to follow his/her audit plan was a material departure from obtaining sufficient evidence. Translated, DCAA's use of templates and standard verbiage (in a risk assessment) misstated the risk and/or overstated the audit planning, but that's not the DoD-IG's problem (they aren't there to acknowledge that the audit plan was overstated).

There is much more within the DoD-IG report, but not much of it worth discussing other than to note that DCAA's reactions are of more than passing interest because the after-affects will be felt by contractors audited by DCAA. To its credit, DCAA did not summarily agree with a number of DoD-IG recommendations and in that context DCAA is to report back to the DOD-IG with DCAA's plans or alternative plans. Perhaps DCAA will realize that one of its self-inflicted wounds is its bloated and over-stated risk assessments which ultimately plan more than is necessary. If DCAA simply reduces the amount of time spent on audit risk assessments, they will minimize these self-inflicted wounds and more importantly, actually begin audits sooner than later.

In terms of one final editorial comment, it's obvious that any and all efforts to reduce contract administrative costs ("acquisition streamling"), including responding to DCAA contract audits, will go nowhere as long as we have the DoD-IG which is "in the weeds" and second guessing DCAA's audits…but it does sound a lot like DCAA in the weeds and second-guessing contractor business systems.

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Redstone Government Consulting, Inc., Radiance Technologies, Inc., and Warren Averett are sponsoring a CFO/Controller roundtable for Government Contractors.

All Government contractor CFO's or Controllers are invited to participate. The meetings are held quarterly and will include lunch and networking from 11:30am – 1:00pm. The next meeting is TBD. Participants will be notified via email announcements for all future locations and seminar topics.

The CFO Roundtable is **free** to attend. All participants will be invited to share topics of interest and the group will be interactive. Redstone GCI, Radiance Technologies, and Warren Averett will strive to provide speakers on topics that are of interest to the group each quarter. Please provide us your email address and we will notify you 30 days in advance of each meeting. RSVP's are required.

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Our Company's Mission Statement: RGCI enables contractors doing business with the U.S. government to comply with the complex and challenging procurement regulatory provisions and contract requirements by providing superior cost, pricing, accounting, and contracts administration consulting expertise to clients expeditiously, efficiently, and within customer expectations. Our consulting expertise and experience is unparalleled in understanding unique challenges of government contractors, our operating procedures are crafted and monitored to ensure rock-solid compliance, and our company's charter and implementing policies are designed to continuously meet needs of clients while fostering a long-term partnership with each client through pro-active communication with our clients

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.

Specialized Training

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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