

A Roadmap for Managing DCAA Audits

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Overview

A Roadmap for Managing DCAA Audits

1. Basic rules – what DCAA can and cannot demand
 - FAR 52.215-2, FAR 52.216-7
 - DCAA demands
 - Must audit comply with GAGAS?
 - Subcontract audits
2. Management of audits
 - Single point of contact
 - Record-keeping tips
 - Written questions and responses
3. Recent developments that in-house counsel should consider
 - FY 2018 NDAA
 - Direct Assist Audit Pilot Program
 - FY 2019 NDAA proposals to amend DCAA audit process

Overview (Cont)

4. Current cost and audit issues arising during audits

- Recent case law
 - *Kellogg Brown & Root Services, Inc.*, ASBCA No. 58175
 - *Northrop Grumman Corporation*, ASBCA No. 60190
 - *Luna Innovations, Inc.*, ASBCA No. 60086
- DCAA Memos
- OUSD Memos

5. Litigation of audit findings

- Forum (BCA vs. CFC)
- Process
- Contractor defenses
- Government claims
- Right to offset/withhold

Basic Rules – What DCAA Can and Cannot Demand

Source of DCAA Audit Rights

- FAR 52.215-2, “Audit and Records – Negotiation”
 - (a): “Records” includes:
 - “...books, documents, accounting procedures and practices, and other data, regardless of type and regardless of whether such items are in written form, in the form of computer data, or in any other form.”
 - (b): For CR, incentive, T&M, labor-hour, or price redeterminable contracts: Contractor “shall maintain and the Contracting Officer, or an authorized representative of the Contracting Officer, **shall have the right to examine and audit all records and other evidence** sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred directly or indirectly in performance of this contract...”

Source of DCAA Audit Rights

- FAR 52.215-2, “Audit and Records – Negotiation”
 - (c): Certified Cost or pricing data: if provided by contractor, the CO, or an authorized representative of the CO, “in order to evaluate the accuracy, completeness, and currency of the certified cost or pricing data, shall have the right to examine and audit all of the Contractor's records, including computations and projections...”
 - (f): Availability. Contractor must make available at its office at all reasonable times the records, materials, and other evidence described in the Clause “until 3 years after final payment under this contract or for any shorter period specified in Subpart 4.7, Contractor Records Retention, of the [FAR], or for any longer period required by statute or by other clauses of this contract...”

Source of DCAA Audit Rights

- FAR 52.216-7, “Allowable Cost and Payment”
 - (d): Submission of final annual indirect cost rate proposal in accordance with FAR 42.7
 - (g): CO may have invoices, vouchers, statements of cost audited, payments reduced for unallowable costs or adjustments for under/overpayments.

Source of DCAA Audit Rights

- FAR 31.201-2(d)
 - Contractor is responsible “for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles . . . The [CO] may disallow all or part of a claimed cost that is inadequately supported”
- Few regulations seem to impose specific requirements
 - FAR 31.205-33(f), “Professional and Consultant Service Costs”
 - FAR 31.205-46(a)(7), “Travel Costs”

Source of DCAA Audit Rights

- *BearingPoint, Inc.*, ASBCA Nos. 55354 et al. (Oct. 16, 2009)
 - USAID determined contractor security costs in Iraq not allocable due to lack of contemporaneous documentation
 - “We reject AID’s central argument that the disputed labor charges are unallocable for insufficient documentation. The contract clauses do not impose the stringent requirements of either ‘nice neat little files’ that [the CO] sought or the contemporaneous records for which AID appears to be arguing . . . [FAR 52.215-2(b)] prescribes no form that the ‘records’ or the ‘other evidence’ must take, and in fact we have read the clause more liberally than AID’s position suggests.”

Limits to DCAA's Demands

- Although the right to audit is broad, the contract terms define the limit
- DCAA cannot demand as a matter of right
 - Employee interviews
 - Office space
 - Creation of documents, analyses for special purpose
- Many contractors accommodate DCAA demands to maintain business relationship

GAGAS

- Generally Accepted Government Auditing Standards (GAGAS)
- Incorporated into DCAA Contract Audit Manual (DCAM), DCAA Instructions
- Types of work covered by GAGAS are classified as financial audits, attestation engagements, or performance audit
- Several reports on DCAA compliance with GAGAS
 - DoD IG (DODIG-2015-061): substantiated complaint alleging that DCAA field office did not comply with GAGAS or agency policy when it questioned \$6.6M in contractor-claimed subcontract costs
 - GAO (GAO-09-468), *Widespread Problems with Audit Quality Require Significant Reform*

Subcontract Audits

- Prime contractors typically require subcontractor proposals to be subject to audit rights
 - FAR 15.408, Table 15-2
- Prime contractors typically flow down required audit requirements to subcontractors
 - FAR 52.215-2, Audit and Records—Negotiation
 - FAR 52.216-7, Allowable Cost and Payment
 - FAR 52.230-2, Cost Accounting Standards

Subcontract Audits

- Significant Issue for Subcontractor = Who conducts the audit – US Government or Prime Contractor?
 - Does subcontractor want to disclose financial/cost information to prime?
 - Does subcontractor want to permit US Government into its books and records?
 - Subject of prime/subcontractor negotiation
 - Subcontractors must carefully review subcontract terms and conditions

Subcontract Audits

- *Lockheed Martin Integrated Sys., Inc.*, ASBCA No. 59508, 17-1 B.C.A. ¶ 36597
 - May 2014: DCAA issued audit report questioning subcontractor costs; COFD mirrored DCAA audits
 - Alleged Lockheed failed to maintain documents to substantiate it reviewed subcontractor's resumes/timesheets
 - Claimed a "literal interpretation of FAR 42.202 requires the prime contractor to act on behalf of the Government and serve as both the Contracting Officer (CO) and the Contracting Administrative Office (CAO) for each subcontract that it awards under a Government flexibly priced contract."
 - Board granted Lockheed's Motion to Dismiss
 - FAR pts. 42 and 44 did not impose specific responsibilities on Lockheed to manage subcontractors because they were not incorporated into contracts
 - Even if provisions were incorporated, do not impose the duties Government alleged were breached such as requiring subcontractors to submit incurred cost submissions to prime or requesting audits from DCAA if subcontractors refuse

Management of Audits

Management of Audits – General Considerations

- Document entire process, starting with entrance conference
- During entrance conference establish audit scope and duration
- Maintain a single point of contact for consistency
- Establish clear channels of communications
- Keeping a record of: DCAA requests; documents provided; dates on which documents provided

Management of Audits – General Considerations

- Keep track of audit request response time (both contractor and government auditor)
- Track all written questions and written responses (both contractor and government auditor)
- Consider pressure on DCAA to reduce audit completion time
- Request an Exit Conference
- Document any disagreement with audit findings

Management of Audits – Specific Cost Concerns

- Risk based auditing
 - DCAA policy: all adequate incurred cost proposals under \$250 million auditable dollar value (ADV) will be assessed for high or low risk using the Risk Assessment Checklist
- Statistical sampling
 - Selects a representative sample of a group of transactions – unallowable costs identified then projected to the universe subject to sample
 - DCAA EZ-Quant software used for statistical sampling
- Track DCAA Audit Alerts on cost areas
 - *DCAA Audit Alert on Identifying Expressly Unallowable Costs* – (December 18, 2014 & January 7, 2015)

Management of Audits – Specific Cost Concerns

- Clarify with government auditor nature of the cost being questioned, reason for questioned cost
 - Questioned due to cost reasonableness? Allocability? FAR Part 31 cost principle?
- Establish applicability of Cost Accounting Standards (CAS), FAR, or other contract provisions / guidance
- If contractor has any large, non-recurring costs, consider preparing justification memos
 - Mass relocation, mass severance

Recent Developments that In-House Counsel Should Consider

Incurring Cost Audit Backlog

- DCAA frequently waits several years before initiating incurred cost audits
- DCAA may deem incurred cost proposal “inadequate,” and not start clock on review until it receives what it deems an “adequate” submission
- As a result, DCAA and contractors may wait years before contractor costs and rates are settled for particular year
- Section 803 in FY 2018 National Defense Authorization Act (NDAA) is the latest attempt by Congress to address this backlog

FY 2018 NDAA – Section 803

- Permits use of “qualified private auditors” to perform audits to eliminate, by October 1, 2020, any backlog of incurred cost audits of the DCAA
- “Qualified private auditors” must be:
 - Free of conflicts of interest in performing the audit
 - Possess “necessary independence”
 - Sign non-disclosure agreements
 - Limit use of audit data only for purposes stated in contract
 - Take “all reasonable steps” to protect proprietary and nonpublic data” furnished during audit
 - Not use any data to compete for Govt. or non-Govt. work

FY 2018 NDAA – Section 803

- Use of Qualified Private Auditors – Issues for In-House Counsel:
 - Is there a contractual right for the government to use “qualified private auditors”?
 - QPA’s potential conflicts of interest
 - QPA’s access to the contractor's proprietary information
 - Should counsel require nondisclosure agreements for QPAs?
 - Are QPA work papers available under FOIA?
 - Section 803 states: QPAs “shall develop and maintain complete and accurate working papers on each incurred cost audit. All working papers and reports on the incurred cost audit prepared by such qualified private auditor shall be the property of the Department of Defense...”

FY 2018 NDAA – Section 803

- Requires DOD to submit a plan to Congress by Oct. 1, 2018 to reduce audit backlogs, including:
 - Identifying audits appropriate for private auditors
 - Estimating the number and value of audits to be performed by private auditors between FY 19 thru FY 25
 - Meeting all FAR requirements for acquisition plans

FY 2018 NDAA – Section 803

- Audit timing requirements
 - Requires DOD to ensure all audits performed by DCAA or private auditors are performed timely
 - Requires DOD to notify a contractor within 60 days after receipt of an ICS whether the submission is a qualified incurred cost submission
 - Establishes a deadline of one-year to complete the audit, subject to waiver
 - As of Oct. 1, 2020, if audit findings are not issued within one year, the audit “shall be considered to be complete and no additional audit work shall be conducted.”

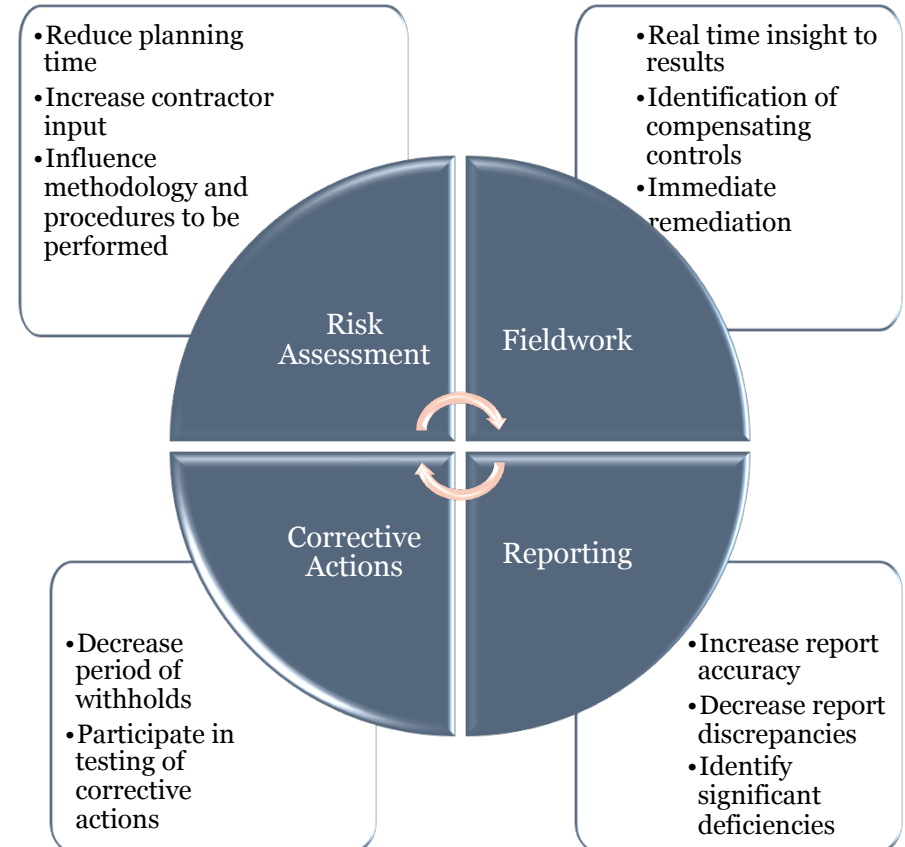
FY 2018 NDAA – Section 803

- Multi-Year Auditing
 - Places certain limits on multiyear auditing to ensure that multiyear auditing is conducted only—
 - “(A) to address outstanding incurred cost audits for which a qualified incurred cost submission was submitted to [DCAA] more than 12 months before the date of the enactment of this section;” or
 - “(B) when the contractor being audited submits a written request, including a justification for the use of multiyear auditing, to the Under Secretary of Defense (Comptroller).”

- Multi-Year Auditing – Issues for In-House Counsel
 - Is there a contractual right for multi-year audits?
 - Should the company issue the letter drafted by DCAA requesting multi-year audits?

Direct Assist Audits – *What are they?*

- To address uncertainties regarding the use of third party auditors, contractors and DCAA are piloting the use of direct assist audits
 - Direct assist audits represent a collaborative audit whereby contractor personnel and DCAA auditors are one team performing the audit
 - DCAA and contractor personnel participate in all parts of the audit
 - Planning
 - Fieldwork
 - Reporting
 - Corrective Actions
 - Contractor personnel performing the audit remain independent of the process being audited, similar to internal auditors
 - DCAA maintains responsibility to issue its opinion and recommendation to DCMA



DFARS Business System Audits – *Benefits & Risks*

Benefits

- Planning the audit to focus on key controls
- Identifying compensating controls to reduce deficiencies before they are reported
- Understand deficiencies and implement corrective actions in real time
- Minimize the impact to cash flow by reducing withhold periods
- Reduce audit redundancy and timeline

Direct Assist Audits

Risks

- Opportunity cost of using internal resources and/or hiring additional expertise
- Participating in pilot may result in deficiencies being identified more timely
- Contractor may have to realign organizational structure to demonstrate independence

- MMAS audit timeframe was reduced from 18 months to 8 months
- Estimating system audit timeframe was reduced to 6 months
- Accounting system audit timeframe is expected to be 6 months

- DCAA MRD 18-PIC-001(R) Audit Alert
 - Audit Alert on 2018 NDAA Section 803 Timeliness Requirement for Incurred Cost Adequacy Reviews and Audits, issued on January 29, 2018
 - Confirms that Agency policy will be revised to require incurred cost submissions to be reviewed for adequacy within 60 days of receipt for any ICS received after Dec 12, 2017
 - DCAA CAM also updated to reflect this requirement
 - Agency will be providing guidance for complying with the NDAA one-year requirement

FY 2019 NDAA

- In-house counsel should be aware of FY19 NDAA provisions.
 - H.R. 5515 passed in the House on May 24, 2018
 - Senate passed an amended version of H.R. 5515 on June 18, 2018
 - H.R. 5515 as passed in the House included Section 915, *Review of Functions of Defense Contract Audit Agency and Defense Contract Management Agency*
 - Required DoD to conduct a review of the functions of DCAA and DCMA, including: 1) validation of the mission / function of each Agency; 2) determination of whether there are functions performed by either Agency that could be more appropriately performed by the other Agency, other DoD Agency, or commercial providers
 - Senate removed this Section from the Amended Bill

Current Cost and Audit Issues Arising During Audit

Current Cost & Audit Issues – Case Law

- *Kellogg Brown & Root Services, Inc.*, ASBCA No. 58175 (March 15, 2018) (denying contractor claim for subcontract costs because contractor did not adjust troop levels in DFAC contract pursuant to ACO Letter of Technical Direction)
- *Northrop Grumman Corporation*, ASBCA No. 60190 (Jan. 9, 2018) (government motion for reconsideration denied; Board rejects government position that contractor incurred costs “by operation of law”)
- *Luna Innovations, Inc.*, ASBCA No. 60086 (Nov. 29, 2017) (employee stock option costs calculated on Black-Scholes model were unallowable but not expressly unallowable)

Current Cost & Audit Issues – Memos

- Department of the Navy Memorandum, *Allowability of Environmental Remediation Costs* (Jan. 12, 2018)
 - Considerations for CO when making allowability determination include: negligence, responsible pursuit of insurance or contribution/subrogation recovery, negligence, nature of business
- DCAA Memorandum, *Audit Guidance on Application of DFARS 231.205-18, Independent Research and Development and Bid and Proposal Costs* (Nov. 21, 2017)
 - Provide auditors with guidance in applying the requirements of DFARS 231.205-18
 - DPAP issued class deviation for rule where contractors required to engage in or document a technical interchange
- DCMA Memorandum, *Sustention of Statistical Projection of Questioned Costs and Penalties* (May 9, 2017)
 - DCAA “expressed concern that DCMA sustention rates of costs questioned in final incurred cost audits has steadily declined...Although DCAA acknowledges there may be a number of barriers to obtaining sustention on questioned costs, statistical sampling was identified as one of those barriers.”

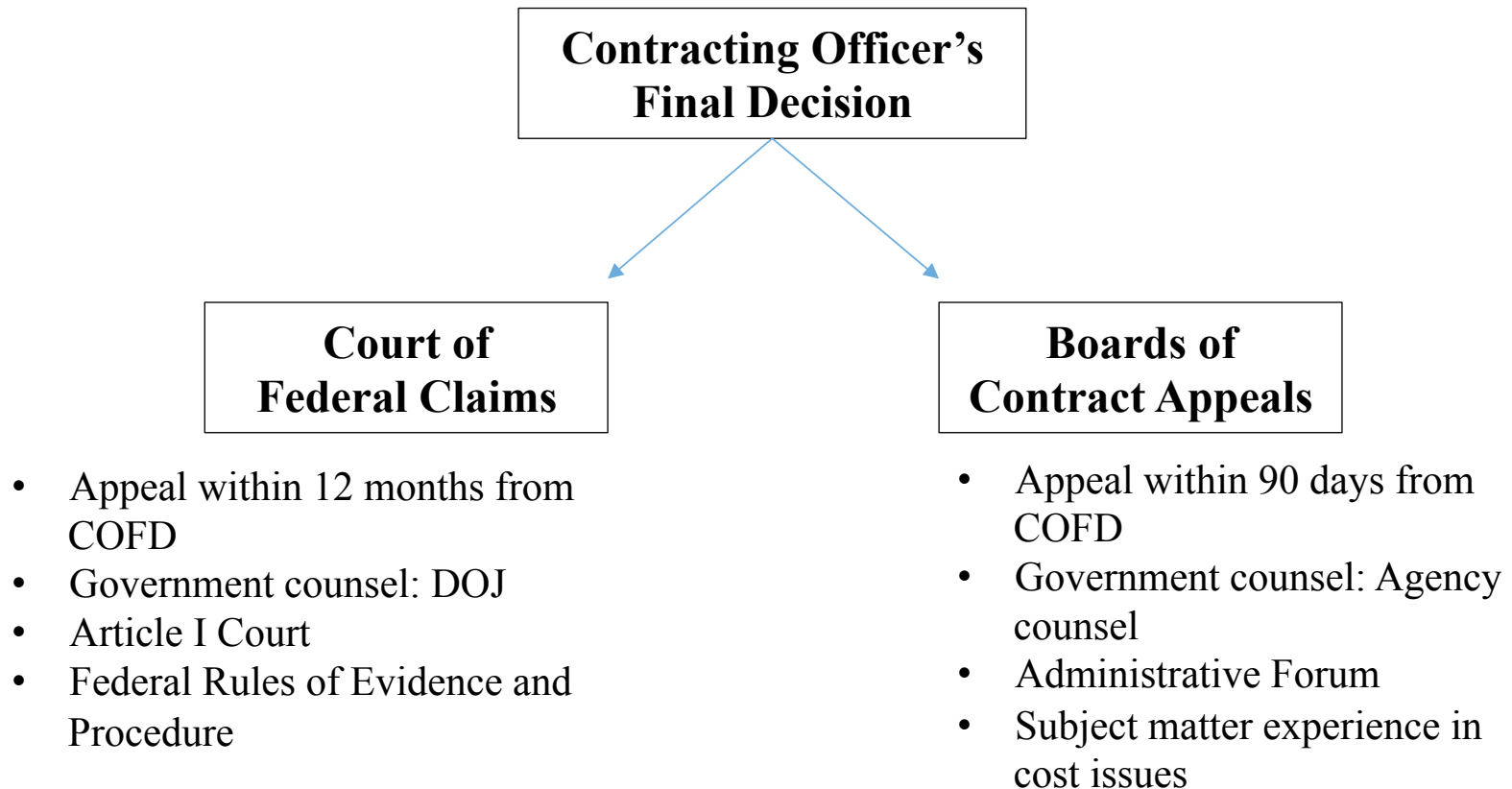
Current Cost & Audit Issues – Class Deviations

- OUSD Memorandum, Class Deviation – *Contract Closeout Authority* (May 4, 2018)
 - CO may close out contracts where:
 - Contract was entered into on a date that is at least 17 fiscal years before the current fiscal year;
 - Has no further supplies or services due under the terms of the contract; and
 - Has been determined by an individual, at least one level above the contracting officer, to be not otherwise reconcilable,
- OUSD Memorandum, Class Deviation – *Threshold for Obtaining Certified Cost or Pricing Data* (April 13, 2018)
 - COs use \$2 million as the threshold for obtaining certified cost or pricing data

Litigation of Audit Findings

Litigation of Audit Findings – Considerations

Forum (BCA vs. CFC)



Litigation of Audit Findings – Considerations

- Process considerations (BCA and CFC)
 - Pretrial
 - Discovery
 - Motions
 - Trials
 - Decisions

Litigation of Audit Findings – Considerations

- Contractor defenses
 - Statute of limitation
 - Latches
 - Acceptance
 - Payment
 - Accord and Satisfaction
 - Failure to comply with contract terms
 - Substantive defense of costs questioned
- Government claims
- Right to offset/withhold

Speaker



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Stuart Young leads the legal function for AECOM Federal. His practice focuses on Government contracts, including claims and protests, compliance, cost type contracts, and risk management. He also provides legal support in the areas of labor and employment law, international law, export control, cyber security, corporate law and intellectual property. He manages outside counsel and supervises litigation for AECOM Federal. Since 1999, Mr. Young has been General Counsel for the legacy companies that merged into AECOM Federal, including URS, EG&G and Lear Siegler Services.

From 1992 – 1999, Mr. Young served as Corporate Counsel at DynCorp. In this role he drafted teaming agreements, non-disclosure agreements, joint venture agreements and contract and subcontract documents. Mr. Young litigated bid protests and contract disputes, was admitted under GAO and GSBCA protective orders, and served as first chair at bid protest hearings. He was heavily involved in international law issues, including the negotiation of contracts with foreign governments, and foreign registration and tax issues.

Mr. Young worked at the General Services Administration from 1984 – 1992. As Senior Assistant General Counsel for GSA, he was in charge of handling bid protests filed against Federal Supply Service, and handled contract formation, contract administration, cost and pricing issues, and GSA Multiple Award Schedules.

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Stephen D. Knight is a member in the Vienna, VA law offices of Smith Pachter & McWhorter, PLC. Mr. Knight specializes in a variety of government contracts issues and has substantial expertise in the area of claims and disputes, including defective specifications, delay and disruption, changes, and contract interpretation. He also handles matters involving complex questions of government contract cost accounting, cost allocability, cost allowability, material accounting, labor accounting, contract payment, and defective pricing. He has advised clients on sensitive issues of government contract compliance, disclosure, and the government's right of access to records. Mr. Knight has substantial experience in the area of procurement fraud, including the representation of clients during grand jury and Inspector General criminal investigations, as well as civil investigations, and litigation pursuant to the Civil False Claims Act and its Qui Tam provisions.

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- Providing expert advice surrounding the US government regulatory requirements including Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS), Truth in Negotiations Act (TINA), cost allowability, allocation methodologies, disclosure statement issues, pension and incentive compensation, claims, etc.
- Evaluating the adequacy of a contractor's business systems as compared to the DFARS Business System requirements, developing corrective action plans, assessing the effectiveness of remediation activities and responding to government notifications of system deficiencies.

Questions?

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