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Contractors and Adequate Accounting Systems: The Saga Continues

By Michael Steen, Senior Advisor

In our Third Quarter Government Contract Insights Newsletter we reported DCAA's renewed interest in performing audits of contractor accounting systems for compliance with the 18 criteria listed in DFARS 252.242.7006(c). At the recent Redstone Edge Conference (held on December 4 in Huntsville), DCAA's representative confirmed that DCAA is refocusing available audit resources on contractor business systems, particularly accounting systems. The DCAA spokesperson also reconfirmed that DCAA uses the DFARS criteria whether or not the auditee (contractor) has a contract with the DFARS business system clause. Why ask about this? In terms of numbers, most contractors do not have a contract with the DFARS business system(s) clause(s) because most contractors do not have contracts subject to the Cost Accounting Standards (CAS)) (the DFARS business systems clauses and the business systems administrative clause 252.242-7005 only applies to a DOD contract which is also subject to CAS).

Although we could endlessly debate the validity of using regulatory criteria which isn't actually in any contract held by the auditee (the contractor), the fact is that DCAA uses that criteria and DCMA (and other contracting officers) expect contractors to comply with that criteria. Contractors which fail to meet one or more of the criteria will be determined and reported as having an inadequate cost accounting system accompanied by requirements to develop and implement a formal corrective action plan (CAP) in order to gain redemption in the context of an adequate accounting system. Although most contractors are not subject to the DFARS business systems payment withholds in DFARS 252.242-7005 (up to 10% if two systems have significant deficiencies), many contractors would prefer a payment withhold in contrast to receiving a CO final determination of an inadequate

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accounting system with the unstated penalty of being excluded from obtaining new Government contracts which require an adequate accounting system (e.g. cost-type or other flexibly-price contracts where payments are a function of contractor costs).

In terms of what to expect if DCAA comes knocking (notifies a contractor of a planned "post-award accounting system audit") is a lengthy DCAA questionnaire along with follow-up inquiries and questions, all as part of DCAA's risk assessment and audit planning. Once the audit moves from planning to execution (the latter starts on the entrance conference date), the auditor or audit team will be on-site performing transaction testing for an extended period of time (for contractors with the CAS covered contracts which actually include DFARS business system clauses, the "extended period of time" will involve thousands of audit hours whereas these audits for non-CAS contractors will typically involve hundreds of hours).

One particular note of caution for contractors, DCAA approaches these and almost all other audits with preconceptions in the form of DCAA's predetermined (or one-size fits all) expectations for contractor compliant policies and procedures which is at odds with the foundations of performing an attestation audit. Not that DCAA will predictably back-off, but a properly performed attestation audit should involve the auditor's gaining an understanding of "the" auditee's (contractor's) policies and procedures and the contractor's explanations or walk-through wherein the contractor is allowed to demonstrate how it complies with the regulatory criteria. By implication, and as essentially stated in the promulgation comments which accompanied the business systems rule, one contractor's approach could be compliant, but dissimilar from most other contractors. The criteria is to be used as a conceptual point of reference and not for standardized or prescriptive practices employed by each and every Government contractor. In a recent DCAA accounting system audit, auditor expectations or preconceptions were obviously based upon his or her experience with other contractors which led to auditor assertions that dissimilar accounting policies were non-compliant. For example: "your chart of accounts is unlike others, therefore it is a non-compliant (unacceptable) accounting framework". This is prevalent with DCAA audits which are rarely receptive to alternatives which are compliant, but immediately discounted as inadequate because of auditor preconceptions for standardized conformity. In this (and other) recent audits, DCAA's statements of conditions and recommendations (SOCARs) repetitively make a general reference to "other contractors" as if the regulatory criteria is defined by "majority vote."

We are aware of some DCAA accounting system audits wherein the contractor held fast to its understanding of the regulations and the fundamental concepts of attestation audits by repetitively offering to provide a detailed, point-by-point demonstration of contractor-specific compliant practices while steadfastly refusing to complete DCAA's audit planning questionnaire. Although this contractor strategy maybe at odds with DCAA's preferences, DCAA's own audit program for post-award accounting system audit at non-major contractors provides that obtain and document an understanding of the contractor's compliance with the DFARS accounting system criteria should be obtained during the walk through. Additionally, these contractors are on rock-solid ground given that one or more of the business systems explicitly require the contractor to demonstrate their compliant practices (if requested to do so by the Contracting Officer).

Although most contractors have valid reasons for placating DCAA or any other Government reviewer or auditor (i.e. being responsive to DCAA questionnaires), there is another aspect of DCAA's preconceptions which shows itself in DCAA's wording when citing a contractor for non-compliance with the regulatory criteria. The recurring issue pertains to DCAA auditors with a tendency to reword, expand or truncate the regulatory criteria to reinforce the assertion of a non-compliance. It's one thing for an auditor to explain his or her interpretations and to clearly identify those as interpretations (e.g. fill in the blanks when dealing with generic criteria such as a requirement for sound internal controls), but auditors are also known for including their revised wording in quotation marks as if the modified wording is a direct quotation from the contract clause. This seemingly subtle difference has proven to be important to contractors (in responding to DCAA draft audit reports and/or Contracting Officer initial determinations blindly based upon the DCAA audit report) by providing the contracting officer with a contractual basis for not supporting or sustaining DCAA's assertions.

To summarize reasons for continuing to focus on accounting system audits and compliance:

- Contractors need to be aware of audit exposure and risks as DCAA redirects audit resources from audits of contractor indirect cost proposals to contractor business systems. This exposure applies regardless of a contractor's status in terms of being CAS covered and having contracts with the DFARS Business Systems Clause(s).
- Reinforce audit risk mitigation which involves knowledge of the criteria (in this case DFARS 252.242-7006(c)(1) to (c)(18)) and either self-assessing or obtaining an independent third-party assessment for

compliance. Do not fall into the trap of going down the list and merely assuming that the system complies with the 18 criteria.
- Recognizing that DCAA has developed preconceptions/ expectations which may or may not give consideration to alternative compliant practices.
- Recognize that DCAA assertions/conclusions may involve DCAA's "artistic liberties" in terms of revising the actual regulatory wording and if/when that occurs, a contractor is well-served to point that out in responding to DCAA and/or in dealing with the Contracting Officer who makes the final decision for the Government.

Government Solicitations and Contractor Accounting Systems

By Michael Steen, Senior Advisor

Over the last few years, we and others have reported on trends in Government solicitations with respect to contractor accounting systems. In particular, solicitations which require a contractor to have an adequate accounting system (previously determined) as a condition of submitting a responsive bid differentiated from submitting a bid subject to a pre-award accounting system audit after the bid proposal is submitted, but before the contract is awarded. One other variation is the solicitation with source selection criteria which gives additional points to contractors with adequate business systems (previously determined by a government audit/review and/or a determination issued by a contracting officer).

As solicitations have evolved to frequently include requirements for previously determined accounting system adequacy, otherwise responsive contractors have been excluded for reasons completely outside their control. The precise wording of the solicitation is critical, some require an adequate system as determined by a DCAA or other government agency audit while other solicitations may permit an adequacy audit performed by an independent third party (i.e. a CPA firm) or a Government audit. A new or "wanna-be" contractor cannot compel a government agency to audit the accounting system; hence, for those solicitations requiring a government audit/adequacy determination, those with no prior government audit are non-responsive.

One other variable in terms of solicitations is the documentation requirement imposed on the bidders. In many cases, a requirement for a specific letter (date and source) or where permitted by the solicitation, an alternate but fully described point of reference.

A recent bid protest decision focused on the specific requirements of the solicitation which may have the intended or unintended consequences of reducing the number of responsive bidders. In this case, the highly competitive solicitation (issued by the GSA for a multiple awardee IDIQ task order contract) included additional points (5,500) if the bidder possessed an acceptable CAS (cost accounting system). The successful protester asserted that it would have been an awardee but for two bidders who inappropriately claimed and received points for having been previously audited which concluded that the contractor had an adequate accounting system.

The solicitation required bidders claiming the 5,500 points to provide verification of a (previously determined) acceptable cost accounting system from DCAA, DCMA or any cognizant federal agency in accordance with FAR 16.301-3(a)(3). Offerors were required to provide contact information for the agency representative (e.g. DCAA), a letter from the agency, an averment that the contractor had not materially changed its accounting system and its DUNS code and CAGE code. In lieu of submitting an agency letter (which might not exist as such and/or the contractor might not have in its possession), offerors could submit a statement of certainty that it possesses an "audited and adequate CAS".

This option of a "statement of certainty" opened the door for interpretations (or creative thinking) for any contractor which believed that an "audited and adequate CAS" could be imputed from other (sort of) relevant facts. In the case of the two awardees, each (respectively) provided a statement of certainty that was based upon their respective submissions of annual incurred cost submissions (ICS) which had been deemed adequate by DCAA. In each case, the ICS was presumed to include cost-type contracts and the ICS could not be adequate if the underlying cost accounting system was not adequate. Additionally, performing on cost type contracts led to the presumption of a previous contracting officer determination of an adequate cost accounting system as prescribed by FAR 16.301-3(a)(3). Although the statements of certainty were acceptable to the source selection official (contracting officer), the GAO found that this was problematic and irrational for two reasons:
- ICPs are submitted for cost-type and/or for Time and Material contracts. The awarding official could not confirm that either ICS included cost-type contracts (FAR 16.301-3(a)(3) pertains to cost-type contracts).

- A contractor can receive a cost-type contract without an audit and adequacy determination by a cognizant federal agency (CFA) of the contractor's accounting system. Per the GAO, in some cases, procurement history has shown that the adequacy determination was based upon facts/factors other than an audit by a CFA.

In the published GAO decision, the GSA was required to go back and evaluate the bid protestors proposal (and points) after correcting the points erroneously given to at least two other awardees (there were other documentation errors noted by the GAO). Hence, the bid protestor may have won the battle, but lost the war, so to speak (the GAO decision stops at the point of requiring a reevaluation and there is no public record of the outcome of the reevaluation). In terms of lessons learned, the two awardees could have bolstered their respective statements of certainty by noting that their ICS's included cost-type contracts; however, it is unlikely that either could have addressed the question of a predetermination of system adequacy based upon an audit by a cognizant federal agency (If either had that information, that would have been the more direct and irrefutable verification which would have been included in their bid proposals).

In terms of universal lessons for offerors on Government solicitations, the fact is that imputing a government determination of accounting system adequacy from incurred cost submissions was a logical and rational approach which worked with the contracting officer (but for the bid protest, the two bidders were "awardees"). In this case, the error (alleged by the GAO), did not disqualify either of these two awardees, so why not employ the strategy given that rational persons (i.e. the contracting officer) would most likely accept it (hint: GAO decisions aren't necessarily reflective of decisions by rational persons). Additionally, that bidders need to recognize that the specific wording of any given solicitation may be such that a bidder is facing an insurmountable obstacle which the bidder can neither control, nor overcome. In this case, had the solicitation had a requirement for a (responsive) contractor to provide verification of an audited and adequate CAS, any bidder falling short would be incurring bid proposal costs with a high probability of being deemed non-responsive. Not getting 5,500 additional points is very different than being deemed non-responsive and excluded from further consideration.

Lastly, potential bidders can always protest the terms of a solicitation (in hopes that the solicitation will be revised to eliminate insurmountable obstacles), but recognize that the Government has embraced the use of predetermined adequate contractor business systems as source selection criteria using the logic that a contractor with documented, adequate business systems lessens the Government's contracting risk. In other words, this strategy isn't going away in spite of the fact that it is clearly at odds with other Government initiatives to convince more companies to pursue Government contracts.

Miscellaneous Compliance Topics and Government Agencies "In the News"

By Michael Steen, Senior Advisor

GAO Annual Report for Fiscal Year 2019

There are some of us who anxiously await the GAO's Annual Report (it's one thing we can still look forward to this time of year when we no longer have the Sears Christmas catalogue). Although it might be unintended, the 2019 GAO Annual Reports brings to mind Santa Claus in terms of all of the wonderful gifts the GAO delivers to all of us (that's a fact, just read the GAO Annual Report and their self-declarations). Even more reminiscent of Santa Claus (or other mythological figures) we have the GAO's performance results including its $214.7 billion in financial benefits which translates into $338 for each dollar invested in the GAO (based upon its FY2019 Agency cost of $638.1 million). As points of comparison, most IGs (Inspector Generals) only report ROI's of $20 to $25 per dollar and DCAA only returns about $5 for every dollar in its budget. Although all of these agencies are audited in some form or fashion, their self-declared ROIs are not subject to audit; but they are in their respective annual reports, so fully reliable and trustworthy.

In terms of the details behind the GAO's record setting ROI, they noted $136.1 billion (63.6% of their total ROI for 2019) is attributed to a 2009 (Weapons) System Acquisition Reform Act (for which the GAO takes credit). The GAO compared cost growth from 1999 to 2008 (2.91%) to the cost growth from 2013 to 2017 (-.44%) and used that decrease as the basis for claiming a $136.1 billion "financial benefit". While acknowledging that the GAO could not determine if other factors contributed to the reduction in cost growth, the GAO declared victory and took credit for the entire amount. Noting that this is the same agency which is leading the charge for auditable financial statements for the United States Government, we can hardly wait for the creativity to begin. Apparently, Santa Claus is alive and well working with the GAO; Ho Ho Ho.

DoD-IG Semiannual Report to Congress (April 1, 2019 – September 30, 2019)

The DoD-IG Semiannual Reports to Congress include hundreds of pages of IG accomplishments, but also include Appendices E, F and H which provide a snapshot on contract audits (DCAA) issued in the six-month timeframe. Appendix E lists the number of reports, dollars examined, cost questioned, and funds put to better use (cost questioned on forward pricing bid proposals…not yet "costs") by type of audit. In total 1,895 audit reports which questioned $5.582 billion out of $269.765 billion examined. Forward Pricing (bid) Proposals continues to be DCAA's high payback type of audit contributing 70% of the cost questioned against 21% of the total dollars examined (DCAA questioned approximately 7% of the forward pricing dollars examined). Of passing interest, DCAA only issued 11 defective pricing audit reports which questioned $88.6 million (recommended price reduction), a type of audit which is expected to ramp-up significantly in 2020 and beyond (see the related article in our Third Quarter Government Contract Insights.

Perhaps most noteworthy in the IG report is footnote (9) in Appendix F which reported Contracting Officer actions to disposition DCAA audit reports. In this six-month period a 37.9% sustention rate ($464 million sustained on $1,223 million questioned). This is a significant improvement (on average this has been approximately 30% over the past four years), but still reflects the fact that DCAA report $759 million (62.1%) in unsustainable cost questioned. Equally noteworthy in the IG Report is Appendix H, "Audit Reports with Significant Findings" (for the most part issued by DCAA in the six-month period). For the six-month period ending September 30, 2019, there are only 2 pages listing only 7 DCAA audit reports; in contrast, prior six-month periods have included 8-9 pages listing 20-25 audit reports. The 7 audits listed totaled $149.5 million in cost questioned which only accounts for 9.5% of the total cost questioned (for similar audit types) from Appendix E. Assuming DCAA is providing this data to the IG, one has to believe that DCAA is i) too busy to provide more examples or ii) issuing lots of audit reports with individually insignificant cost questioned. Regardless of the limited amount of data, of the seven reports listed, the brief synopsis of the issues is a reminder that DCAA continues to question significant direct subcontract costs (in some cases 100% of a subcontractors costs feeding into prime contractor cost-type and T&M contracts).

ASBCA Case Focused on Subcontracting and Subcontractor Costs

ASBCA Case 61227 involved appellant (contractor) motions for partial summary judgment and summary judgment. The published decision is only seven pages, in part reflecting the limited amount of data within this particular motion for summary judgment. The FAR clauses at issue and the results:

- **52.244-2 and 33.201.** Approval to subcontract and the six-year statute of limitations on a claim; Government claim in this case because DCAA questioned $698,685, in part based upon the prime contractor's failure to comply with the subcontract notification and approval clause. In the narrow context of cost disallowed for failure to obtain ACO approval to subcontract, the contractor prevailed on its motion for partial summary judgment because the ASBCA agreed that the Government had been aware of these subcontracts by virtue of supporting details on multiple interim public vouchers, in all cases more than six years before the costs were questioned. However, the results could be very different had the issue involved more recent direct subcontract costs on prime contracts if the prime failed to comply with 52.244-2. In other words, failure to comply with the approval to subcontract clause has cost recovery implications, thus this is more than just an administrative oversight.
- **31.201-2. Determining Allowability.** Although there are few details in the ASBCA decision, the issue involves the lack of documentation related to subcontractor costs ($698,685). Thus, the issue involves 31.201-2(a) and 31.201-2(d); essentially an issue involving the lack of documentation to convince the Government that the direct subcontract costs are allowable, reasonable and allocable to the prime contract. The lack of documentation appears to be a by-product of i) the passage of time and ii) subcontractor mergers or acquisitions in which case the performing subcontractor records and its employees are not accessible to the acquiring subcontractor. Unfortunately for the prime contractor, the ASBCA did not address this issue other than to conclude that material facts are in dispute, particularly contractor assertions that government delays (in performing the incurred cost audits) prejudiced the contractor's ability to produce documentation.

The published decision doesn't give any details in terms of documentation requested (in the audit) and documentation provided; however, it is a reminder that incurred cost audits will focus on direct subcontract costs claimed on prime contracts (cost-type or T&M) and if there are issues, it will frequently involve the entire amount of the subcontract costs. Although the audits involved predate another very significant case (Cases 59508 & 59509) involving subcontract cost

allowability (and the decision was for the contractor, allowing approximately $120 million in questioned and ACO disallowed subcontract costs), other evidence confirms that DCAA has not backed-off its strategy of auditing and questioning significant subcontract costs based upon documentation available (or not available) at the prime contractor.

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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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