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DCAA 2018 Annual Report to Congress: Nominated for Best Creative Reporting by a Federal Government Agency

By Michael Steen, Senior Advisor

Although DCAA's 2018 Annual Report to Congress was posted much later this year (than the 2017 Report), it was worth the wait for the American Taxpayer (well at least for those who accept DCAA's unaudited data at face-value). Once again, DCAA highlights:

- Its positive "return on investment" of approximately $5 saved for each $1 spent (total net savings or $3.2 billion divided by $660 million which is DCAA's funding). To be sure, since these annual reports began in 2014, DCAA's ROI has exceeded $5 to $1, but as long as it is more than $1 to $1, DCAA will remind Congress that DCAA more than pays for itself.
- Improvements in audit response times, for example incurred cost audits issued in 125 days (measured from the date of the entrance conference to the report issuance date).
- Questioned costs sustained of 51.4% (overall), with sustention rates for audit type ranging from a high of 68.3% for special audits (which include contractor claims for equitable adjustments and claims related to terminations) to a low of 24.1% for incurred cost audits (audits of contractor indirect cost rate proposals submitted as required by FAR 52.216-7(d)). Notably, DCAA claims a 61.6% sustention rate for audits of contractor forward pricing (bid proposals) and that is critical in bringing the overall sustention rate up to 51.4%, because forward pricing is about 65% of DCAA's audit workload (measured in dollars audited).

THIS ISSUE:

- A spectacular return on investment of $22.10 to $1.00 on DCAA audits of Forward Pricing (primarily contractor bid proposals).
- The total elimination of the incurred cost backlog (actually reduced down to 152 as of 9/30/2018, but who cares about 152 when compared to 21,000 as of 9/30/2011).
- Communications with contractors (including outreach programs) and industry associations as well as collaborative efforts to implement acquisition reform (references to Section 809 and 803 of recent NDAAs).
- Process efficiency improvements attributed to an automated system developed by DCAA information systems specialists to match DCAA's open audits to DCMA listing of incurred cost contracts with cancelling funds (saving hundreds of hours and freeing up audit teams to more quickly finish the audits).

What DCAA does not highlight includes the following:

- It continues to have quality control issues in its Report to Congress, including a transposition error for the audit reports' count in Table 5 on page 8 (listed incurred cost count as 651 and special audits' count as 2,207, counts which were transposed and an obvious error as confirmed by other references to incurred cost audit reports of 2,207). The good news, DCAA avoided its 2017 miscue of over-stating dollar amounts as a result of truncating gross dollar amounts by dropping three zeroes (000) but reporting the net dollars shown in millions as if the truncation had been six zeroes (a reporting error which effectively and inaccurately converted billions into trillions as noted in our 2018 Q2 Newsletter; suggesting that DCAA might be reading the Redstone Government Contract Insights Newsletters).
- DCAA auditors issue less than one audit report per year per auditor. In 2018, 4,148 auditors issued 3,717 audit reports (or .9 audit reports for each auditor). We acknowledge that DCAA audit resources are not always expended on audits which generate audit reports (such as low risk incurred cost contractor submissions which are closed with a rate agreement letter but without an audit); however, the low risk procedure has been in place since 2012 and there have been a number of years where the numbers (closed without audit) were much higher than in 2018 yet the number of audit reports per auditor was significantly better than .9 for each auditor. The point, 2018 is the "low water mark" in terms of audit reports issued per auditor. Although it should not be taken too seriously, if one does correlation analysis (relating the trends in number of auditors to the number of audit reports), if DCAA has approximately 11,000 auditors it will be issuing 0 audit reports.
- DCAA's numbers of auditors who are CPAs is at 23%, down from almost 40% when the Agency considered this particular professional certification as a prerequisite for promotion into any supervisory or management position. Obtaining this certification may not automatically equate to better auditors/auditing, but it certainly reflects on one's self-discipline to pursue and obtain a professional certification which involves a significant amount of self-study and a measured level of competency in the fields of accounting and auditing.
- DCAA's cost questioned sustention rate is only partially validated by an independent source (DoD-IG Semi-Annual Reports to Congress) and notably missing from that independent source's validation is the relatively high sustention rate on forward pricing (61.6%). Thus, the unaudited, unvalidated sustention rate of 61.6% in combination with the fact that forward pricing audits account for 65% of the dollars audited (Table 3 of the 2018 Report), causes DCAA's average sustention rate to be 51.4%. In the aggregate, one might conclude that DCAA advisory assertions are sustainable about 50 % of the time. However, the real test (of the reliability and sustainability of DCAA assertions) is on incurred cost audits where the sustention rate is only 24.1%. Incurred cost audits are classic auditing, that is after-the-fact testing a contractor's certified indirect cost rate proposal for compliance with the contract terms and conditions (e.g. FAR, DFARS, CAS, etc.) Before issuing an incurred cost audit, DCAA provides a draft audit report to the contractor for rebuttal comments, thus giving DCAA the opportunity (and benefit) of reconsidering DCAA's preliminary assertions/conclusions and to revise the final audit report to exclude cost questioned which are not likely sustainable based upon all relevant facts and regulatory interpretations. In spite of this process which should yield relatively high sustention rates (because the contractor rebuttal will typically explain why the audit assertions/conclusions are not consistent with the regulations), DCAA is wrong on 76% of its incurred cost audit exceptions. This one statistic raises a very basic question as to the validity of DCAA's unaudited representations of an overall

sustention rate of 61.6% and/or confirms that DCAA auditors rarely give consideration to valid contractor rebuttals (a disservice to everyone involved).

- DCAA's success on the so-called incurred cost backlog is an example of reporting the numbers but changing how one reports and/or defines those numbers. At one point, the backlog was the total inventory of contractor indirect cost rate proposals (determined to be adequate) in DCAA's in-box. As mentioned in the 2018 report (first paragraph on page 9), when a (contractor indirect cost rate proposal) is adequate, it becomes part of DCAA's inventory of incurred cost audits (as of the date it is determined adequate). However, for purposes of the incurred cost "backlog", DCAA has unilaterally and without any meaningful disclosure decided to re-define that portion of the overall incurred cost inventory as those on hand more than two years (down to 152 as of 9/30/2018). By implication in the 2018 NDAA, Congress no longer cares or wants to hear about DCAA's representation of the incurred cost "backlog" (a number which was greatly reduced, in large part due to DCAA's changing the definition) and now requires DCAA to complete the fieldwork on an adequate indirect cost rate proposal within 365 days of receipt by DCAA.
- DCAA's average time to complete an incurred cost audit was 125 days in 2018 (which compares favorably to 2014 to 2018 trend data in Figure 7, page 14). However, DCAA falls short of full and meaningful disclosure by failing to explain that for years, it had been measuring this (elapsed days) by comparing the audit report date to the date that an adequate indirect cost rate proposal had been received, a comparison which yielded elapsed days approaching or exceeding 1,000. To assist DCAA in improving this metric, DCAA decided to redefine the elapsed days as measure from the date the audit was actively started. This dramatically reduced the elapsed days and was followed by another undisclosed DCAA strategy (2017 and 2018) to bifurcate the audit by separating its time-consuming audit planning and risk assessment steps from the audit execution steps (about 50% of the audit program addresses the audit planning and risk assessment. Specifically, the audit start date is now much later, the audit report date "is what it is", and the undisclosed strategy yields elapsed days which have been artificially shortened. At the very least, there is no meaningful comparability from 2014 to 2018, yet DCAA provides comparison charts with no footnotes explaining differences and/or how they manipulated the metric. But again, the 365-day requirements of the 2018 NDAA redefine audit timeliness related to incurred cost audits (i.e. if DCAA meets the 365-day completion date requirement, there simply won't be any incurred cost submissions beyond a one-year inventory, much less any falling into DCAA's self-created categorization of "backlog").

As in the present, past and presumably in the future, DCAA's Annual Report to Congress will be analogous to motion pictures which are "based upon actual events" which might not be (or are rarely) the same as the actual events. No one said that artistic liberties had to be confined to the arts. And as we've stated in the past, one has to expect DCAA to put its best foot forward, which includes taking advantage of the absence of any reporting standards.

DCAA Audit Policy Addresses Expressly Unallowable Costs

By Michael Steen, Senior Advisor

In typical DCAA delayed reaction mode, the audit agency has finally revised its audit policy which is designed to help its auditors differentiate "expressly unallowable cost" from "unallowable cost". MRD 19-PAC-002(R), dated May 14, 2019 replaces two 2014 MRDs which had slightly misinterpreted some FAR Part 31 Cost Principles (subparts) which resulted in DCAA audits which tended to default to categorizing virtually any unallowable indirect cost as expressly unallowable (thus subject to FAR 52.242-3 penalties). In fairness to DCAA, the problem is at least partially caused by inconsistent (similar, but not identical) FAR Part 31. 205 terminology which describes unallowable activities/costs. As addressed in excruciating detail by a number of 2016-2018 ASBCA decisions, "each word counts", such as an extract from FAR 31.205-1, which define unallowable advertising and public relations): Public relations means all function and activities dedicated to: (1) Maintaining, protecting, and enhancing the image of a concern or its products; or (2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising, customer relations, etc.… and (c) Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, **as well as the applicable portion of salaries, travel, and fringe benefits of**

employees engaged in the functions and activities identified in paragraphs (a) and (b) of this subsection.

As debated/discussed in the ASBCA case, "all functions and activities" is all encompassing; however, these must also meet the "dedicated to" criteria. The section highlighted in the published ASBCA decision is significant because it refers to (expressly unallowable) salaries and fringe benefits which is less inclusive than other FAR Part 31 subparts which refer to compensation associated with an unallowable activity ("compensation" which is defined in FAR 31.205-6) is much more inclusive/broader than salaries and fringe benefits). Of passing interest, the FAR extract (above) also demonstrates internal inconsistencies such as one reference to employees "engaged in" certain activities whereas the lead-in sentence refers to activities "dedicated" to.

At any rate and back to DCAA's recent MRD, for the most part its 33-page table (listing types of expressly unallowable costs in either FAR Part 31-205-XX or DFARS 231.205-XX) is merely an extract from the regulations without explanatory notes or elaboration. Additionally, the 33- page table only lists the part of a regulation which defines expressly unallowable costs without including any part of the regulation which defines an allowable cost (having both pieces may be needed to fully understand and differentiate allowable versus unallowable costs).

Lastly, the recent DCAA MRD does not include all references to all costs which are unallowable based upon non-DOD FAR supplements (such as DEARS for Department of Energy) or allowability issues "hidden" in other FAR subparts (e.g. FAR 47.4 related to the requirement to use a U.S. Flag Carrier (Airline) for international flights). Also missing from the DCAA MRD is any reference to Directly Associated Unallowable Costs (FAR 31.201-6(a)) which have been deemed expressly unallowable by published decisions (caution, one must read the published decisions to understand the specific facts which were considered, in particular, the interrelationships of 31.201-6 to a specific cost principle in 31.205-XX).

If one is seeking a 100 percent reliable, single source to address all categories of unallowable versus expressly unallowable costs, unfortunately, no single source exists. There remain matters for interpretation which means risk to contractors; however, DCAA's MRD does include one very important factor (favorable to contractors) in the following statement (drawn from published decisions) in DCAA's Summary paragraph:

"The Government must show that it was unreasonable, under all circumstances, for a person in the contractor's position to conclude that the costs were allowable".

To better understand the wonderful world of expressly unallowable costs, one should consider spending a few hours reading a number of ASBCA Cases (including 57795, 57576, 57679, 58,290, 57743, 57798, 58280).

DOJ Seemingly Ignores "Mandatory Disclosures" (FAR 52.203-13) in Revising DOJ Guidelines for "Contractor Voluntary Disclosures and Cooperation" in False Claims Act Matter

By Michael Steen, Senior Advisor

Although it's already been addressed by innumerable articles (primarily authored and published by law firms), it is worth noting that the DOJ (in its May 7, 2019 revised guidelines) is obviously hoping to convince contractors to self-report and then fully cooperate with any Government investigations on matters which could be a violation of the False Claims Act (FCA). Notably, the DOJ is willing to give contractors "credit" for making voluntary (proactive and timely) disclosures while also considering other forms of credit (i.e. for disclosing the individuals substantially involved in the misconduct, preserving, collecting and disclosing relevant documents, admitting liability or accepting responsibility for the relevant conduct (misconduct?), and implementing timely corrective actions including more effective controls).

Not to take away from the "glass is half-full" implications of the recent DOJ Guidelines, but it is ironic that the DOJ references "voluntary disclosure" ignoring the very common contract clause (FAR 52.203-13) which "requires" timely disclosure of a number of matters, most falling into the category of a potential violation of the False Claims Act. This contractual clause, which is required in contracts which exceed $5.5 million and have a period of performance of at least 120 days, states in part that the Contractor shall:

- Have a written code of business ethics and conduct with a copy made available to each employee engaged in performance of the contract,

- Exercise due diligence to prevent and detect criminal conduct and promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.
- **Timely disclose in writing to the agency OIG** (Office of Inspector General), with a copy to the contracting officer, whenever in connection with the award, performance or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed i) Criminal fraud, conflict of interest, bribery or gratuity violations or ii) a violation of the Civil False Claims Act.
- For other than a small business, a requirement for a business ethics awareness and compliance program and internal control system which include monitoring, periodic reviews, internal hotline/reporting mechanism, corrective actions, disciplinary actions, and timely disclosure (to and OIG).

The required or "mandatory" disclosure requirements are self-evident in the contract clause and were discussed at length in the 30-page final rule, published in the Federal Register on November 12, 2008. Although it is not per se in the final FAR 52.203-13, the final rule public comments and FAR Council responses (assisted by the DOJ) emphasized compliance by connecting noncompliance to the risk of debarment or suspension. Hence, we have a "slight" contrast between the expectations of the DOJ then and the DOJ today, but in-spite of the softer tones of the more recent DOJ guidelines, the fact is that FAR 52.203-13 includes required versus voluntary disclosures.

Of passing interest, in the wake of the final rule, DCAA created an audit program focused upon testing contractors for compliance with FAR 52.203-13 and -14 (requirement for certain agency hotline posters). That audit activity, 11060, was a stand-alone assessment of the Contractor's Control Environment and its audit steps were probably the most invasive of any DCAA audit program including steps to review internal hotline reports, corrective actions, and employee personnel files (for an auditor to assess the sufficiency of any disciplinary actions). That audit activity and audit program have disappeared from DCAA's website (www.dcaa.mil) and what remains is a very abbreviated (non-specific) reference in other audit programs including the accounting system (11070) which does reference FAR 52.203-13 and -14. DCAA never publicly explains why it removes an audit program although by implication it was removed because DCAA was no longer performing the stand-alone audit. Regardless, if the clauses are in one's contracts, one has to assume that at some point a DCAA (or other Government Agency) auditor may inquire about a contractor's business ethics policy and controls. If the initial responses are vague or noncommittal, this could become an audit lead, thus expanding into further inquiries and an unfavorable audit report.

Compliance with FAR 52.203-13 is for the most part, in the best interest of the company/contractor, notwithstanding the potential "mandatory disclosure" should certain misconduct be uncovered. Based upon experience helping clients/contractors who have uncovered employee schemes (e.g. misuse of employer credit cards or other misappropriation of funds), timely internal discovery is critical in terms of mitigating losses and implementing stronger internal controls. Similarly, having an effective internal hotline/reporting mechanism has the advantage of giving a contractor information and the ability to investigate before any Government Agency involvement (not to hide the issue, but to fact-find and initiate corrective actions before notifying a Government OIG). History has shown that the absolute worst option is for a contractor to be the last to know which happens when it is visited by agents from NCIS, DCIS, or another investigative agency or the contractor receives a civil investigative demand (for boatloads of documents) and with little or no information concerning the alleged misconduct.

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