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Government Accountability Office (GAO) Record Year in "Financial Benefits" for the Tax Payer

By Michael Steen, Senior Advisor

In an attempt to start our 2019 newsletters on a positive note, we are proud to share the good news from February 2019 report (GAO-19-403T, "Fiscal Year 2020 Budget Request") wherein the leading sentence highlights the $340 Billion in financial benefits resulting from GAO work from 2014-2018. Even better, that Fiscal Year 2018 was a record year of $75 billion in financial benefits as a by-product of the work of approximately 3,000 FTEs (Full Time Equivalents). Per the GAO, the $75 billion represents a return on investment of $124 for every dollar in the GAO budget. By comparison, DCAA (in its annual reports to Congress from 2014 to 2017; 2018 is not yet published), reports annual net savings averaging $4 billion with a return on investment averaging $6 for every dollar in DCAA's budgets. Various IGs (Inspector Generals) have reported ROIs in the range of $20 to $25 per budget dollar over the past few years.

After our euphoria subsided, we then considered some other facts which (apologetically) might dampen our readers' conclusions that our tax dollars are being well spent. Some of those other facts:

- The GAO's reported financial benefits are basically a reflection of inefficient and/or ineffective Government operations (in many cases, financial benefits representing funds which could have been better used…whatever that means). And a number of GAO reports include "repeat" findings for the same or similar Government operations, but at different points in time with similar results, suggesting that with the passage of time, Government inefficiencies seem to resurface.

THIS ISSUE:

- The GAO's financial benefits are i) not audited, ii) not subject to any other independent validation, iii) not subject to any authoritative financial reporting standards and iv) presented as the lead sentence in the GAO request for a 2020 budget including a requested budget increase of 9.8%. Could there be an element of risk that the reported "financial benefits" might be biased and self-serving

- Reliance on Return on Investments (ROIs) across Government Agencies is like investing in mutual funds invested in the economies of un-regulated developing countries. In all cases, the data is unaudited (or rarely audited), not subject to other reliable means of validation and "could be" influenced by implied or explicitly desired outcomes (increased budgets or new investments).

- If Congress believed in any of the positive ROIs (Government Agencies) ranging from a low of $6 to $1 and a high of $124 to $1, wouldn't Congress be motivated to grant any and all budgetary increases (after all a $1 investment would yield significantly more in financial benefits, perhaps chipping away at the $23 Trillion National Debt)?

Not to take away from some of the benefits of the GAO, the IGs or DCAA, but the fourth point (above) suggests that what we have here is either a failure (by Government Agencies) to communicate (to Congress) or Agency representations which are recognized as unverified and just slightly self-serving. It is what it is, and we will continue to look forward to these agency (ROI) reports even if it provides only momentary euphoria.

DCAA Audit Policies on Subcontractor Assist Audit and on Audits Involving Incomplete or Inadequate Contractor Proposals

By Michael Steen, Senior Advisor

DCAA issues few publicly accessible audit policy notifications (historically MRDs or Memorandums for Regional Directors, but now expanded to include CADs/Corporate Audit Directors and DCAA Assistant Directors, HQ); hence, we are inclined to take note of those which are published. Two were issued (posted on www.dcaa.mil) over the last few months, including:

19-PSP-001(R), January 11, 2019.

In its updated audit guidance for auditing incurred subcontract and Inter-Organizational costs, DCAA has fundamentally changed from somewhat open-ended and ill-defined assist audit requirements to assist audits which will only occur when specifically requested by the DCAA auditor in the context of an annual audit of a prime contractor. Previously, DCAA required notifications (prime auditor to subcontractor auditor) of the existence of an auditable subcontract (and the duration of the subcontract) but deferred to the subcontractor auditor to determine if/how/when to audit the subcontract costs. Going forward, the annual subcontractor costs will be considered for audit as part of the audit planning and risk assessment at either DCAA office. If the collective decision is that the subcontract costs are low risk, they will not be audited and will not be counted in DCAA's audited dollars.

From a practical perspective, the impact of this revised audit policy might be transparent or perhaps invisible to contractors. For at least ten years DCAA has been hit or miss in terms of assist audits of subcontract costs (although subcontract costs might have been tacitly audited in the universe of total dollars audited at a contractor having auditable prime contracts and auditable subcontracts). More obvious, DCAA has been missing in action in terms of responding to a prime contractor request for an assist audit of a subcontractor's costs and even if DCAA happens to audit subcontractor costs, the audit results are not releasable to the prime contractor (unless the subcontractor agrees to release the results; which never happens).

Noting that DCAA is all but out of the picture of auditing subcontract costs, FAR 52.216-7(e) makes this a moot point. That regulation states that it is the prime contractor responsibility to establish final rates and costs for the prime contractor's subcontracts (in Southern terms, their ain't no regulatory expectation for DCAA assist audits). But DCAA never removes itself from the picture because its incurred cost audit program (10100 activity code) includes steps related to closed subcontracts (listed as closed on the subcontractors Schedule I of its Incurred Cost Proposal) for which the prime contract is still administratively open. DCAA's direction to its auditors: "The Government still has recourse to recover costs through the prime contractor". The implications or significance of this statement in the audit program links back to a statement in 19-PSP-001 that: "Although it is the prime contractor's responsibility to manage its subcontracts, auditors should not question subcontract costs based solely on the deficiencies in the prime contractor's subcontract management process" (note that the audit program includes a step for the auditor to

obtain and evaluate the prime contractor's subcontract management). Per 19-PSP-001, issues involving prime contractor management of subcontracts should instead become the bases for a potential business system deficiency report.

DCAA's redirection on subcontract management (not to question subcontract costs based solely on deficiencies in prime contract management of subcontracts), is involuntary because it is a by-product of ASBCA 59309 and 59509 wherein the Government lost on this very issue. Prime contractor management of subcontracts was the basis for $117 million subcontract cost questioned (within the prime contractor incurred cost audits). Even though that ASBCA decision should have been a very embarrassing event for DCAA (because of the ASBCA statement that the basis for the Government assertion and claim was a "legal theory created by a DCAA auditor"), DCAA simply can't leave it alone. Although subcontract management is at best a highly subjective interpretation without any well-defined regulatory basis, DCAA auditors will now try to leverage their subjective interpretations and expectations by holding hostage a contractor's business system (reference to DFARS 252.242-7005).

Government contractors (primes) should not expect any lessening of the Government interests in prime contractor policies and procedures related to subcontract management (which also includes prime contractor cost or price analysis of subcontractor proposals discussed in the next subsection). The Government continues to believe that prime contractors can do significantly better in terms of reducing overall contract costs/prices through better management of subcontracts. This fact or myth was created by the CWC (Commission on Wartime Contracting) in its 2011 reports which highlighted $31 to $60 billion in fraud, waste and abuse attributed in large part to prime contractor failures with respect to subcontracting (although much of the detailed discussion pointed to Government failings, not the least of which was the loss of (or lost trackability) of $6 billion in cash).

In reference to prime contractor management of subcontracts, a future Redstone GCI webinar (planned for May 2019) will discuss ongoing and evolving issues related to the very broad and ill-defined concept of prime contractor management of subcontracts. Additionally, within this newsletter, the last article discusses the risks of cost reasonableness challenges associated with prime contractors vis-à-vis subcontract costs flowing into Government contracts.

18-PSP-006(R), November 27, 2018.

This publicly accessible audit policy provides updated internal guidance for DCAA auditors in auditing and reporting "Incomplete or Inadequate Prime Contractor Cost or Price Analysis". The focus is on cost or pricing data (FAR 15.404-3(b)) during proposal audits and contract price negotiations differentiated from after-the-fact prime contractor cost allowability of subcontract costs. 18-PSP-006 is based upon a FAR requirement which clearly applies to a prime contractor, but it also introduces a significant amount of subjectivity (or "professional judgment" in an audit context) in defining what is or is not a complete and/or adequate price or cost analysis of proposed subcontract prices. At any rate, this audit policy highlights the expectation that DCAA auditors will no longer default to reporting inadequate or incomplete subcontract cost or price analysis as "unsupported (proposed) costs". Instead, an expectation that the auditor(s) will attempt to quantify audit exceptions by using decrement factors or other techniques to provide contracting officers with an amount (less than the proposed subcontract cost or price) to be considered in the pre-negotiation objectives of the contracting officer.

DCAA's historical proclivity for summarily reporting subcontract costs as unsupported was a bit of a disservice to the contracting officer, other than encouraging the contracting officer to demand more (cost or price analysis) from the prime contractor before negotiating a final price. Coincidentally, this topic was the focus of a recent DoD-IG report (DODIG-2019-019) which concluded that contracting officers took appropriate action to address proposal inadequacies, but in a number of cases, the contracting officers failed to adequately document the appropriate actions. At least by implication, one might expect 18-PSP-006 to result in fewer audit reports asserting that prime contractor proposals are inadequate for price negotiations because of incomplete or inadequate subcontract cost or price analysis. Unfortunately, that won't happen because the audit policy only changes the expectation for the auditor to use techniques to evaluate the proposed subcontract cost or price to question some portion of the proposed subcontractor cost or price, and **not** report unsupported costs ("not" is highlighted in the DCAA audit policy).

Contractors should recognize that 18-PSP-006 will introduce something of a double jeopardy scenario in terms of DCAA auditors:

- Questioning some portion of proposed subcontract costs (instead of simply unsupporting the entire amount), and

- Issuing a second report asserting a business (estimating) systems deficiency (DFARS 242-215-7002 and 252.242-7005),

What's DCAA's motivation for changing its policy? An optimist would opine that DCAA is trying to be more of a service to contracting officers (providing an amount for questioned costs instead of merely "throwing the issue over the fence" for the CO to address). A pessimist (or realist) will recognize that this policy is somewhat self-serving for DCAA by: i) increasing amounts of costs questioned and ii) increasing amounts reported as dollars audited. All else being equal, the changes will result in higher cost questioned, higher net savings, and increased productivity (dollars audited per audit hour). Like many other DCAA audit policies, the change has absolutely no connection to any change in any regulation and assuming the change generates more favorable statistics for DCAA, rest assured that DCAA will not highlight that fact in its Annual Report to Congress.

Prime Contractor Settlement with Subcontractor Does Not Equate to Government Acceptance

By Michael Steen, Senior Advisor

On a continuing theme of prime contractor management of subcontracts, a recent ASBCA decision (Nos 57530 and 58161) is a reminder that amounts for prime contractor settlements of subcontractor claims (essentially a subcontractor request for equitable adjustment or REA) are subject to Government scrutiny (audits, questioned costs and CO (Contracting Officer) disallowance of costs). In the ASBCA decision the prime contract was cost-type and the subcontract was fixed-price, including clauses which pertained to delays and subcontractor rights for an equitable adjustment. Notably the subcontractor rights and responsibilities associated with a potential equitable adjustment were subject to the same FAR and DFARS as would apply between a prime contractor and the Government.

There were a number of Government caused delays related to the prime and the subcontractor setting up living quarters (trailers) at a military installation (camp) in Iraq in 2003. Ultimately the prime settled multiple subcontractor REAs for approximately $51.2 million of which the Government Contracting Officer issued an interim determination allowing $25.5 million but disallowing $25.7 million. Later, the CO reversed his interim determination, allowing only $3.8 million (which related to lease costs which were adequately documented) and disallowing $47.4 million. The disallowance was premised upon cost reasonableness, FAR 31.201-3. Of significance to any issue involving 31.201-3, if cost reasonableness is challenged by the Government, the burden of proof is on the contractor to support cost reasonableness.

The ASBCA decision was wholly for the Government, stating: "The prime contractor is not entitled to any recovery. The (prime contractor) appeals are denied".

This prime contractor has become an unintended role-model for what not to do related to cost reasonableness and fixed-price subcontracts' costs flowing into cost-type prime contracts. In three published decisions, the prime contractor has failed to demonstrate that fixed price subcontract costs (initial price or increases attributed to REAs) were reasonable. In total, the reasonableness issues approximate $150 million of costs paid to subcontractors, but ultimately disallowed by the Government with the disallowance upheld in published decisions. In terms of some lessons for any Government contractor:

- Fixed-price subcontracts flowing into cost-type prime contracts open the door for Government challenges to the initial fixed-price or any revisions (REAs). This fact is highlighted in the DCAA audit program related to incurred cost audits.

- Urgent and/or rapidly changing Government requirements do not yield waivers from contractual clauses (FAR or DFARS). Although risky in themselves, urgent requirements may necessitate unpriced contracting (or subcontracting) actions in which case performance begins before prices are negotiated.

- Internal contractor documents which ultimately support the Government assertions may not be a factor in the Government's initial determinations, but they will likely be a factor if issues move into litigation (involving discovery). In all the cost reasonableness issues with this prime contractor, internal documents very clearly pointed to subcontract administration failures. In the most recent case of the REA, internal documentation (e.g. internal quality control reviews) that the subcontract settlement was not based upon any subcontractor cost data which was at odds with

the FAR/DFARS clauses incorporated into the subcontract.

- After-the-fact reinterpretations of the facts (to support different reasons for asserting cost reasonableness than those evident in any contemporaneous documentation) are likely to be disregarded by a competent administrative judge. In the case of the REA, the prime contractor introduced a new (and inapplicable) theory that there was no requirement for subcontractor cost data because the items were commercial. Nothing in the actual prime contractor procurement file was consistent with the "commercial item" argument. Nice try, but likely dead on arrival.

The cost reasonableness issues for this particular prime contractor may not extend to many other contractors because this contractor has, since the early days of the Iraq war (2003), been the target of a multitude of DCAA audits. DCAA may have taken what seems to be an unusual (and perhaps unfair) interest in this particular contractor; however, DCAA's audits and audit conclusions must ultimately stand-up to the independent decisions of contracting officers as well as in disputes where all relevant facts are presented to the ASBCA or Court of Claims. All contractors subject to FAR 52.216-7 (Allowable Cost and Payment Clause) do need to recognize the risks that the Government has the contractual rights to challenge the reasonableness of costs, including subcontract costs. Translated, just because the prime contractor paid it, does not equate to Government acceptance (nor should the Government accept the subcontract costs if the prime contractor fails to appropriately consider and/or document either its prime contract clauses or, in the case of the REA, its subcontract clauses).

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LIVE – Register Here

April 25, 2019 – Unanet: The Basics of Ad Hoc Reporting Webinar
WEBINAR – Register Here

May 15, 2019 – Navigating the Challenges of SCA Compliance Training Webinar
WEBINAR – Register Here

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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 Purchasing Systems (CPSR), Estimating Systems, Accounting Systems, FAR Part 31 Cost Principles, TINA and defective pricing, and basics of Cost Accounting Standards (CAS), 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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Our Company's Mission Statement: Redstone GCI 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.

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