REDSTONE Government Consulting

Government Contract INSIGHTS

A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 85

DCAA's 2017 Annual Report to Congress: It Just Keeps Getting Better…per DCAA

By Michael Steen, CPA, Senior Advisor

DCAA's Fiscal Year 2017 Annual Report to Congress which is available here, continues to provide Congress (and the rest of us) with statics and narratives which paint DCAA in the best light possible. To be sure, through its inception and as revised by subsequent NDAAs (National Defense Authorization Acts), Congress imposes certain reporting requirements; however, Congress does not impose any specific reporting standards nor are there any indications that DCAA's representations are subject to independent audits. Translated, DCAA must provide Congress with specific data, but DCAA has tremendous latitude in terms of highlighting the good news and masking the "not-so-good" news. In addition, unlike publicly traded corporations which are subject to SEC reporting standards, the absence of reporting standards for its annual report to Congress allows DCAA to change current reporting without restating any prior reports. In other words, year-to-year comparability may not be what it seems.

At any rate, some of the highlights from DCAA's 2017 report:

- Effective in 2017, DCAA now has four Corporate Audit Directorates (or CAD, focused on the seven largest major defense contractors) which has enabled DCAA to develop contractor-based expertise and innovative audit processes. Editor's comment: DCAA has always had auditors in-residence at these seven (and other large) contractors; hence, contractor-based expertise has been in existence for at least 30 years. However, there is now a Senior Executive (SES) with the authority to direct all auditors assigned to the CAD, a significant

THIS ISSUE:

improvement in assuring consistency in audits and audit interpretations. Previously a GS-14 (Resident Auditor) for one contractor segment had the authority to issue his or her audit reports which were not necessarily consistent with those of a different Resident Auditor for a different segment (in each case, segments of a single consolidated corporation, such as Lockheed Martin), perform multiple years of incurred cost in one audit rather than separately performing audits of each year's incurred costs). Perhaps obvious, but a contractor requesting a multi-year audit should consider using its own wording and also recognize that multi-year (concurrent/combined) audits should be more efficient, but there are no guarantees (particularly if the auditor is marginally competent and spends needless hours auditing "in the weeds").

- Although it is tucked-away on page 16 of DCAA's Report, Section 5, *Outreach Actions Toward Industry*, subparagraph A, *Joint Audit with Industry*, is quite possibly the most significant "good news" for government contractors. DCAA reports significant success on a coordinated audit with Textron/AAI and its internal audit team. DCAA highlights the collaborative approach to jointly audit three of six contractor business systems and the all-important fact that DCAA is actively pursuing other opportunities for joint audits (with other contractors). Editor's comment: This is a remarkable "about-face" for DCAA, whose (prior) Director publicly and consistently stated that "DCAA could not rely on the work of internal auditors" (in the absolute, regardless of DCAA's involvement in planning and executing these audits). There is nothing new about this concept, a concept which has been in play with DCAA and large contractors since the 1990s and before). Why change now? Who knows other than speculating that external pressures have caused DCAA to stop making excuses (for not auditing contractor business systems) and find a solution; in this case, one that has always existed, is compatible with Government Auditing Standards, and has the potential to dramatically change DCAA from an isolationist focused on absolute independence from contractors to more of a collaborative partner with industry.

- DCAA's Incurred cost backlog is now down to the equivalent of 14.3 months and on-track to be eliminated by September 30, 2018. The incurred cost backlog refers to contractor indirect cost rate proposals (annual submissions required by FAR 52.216-7) and the 14.3 months represents 2,860 submissions (page 9 of DCAA's report).

  Editor comments: Using this data, one might think that DCAA apparently receives 2,400 contractor submissions annually (using simple ratios of 14.3/12; if 2,860 represents 14.3 months, then 12 months = 2,400 incurred cost submissions). Unfortunately, one cannot use DCAA's reported backlog (2,860) to derive anything in terms of annual submissions. Per DCAA, the incurred cost "backlog" is not the same as the total number of contractor incurred cost submissions awaiting audit. Per DCAA, the "regular" inventory are contractor submission for the two most recent years, whereas the "backlog" inventory are the incurred cost submissions more than two years old. Confusing at best, and misleading at worst because it leaves the reader to guess exactly how many contractor submissions are in DCAA's in-box. Perhaps this explains why Senator McCaskill sent a letter to the DoD Comptroller wanting to know the current inventory of incurred cost audits (actually, the wrong question, the question should be the current inventory of incurred cost submissions awaiting audit). Ms. McCaskill also wants to know DOD's plans to reduce the backlog to 18 months (per DCAA it was already less than 18 months before Ms. McCaskill sent her October 20, 2017 letter). Of more than passing interest (and adding to the confusion), in her letter to DOD, McCaskill notes that the GAO reported DCAA's overall backlog was 14,000 (at the end of FY2016), but those more than two years' old were 5,000 of the 14,000. Per DCAA's 2016 Report to Congress the "backlog" was 4,677 (relatively close to the 5,000 reported by the GAO). If this data is (almost) accurate, it means that as of 9/30/2016, DCAA had 14,000 contractor submissions, but 9,323 were regular inventory (one or two years old) and 4,677 were more than two years old.

  In and of itself, an example of DCAA changing the way it measures and reports its success in reducing the incurred cost backlog. Along the way, DCAA has redefined the word "backlog" to make it more likely that DCAA can reduce its backlog to 18 months (while not

counting the "regular" inventory of incurred cost submissions). In my day with DCAA (which ended 4/30/2007), the backlog was simply the actual number of contractor incurred cost submissions in-house, thus, awaiting audit. DCAA's current (and confusing) strategy reflects a universal principle that the best way to report less-than good news is to make it as confusing as possible.

- DCAA's 2017 statistics (dollars in billions) included total net savings of $3.503B, of which $2.398B was attributable to forward pricing (audits of contractor bid proposals and/or forward pricing rates), $.760B attributable to incurred cost audits and $.347B attributable to special and other audits. DCAA's ROI (Return on Investment) was $5.20 to $1 based upon DCAA's total agency funding of $.670B ($3.503B net savings divided by / $.670B agency funding = 5.20). Editor's comments: As now required by Congress, DCAA distributes its ROI to each type of audit; however, the distribution does not reflect the net savings divided by funding (aggregate costs) for each type of audit. For example, Incurred cost net savings of $759,585,000 lists ROI of $1.10. If this ROI were based upon net savings divided by funding assigned to incurred costs, incurred costs audits consumed funding of $690,532,000 (which is more than the total agency funding for all types of audits). Not that DCAA did it, but one can determine ROI for incurred costs by using Table 2, *Aggregate Cost of Performing Audits by Audit Type*, which shows $296,884,000 for incurred cost audits. Hence, the ROI for incurred cost audits is $2.56 to $1 ($759,585,000 divided by $296,884,000). Inexplicably, DCAA's ROI by audit type is nothing more than pro-rating the aggregate ROI using percentages of net savings by audit type. An unfortunate example of presenting data which might be logical in total but isn't logical as assigned by DCAA to each of the four audit types.

- DCAA's overall (cost question) sustention rate is 50.4%, which is the weighted average of sustention rates for the four audit types. Forward Pricing yielded a 66.2% sustention rate, whereas incurred costs yielded 28.6% (the two other audit types were in the low 40% sustention rates). For what it's worth, the sustention rate for incurred costs can be validated against another source, the DOD-IG Semi-Annual Reports to Congress (Appendix F) and DCAA's reported 28.6% is relatively close to the data per the DOD-IG (data which is provided by DOD Contracting Officers through DCMA). There is no independent source to validate DCAA's 66.2% attributed to forward pricing, but apparently the same cadre of auditors have more defensible findings for forward pricing than for incurred cost…or DCAA makes a number of favorable assumptions when determining cost savings on forward pricing (and these assumptions cannot be validated by using another independent source).

- Not exactly a highlight, but one immediate observation, DCAA can't seem to grasp how to truncate dollars and then present those amounts in tables. Tables 2, 3 and 4 (Pages 5 and 6 of DCAA's Report) are three tables with dollar amounts and a note that the amounts are in (millions). In Table 2, DCAA assigns its total agency funding (listed as $669,670 (millions)) to each of the four audit types. For example, the reader is told that $296,664 (million) was expended for incurred cost audits. Table 3 reports audit exceptions and exceptions sustained, once again with dollar values in (millions). And finally, Table 4 reports ratio of cost questioned sustained to each of the four types of audits. What's wrong with DCAA's depiction of dollars? When truncating dollar amounts, DCAA is only dropping three zeros (000) which means that the dollar amounts (shown in the tables) are in (thousands) not (millions). Using DCAA's flawed reference to millions, one would add six zeros to the amounts displayed; if one does this to DCAA's annual funding, $669,670 becomes $669,670,000,000 (which is relatively close to DOD's total funding; we know DCAA's annual funding is $669,670,000). Anyone familiar with the data and/or anyone relating other sections of the report to these tables, can deduce the correct amounts from the tables. However, it begs the question, how can an audit agency in reporting data to Congress not grasp the concept of how to accurately and correctly truncate and report dollars. Perhaps DCAA's unintended message, numbers confuse DCAA.

One final thought on DCAA's Annual Report to Congress, it goes without question that DCAA (or any other agency reporting to Congress) will make every attempt to put forth the

best possible story. One would hope that DCAA's data is valid; however, it is not subject to independent audit verification. Thus, we might be reading a report which is similar to a statement commonly seen in motion pictures, the following (movie or in this case, report) is based upon actual events. "Based upon" and "actual events" might be similar and they might not; it depends upon the artistic liberties of the author.

Defective Pricing: Making a Comeback in Terms of Increased Contractor Risk?

By Michael Steen, CPA, Senior Advisor

In our last newsletter (volume 84), we mentioned a DPAP (Defense Procurement and Acquisition Policy) waiver which increased the TINA (contract value) threshold to $2,000,000 million (up increased from $750,000). This change was to comply with a recent NDAA and no one has published any data which estimates the number of DOD pricing actions which will now be exempt from TINA. As we stated in the last newsletter, essentially a "so what" change given the fact that an extremely small number of pricing actions are ever audited (after the fact) for TINA compliance (or non-compliance which would be defective pricing). As a point of reference, based upon DOD-IG reports to Congress, for the 12 months ended 3/31/2018, DCAA issued 27 Defective Pricing Reports with approximately $120 million in recommended price adjustments. Other information in those DOD-IG reports suggests that the $120 million is largely associated with fewer than five reports. The conclusion, very few contracts with the TINA clause are ever audited and for those which are audited, a very small number generate the lion's share of the recommended price adjustment (and we don't know how much of the $120 million was upheld in negotiations/settlements).

A number of recent blogs are now highlighting increased risks for defective pricing which is a function of a DPAP policy which (sort of) increases the risk of defective pricing for DOD contractors. Its June 7, 2018 memorandum directs DOD contracting officers to only allow contractors up to five days for "sweep data" (last minute sweeps to identify any additional cost or pricing data which is typically provided to the PCO after price negotiations have been completed). Mr. Assad (Director of DPAP) states that the inefficient process of contractor sweeps significantly contributes to the acquisition lead-time (of course he provides no empirical data supporting his statement, nor does he provide any information supporting his assertions that contractor sweeps are a significant factor adding to acquisition lead-times).

Mr. Assad goes on to remind contractors that the regulatory requirement for cost or pricing data is before agreement on price and that untimely submissions of sweep data may be indicative of estimating system deficiencies. So now we know when PCOs request a contractor sweep, it is actually a trap which could lead to declarations of an inadequate estimating system (if the contractor provides anything (which impacts the price) with the sweep, per Mr. Assad, this should have been provided before the preliminary agreement on price; hence, indicative of an estimating system failure). Of passing interest, the DP/PAP waiver (DARS Tracking Number 2018-O0012) is signed by Shay Assad, who is now (or has been) dual-hatted (Director of Defense Pricing and Defense Procurement Acquisition Policy). In fact, the position is exactly where it was until a few years ago when Defense Pricing was split from Defense Procurement and Acquisition Policy. Rest assured that the reconsolidation back to one director did not result in doubling Mr. Assad's salary, coincidentally a reminder that for purposes of contractor executive compensation, benchmarking for reasonableness (FAR 31.205-6(b)) recognizes no additional compensation for a company executive who might be "dual-hatted."

Mr. Assad's final "shot over the bow" towards defense contractors is his direction that Contracting Officers shall defer consideration of the impact of any cost or pricing data submitted by a contractor after final price agreement is reached until after the award of the contracting action in order to avoid delays in the awarding of the contract. Any cost or pricing data submitted after price agreement is to be dispositioned using FAR 15.407-1 (implies defective pricing if the contractor sweep provides any data which renders previous data not current, inaccurate, or incomplete and there is an impact on the price). A classic example of bureaucratic arrogance which renders wholly disingenuous the five-day limitation for contractor sweeps. Based upon Mr. Assad's direction, once there is an agreement on price, PCO's will not consider later contractor data even if it is provided within the five-day window. In other words, (to contractors), don't bother with any sweeps after price agreement; the five-day window is a joke.

Although the DPAP memorandum is what it is (not subject to any regulatory review), it illustrates what typically happens when a DOD Executive is pressured by the Secretary of Defense to resolve a problem; in this case, untimely acquisitions. The DOD Executive solution? Blame industry, albeit with absolutely no empirical data suggesting that sweeps are a significant contributor to untimely acquisitions or that contractors are solely responsible for the inefficiencies of sweeps (if there are any). Also an example of a "solution" without any meaningful analysis to define the problem; but Mr. Assad is apparently so intuitive as to be able to solve a problem (allegedly caused by industry) without any validated, measurable inputs. And DOD can't understand why it is so difficult to entice non-traditional defense contractors to consider becoming a defense contractor.

Although it is somewhat coincidental with respect to the DPAP Memorandum, on a slightly positive note, on May 4, 2018, DOD issued a final rule amending DFARS 215.407-1 to add section (c)(1) related to contractor voluntary disclosures of defective pricing. In short, the new section permits the Contracting Officer to request either a limited scope audit or a full scope audit. At a minimum, the Contracting Officer is to discuss with DCAA the completeness, accuracy and potential impact of the voluntary disclosure (we are not sure that it matters, but as of now, DCAA does not have a publicly available adequacy tool for contractor voluntary disclosures, but rest assured DCAA will develop its own non-regulatory adequacy checklist…auditors cannot function without one).

If one pairs the May 4 DFARS change with the June 7 DPAP Memorandum, you can conclude that one (implied) form of "voluntary" disclosure will be anything provided after price agreement (i.e. data from a contractor sweep). Noting that DPAP has directed that any impact should be considered under FAR 15.407-1 (Defective Pricing), data from a contractor sweep will become a voluntary disclosure for which DFARS clearly states that a voluntary disclosure does not waive the Government's rights to pursue defective pricing claims on the affected contract or any other contract.

One final thought on "all of the above", to the extent that a contractor does determine that it failed to comply with TINA, that there is a price reduction (after any offsets), and that the Government has made overpayments as a result, there is another contractual clause which implicates a mandatory disclosure (FAR 52.203-13). Given the potentially severe consequences of failing to make a mandatory disclosure, contractors need to realize that there might not be anything "voluntary" about disclosing defective pricing (if the contractor has performed the necessary analysis to determine that there is defective pricing and that it did unfavorably impact the price negotiated and paid).

Chicken or Egg? A Business Systems Dilemma

By Asa Gilliland, VP & Sr. Manager

The procurement landscape is becoming ever more competitive and acquisition personnel are continually looking for ways to differentiate competitors in the proposal setting. The introduction of DFARS Subpart 242.70 Contractor Business Systems in 2012 provided a new (sort of) mechanism of gauging contractor responsibility when it comes to major business systems involved in the performance of contracts. There are six systems areas which cover accounting, property, purchasing estimating, material management and earned value management systems. Much of the requirements associated with these business systems either directly reflect an existing FAR requirement (e.g. FAR Part 45 and DFARS 252.245-7003 Contractor Property Management System Administration) or borrow heavily from the prior DCAA Internal Control Audit Procedures (ICAPs), which were designed for the audit of major contractors. At the time ICAPs were active (pre-2010), "major contractor" meant north of $100M in annual flexibly-priced sales to the U.S. Government. The DFARS clauses, seem to appear in contracts of all sizes, even though the clauses do not have any teeth unless the contract itself is subject to CAS (see definition of "covered contract" at DFARS 242.7000(a)). Qualifying as a small business is an exemption to CAS under public law, so why would these clauses appear in small business contracts?

Contractor responsibility described in FAR 9.104 provides the contracting officer with several metrics designed to ensure that only responsible contractors are awarded contracts, thus elevating the chance of successful performance. Specifically, FAR 9.104-1(e) states,

> *Have the necessary organization, experience, accounting and operational controls, and technical skills, **or the ability to obtain them** [emphasis added] (including, as appropriate, such elements as production control*

procedures, property control systems, quality assurance measures, and safety programs applicable to materials to be produced or services to be performed by the prospective contractor and subcontractors).

For small businesses, the insertion of the DFARS business system clauses in contracts cannot be ignored and should be viewed as a responsibility check, however it is important to understand the applicability and intent behind the insertion of business system requirements in government requests for proposal. The presence of DFARS 252.242-7005 and one or more of the individual business systems clauses is merely signaling that if the awarded contract is a "covered contract" (i.e. CAS-covered) then there is a mandatory and specific process for evaluation of the business system and a contractual remedy for an inadequate business system (i.e. payment withholds DFARS 242.7000(d)). Inclusion of language like the below, simply means that prospective contractors are required to submit proof of adequacy for certain business system(s) as a condition of responsibility, not fully comply with DFARS business system clauses in performance.

Example RFP Language

Proof of an approved accounting system and approved purchasing system. If offeror's and significant subcontractor's accounting or purchasing system has been reviewed and approved by a Government auditor, provide the auditor's name and telephone number and date of most recent review. Please submit a copy of the Government audit, if available. If an offeror does not have "proof of an approved accounting system and purchasing system" at the time of proposal submission, the offeror will not be rendered non-responsive. However, the offeror must provide proof that its accounting and purchasing system is adequate for determining costs applicable to the contract prior to award.

This presents quite the dilemma for many small business contractors. The only mechanism to trigger a formal review/audit of the business system is by meeting one of the various thresholds for audit/review. These thresholds are large. For example, with respect to a CPSR (Contractor Purchasing System Review) FAR 44.302(a) prescribes a threshold of $25M in sales to the government and those sales exclude what often represents a substantial portion of contract sales (commercial, competitive FFP, et al.). Internal DCMA guidance has since raised the ceiling for CPSR to $50M. We have many clients well in excess of that mark who have never been contacted about a CPSR. Audits are a function of resources, and as a taxpayer I like that those resources are being allocated based on contractor risk. However, as a consultant working with small businesses, it is frequently a point of frustration when clients are prepared and doing things right but simply can't get an auditor onsite because of their size.

So, what's a small business contractor to do?

1. Assess applicability and ask questions (to the extent you can). The DFARS Business System Clauses only apply to covered contracts, but that rarely slows acquisition teams from including them in small business set-aside procurements. A well worded question early in the RFP process can save a lot of headaches later in proposal development.
2. Assess the competitive landscape to determine how important the responsibility requirement is to those evaluating proposals. The reality is that a contractor should not be excluded from the competition simply because they have not had one or more business systems approved by the government. However, if you're the odd man out in a proposal setting without approved systems you need to give the evaluators confidence that you are prepared to get there quickly.
3. If you are routinely seeing language about business system(s) in RFPs you are pursuing, it would behoove you to get an assessment of where you stand with regard to compliance. The fact is, while you may not have been audited, most of the accounting, purchasing, property and other business systems are still gates for responsibility and often required contractually via FAR based clauses (e.g. FAR 52.245-1 Government Property). So, you should still be focused on compliant systems.
4. Develop a Plan of Actions & Milestones (POAM) to address gaps you may have in your existing system or to bring the system into full compliance. An example would be a contractor who has not had a formal CPSR but must still comply with FAR 52.244-2 Authorization and Consent to Subcontract. The POAM would address procedures employed today for compliance with FAR 52.244-2; but also speak to policies, procedures and

practices which would be implemented (and the timeline) if awarded the contract to meet the added CPSR requirements.

Redstone GCI regularly supports clients pursuing major proposal opportunities. In this role, we work closely with our clients to ensure fully responsive, winning proposals. Our role focuses on the cost volume including assistance related to cost/pricing, indirect rate strategy and extends into staffing plans, OCI mitigation and business system planning and narrative. As a firm, Redstone GCI supports over 600 government contractors all over the U.S. and internationally with successful contract performance in all business areas including accounting, program controls, contracts administration, human resources, litigation support/contract disputes, proposals and business systems.

Training Opportunities

2018 Redstone Government Consulting Sponsored Seminar Schedule

Go to the Redstone CGI Training Calendar.

2018 Federal Publications Sponsored Seminar Schedule

Go to http://www.fedpubseminars.com/ and click on the Government Contracts tab.

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.

Blog Articles to our Website

CPSR Guidebook and Threshold Changes: What Should Contractors Expect from DCMA?
Posted by Cyndi Dunn on Tue, Jun 19, 2018
Read More

The "New and Improved" DCMA CPSR Guidebook: Really Improved?
Posted by Asa Gilliland on Tue, Jun 12, 2018
Read More

What are the Top 5 Issues in an ICS Audit?
Posted by Asa Gilliland on Thu, Jun 7, 2018
Read More

Important Update for SAM Registration
Posted by Asa Gilliland on Tue, Jun 5, 2018
Read More

Clarifying Costs: Bid & Proposal and Independent Research & Development
Posted by Courtney Edmonson on Thu, May 31, 2018
Read More

FAR 31.205-6(p) Compensation "Cap" - OMB's Unpublicized Increases for 2016 to 2018
Posted by Michael Steen on Thu, May 17, 2018
Read More

For More Blog Articles: http://info.redstonegci.com/blog

Whitepapers Posted to our Website

What Are The Prime Contractor's Risks Related to Subcontracts
A Whitepaper by Asa Gilliland – Read More

The Audit World's Biggest Myths
A Whitepaper by Wayne Murdock – Read More

DCAA Rejection of Incurred Cost Proposals
A Whitepaper by Michael Steen – Read More

For More Whitepapers:
http://www.redstonegci.com/resources/white-papers

CFO Roundtable

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.

Sign up for CFO Roundtable updates here.

About Redstone Government Consulting, Inc.

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.

Redstone Government Consulting, Inc.

NEW ADDRESS
Huntsville, AL
4240 Balmoral Drive SW, Suite 400
Huntsville, AL 35802
T: 256.704.9800

Email: info@redstonegci.com
On the web: www.redstonegci.com