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Contractor Business System Audits: The Coming Train Wreck

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As the Department of Defense looks for ways to trim inefficiencies and eliminate unnecessary costs, the Defense Contract Audit Agency's wasteful and counterproductive business systems audits would be a good place to start. DCAA has long had a policy of auditing major contractors' accounting and management systems on a cyclical basis based on a documented risk assessment. But the current process is broken. DCAA is applying a standard of perfection that is not only impossible to meet, but has little if anything to do with protecting the Government against unallowable costs. At best, DCAA's business systems audits are adding costs and inefficiencies to an already overburdened procurement system. At worst, they are directly thwarting DOD's ability to award contracts in support of our warfighters. Indeed, DCAA's system audits have become one of the most intractable problems currently confronting major defense contractors, and are receiving board of directors' level attention.

Contractor Business Systems—Current Regulatory Coverage

The Federal Acquisition Regulation and Defense FAR Supplement prescribe requirements for six contractor business systems: accounting, earned value management (EVM), estimating, material manage-

ment and accounting, property management, and purchasing. Regarding contractor accounting systems, DFARS 242.7501 states that contractors receiving cost-reimbursement or incentive-type contracts, or contracts that provide for progress payments based on costs, must maintain throughout contract performance an accounting system and related internal controls that provide reasonable assurance that (1) applicable laws and regulations are complied with, (2) the accounting system and cost data are reliable, (3) risk of misallocations and mischarges are minimized, and (4) contract allocations and charges are consistent with invoice procedures. The administrative contracting officer determines whether the contractor's accounting system is adequate.² However, there is no specific requirement that a contractor seek or an ACO make a determination of adequacy, and there is currently no clause prescribed to incorporate these accounting system requirements into contractors' Government contracts.

Contractor EVM systems are governed by FAR subpt. 34.2, DFARS subpt. 234.2, three solicitation provisions (FAR 52.234-2, Notice of Earned Value Management System—Pre-Award; FAR 52.234-3, Notice of Earned Value Management System—Post Award IBR; and DFARS 252.234-7001, Notice of Earned Value Management System), and two contract clauses (FAR 52.234-4, Earned Value Management System; and DFARS 252.234-7002, Earned Value Management System).³ An EVMS is mandatory for major acquisitions, and may be required for other acquisitions in accordance with agency procedures.⁴ For DOD cost or incentive contracts and subcontracts valued at \$20 million or more, the contractor's EVMS must comply with the guidelines in the American National Standards Institute/Electronic Industries Alliance Standard 748, Earned Value Management Systems (ANSI/EIA-748).⁵ Additionally, for cost or incentive contracts and subcontracts valued at \$50 million or more, the contractor must have an EVMS

that has been determined by the cognizant federal agency to be in compliance with the guidelines in ANSI/EIA-748.⁶ The Defense Contract Management Agency determines EVMS compliance when DOD is the cognizant federal agency.⁷

The requirements for contractor estimating systems are prescribed by DFARS 215.407-5-70 and DFARS clause 252.215-7002, Cost Estimating System Requirements. A large contractor is subject to the estimating system requirements if in its preceding fiscal year, it received DOD prime contracts or subcontracts for which cost or pricing data were required that total at least \$50 million, or at least \$10 million if the procuring contracting officer with the concurrence or at the request of the ACO determines it to be in the best interest of the Government.⁸ An estimating system is considered acceptable if it (a) is maintained, reliable and consistently applied; (b) produces verifiable, supportable and documented cost estimates that are an acceptable basis for negotiation of fair and reasonable prices; (c) is consistent and integrated with the contractor's related management systems; and (d) is subject to applicable financial control systems.⁹ The ACO determines whether the estimating system is acceptable.¹⁰

Contractor material management and accounting systems are governed by DFARS subpt. 242.72 and DFARS clause 252.242-7004, Material Management and Accounting System. An MMAS is a system for planning, controlling and accounting for the acquisition, use and disposition of material.¹¹ A large contractor is subject to a review of its MMAS if in its preceding fiscal year it had \$40 million worth of qualifying sales to the Government, and the ACO, with advice from the auditor, determines an MMAS review is needed based on a risk assessment of the contractor's past experience and current vulnerability.¹² Qualifying sales are contracts and subcontracts for which cost or pricing data were required or that were priced on other than a firm-fixed-price or firm-fixed-price with economic price adjustment basis.¹³ To be compliant, the MMAS must reasonably forecast material requirements, ensure that costs of purchased and fabricated material charged or allocated to a contract are based on valid time-phased requirements, and provide a consistent, equitable and unbiased logic for costing of material transactions.¹⁴ The ACO determines whether the MMAS is compliant.¹⁵

Contractor property management systems are governed by FAR 45.105 and the Government Property clause at FAR 52.245-1. To be compliant, the contractor's property management system must satisfy the 10 outcomes specified in the clause at FAR 52.245-1, including record-keeping and reporting responsibilities, subcontractor control, inventory performance and disclosure, and property maintenance and repair. The agency responsible for contract administration reviews the contractor's property management system, and the contracting officer determines whether the system is compliant.¹⁶

The requirements for contractor purchasing systems are prescribed by FAR subpt. 44.3. A contractor purchasing system review assesses the efficiency and effectiveness of the contractor's purchasing of material and services, subcontracting, and subcontract management from development of the requirement through completion of subcontract performance.¹⁷ A contractor is subject to a CPSR if its sales to the Government (excluding competitively awarded firm-fixed-price and competitively awarded fixed-price with economic price adjustment contracts and sales of commercial items pursuant to FAR pt. 12) are expected to exceed \$25 million during the next 12 months, and the ACO determines that a CPSR is needed.¹⁸ The ACO determines whether to grant, withhold or withdraw approval of the contractor's purchasing system.¹⁹ Contractors without an approved purchasing system are subject to additional consent to subcontract requirements under FAR clause 52.244-2, Subcontracts.

Assessing Control Risk

DCAA's business system audits are tethered only loosely, if at all, to the regulatory requirements for contractor business systems. The Defense Contract Audit Manual requires auditors to document an understanding of a contractor's internal controls in order to assess control risk as a basis for planning related audits.²⁰ For this purpose, DCAA has established standard audit programs for 10 contractor internal control systems: (1) control environment and overall accounting system, (2) general information technology system, (3) budget and planning system, (4) purchasing system, (5) material system, (6) compensation system, (7) labor system, (8) indirect and other direct cost system, (9) billing

system, and (10) estimating system. The DCAM makes clear that these system audits apply primarily to major contractors.²¹ The DCAM expressly acknowledges that nonmajor contractors may use less formal means to ensure that internal control objectives are achieved.²²

The sound bite rationale for conducting contractor business system audits seems laudable enough. As the Commission on Wartime Contracting in Iraq and Afghanistan (CWC) reported last year, “Contractor business systems and internal controls are the first line of defense against waste, fraud, and abuse. Weak control systems increase the risk of unallowable and unreasonable costs on government contracts.”²³ However, the reality is quite different. DCAA is applying a standard of perfection that can—and frequently does—result in finding a contractor’s accounting or other business system inadequate for trivial reasons having nothing to do with unallowable costs being charged to the contractor’s Government contracts.

On Dec. 19, 2008, DCAA issued new guidance to its auditors on reporting audit opinions on contractors’ internal control systems.²⁴ Previously, it was DCAA policy to report a “significant deficiency” or “material weakness” in a contractor’s internal controls only if all of the following conditions applied: (a) the deficiency adversely affected the contractor’s ability to initiate, authorize, record, process or report Government contract costs in accordance with applicable Government contract laws and regulations; (b) the deficiency resulted in a reasonable possibility that unallowable costs would be charged to the Government; and (c) the potential unallowable cost was not clearly immaterial. Under the previous policy, even if a DCAA auditor identified a “significant deficiency” or “material weakness,” the auditor was still free to issue an audit opinion that the system under review was “inadequate in part” rather than “inadequate.”

The Dec. 19, 2008 guidance requires auditors to report a significant deficiency/material weakness if the contractor fails to accomplish *any* control objective tested for in DCAA’s internal control audits, regardless of whether the control objective is directly related to charging costs to Government contracts, and even if the deficiency has not resulted in *any* questioned costs. In addition, the guidance states that if an auditor finds a significant deficiency/material weakness, the audit

report *must* include an opinion that the system is inadequate. The guidance expressly prohibits DCAA auditors from issuing “inadequate in part” opinions.

There are several problems with DCAA’s current business system policy. First, no system of internal control is or can be perfect. Internal control systems are generally designed to provide reasonable assurance of the safeguard, based on the premise that the cost of the control should not exceed the expected benefit.²⁵ Former DCAA director April Stephenson recognized this point in her Sept. 23, 2009 testimony before the Senate Committee on Homeland Security and Governmental Affairs. Stephenson stated, “Business systems and related internal controls are an essential part of any organization and provide *reasonable assurance* for preventing loss of resources, maintaining reliable financial reporting and complying with laws and regulations.”²⁶ It is illogical and contrary to generally accepted Government auditing standards to establish a standard of perfection, particularly if the auditor need not demonstrate *any* relationship, let alone a material relationship, to costs charged to a Government contract.²⁷

Second, there is no statutory, regulatory or contractual basis for many of the “control objectives” that DCAA uses to conduct its audits. For example, DCAA’s “Internal Control Matrix for Audit of Billing System Controls” has a control objective for “management reviews,” which includes an audit procedure for evaluating the contractor’s record of completed internal audits. In performing this audit step, DCAA auditors frequently demand access to internal audit reports, despite the holding in *U.S. v. Newport News Shipbldg. & Dry Dock Co.*²⁸ that DCAA lacks authority to compel production of internal audit reports. In the *Newport News* case, the U.S. Court of Appeals for the Fourth Circuit observed, “Cost verification data, not the work product of internal auditors, is the proper subject of a DCAA subpoena. DCAA performs a critical auditing mission, but it is not running the company.”²⁹ As another example, DCAA’s “Internal Control Matrix for Control Environment and Overall Accounting System Controls” has a control objective for “integrity and ethical values” which includes an audit procedure for verifying “that the contractor performs periodic reviews of company business practices, procedures, and internal controls for compliance with

standards of conduct.” In performing this audit step, DCAA auditors frequently demand access to reports of internal investigations even if the reports are subject to the attorney-client privilege or attorney work product doctrine. A contractor’s understandable (and perfectly legitimate) refusal to provide access to this information is reported as a significant weakness/material deficiency in internal controls.

Third, many of DCAA’s control objectives are subjective, and reasonable minds can differ about what is or is not adequate. For example, there is a policies and procedures control objective in the “Internal Control Matrix for Audit of Billing System Controls” that includes the contractor’s policies and procedures for evaluating and monitoring subcontractors’ accounting and billing systems. Setting aside the fact that nothing in the FAR requires contractors to evaluate and monitor their subcontractors’ accounting and billing systems, there is no objective measure of whether the contractor’s policies and procedures for doing so are adequate. However, any inadequacy, no matter how trivial, could result in an audit opinion that the contractor’s billing system is inadequate.

Fourth, if DCAA issues an audit report finding a business system inadequate, there is no workable process in place to reverse the determination once the contractor corrects the cited deficiencies. Indeed, under DCAA’s current policy, a contractor’s accounting system will be reported as inadequate even if the contractor corrected all of the deficiencies during the audit.³⁰ Once DCAA issues an audit report finding a contractor business system inadequate, it is DCAA policy to conduct a limited follow-up audit to determine whether the contractor has corrected the deficiencies cited in the earlier report. If DCAA finds that the contractor has not corrected all of the previously reported deficiencies, DCAA will recommend that the ACO pursue or continue the suspension of the percentage of progress payments or reimbursement of costs and, if applicable, disapprove the affected portions of the system. On the other hand, if DCAA finds that the contractor has corrected the previously reported deficiencies, DCAA will issue a report stating that the deficiencies have been corrected, but will not issue a report with an opinion that the business system is adequate until after completing a full system audit.³¹ It may be a very long time before DCAA commences a full system audit. In fiscal year 2010, DCAA

established new audit priorities that limited internal control audits to audits of contractors’ billing systems and audits of contractors’ control environment and overall accounting systems.³²

Finally, the business system audits are preventing DCAA from performing other, more important audits. Stephenson testified last year that DCAA has funding for only about 65 percent of the audits that are required.³³ She also acknowledged that the auditing standards do *not* require that DCAA express an opinion on the adequacy of the contractors’ internal control systems.³⁴ The auditing standards require only that DCAA obtain an understanding of the contractor’s internal controls in order to assess risk and plan related audits.³⁵ DCAA has chosen to perform discretionary business system audits while shirking its core mission of performing contract audits to support the negotiation, administration and settlement of contracts and subcontracts.³⁶ Because of its excessive focus on internal control systems and inappropriate standards that do not address materiality, DCAA has fallen behind—or simply ceased performing—required audits of pricing proposals, forward pricing rates, incurred costs and Cost Accounting Standards disclosure statements. DCAA’s recent “audit alert” on forward pricing rates is emblematic of the problem. The audit alert instructed auditors, when auditing a price proposal containing forward pricing rates that have not yet been audited by DCAA, to “recommend that contract price negotiations not be concluded until the audit of the rates is completed and the results are considered by the contracting officer,” *even* if the proposed rates are based on rates from a forward pricing rate agreement negotiated by the cognizant ACO.³⁷

Consequences of an “Inadequate” Business System Audit

A DCAA opinion that one of a contractor’s internal control systems is inadequate can have serious consequences for the contractor. Perhaps most significantly, some COs have interpreted FAR 16.301-3(a)(1) erroneously to mean that a contractor with an “inadequate” accounting system is ineligible for award of a Government cost-reimbursement contract.³⁸ Stephenson may have furthered this misconception with her Aug. 11, 2009 testimony before the CWC. Stephenson stated,

The overarching requirement for Government contractors with systems audited by DCAA is Defense Federal Acquisition Regulation Supplement 242.75, Contractor Accounting Systems and Related Controls, which states in part:

Contractors receiving cost-reimbursement or incentive type contracts, or contracts which provide for progress payments based on costs or on a percentage or stage of completion, shall maintain an accounting system and related internal controls throughout contract performance which provide reasonable assurance that—

(a) Applicable laws and regulations are complied with; (b) The accounting system and cost data are reliable; (c) Risk of misallocations and mischarges are minimized; and (d) Contract allocations and charges are consistent with invoice procedures.

Federal Acquisition Regulation Subpart 16.1, Selecting Contract Types, requires contracting officers to ensure the adequacy of the contractor's accounting system before agreeing on a contract type other than firm-fixed-price type contract. The contractor's accounting system shall permit timely development of all necessary cost data in the form required by the proposed contract type.³⁹

DCAA's control environment and overall accounting system audit should not be confused with the FAR 16.301-3(a)(1) requirement for award of a cost-reimbursement contract. The FAR 16.301-3(a)(1) requirement is a matter of present responsibility. Thus, for example, if a CO determines that a small business is ineligible for contract award because of an inadequate accounting system, the matter must be referred to the Small Business Administration to determine whether to issue a certificate of competency.⁴⁰

To be determined responsible, a prospective contractor must, among other things, have the necessary accounting controls to perform the contract.⁴¹ A pre-award survey is one of the principal means for COs to obtain responsibility information.⁴² A pre-award survey of a prospective contractor's accounting system is typically conducted using a Standard Form 1403, Preaward Survey of Prospective Contractor (General), and SF 1408, Preaward Survey of Prospective Contractor—Accounting System. The SF 1408

provides a recommendation as to whether the contractor's accounting system is (1) acceptable for award of the prospective contract, (2) not acceptable, or (3) acceptable with a recommendation that a follow-on accounting system audit be performed after contract award. The pre-award survey is fairly rudimentary and is designed to assess whether the prospective offeror has an accounting system that is adequate for determining costs applicable to the contract.⁴³ By contrast, the DCAA accounting system review is far more extensive. A simple comparison of DCAA's standard audit programs for systems audits to SF 1403 and SF 1408 demonstrates that system audits go well beyond—and in fact, have very little if anything to do with—the basic criteria of “adequate for determining costs applicable to the contract.”

Many COs do not fully understand that DCAA systems audits and responsibility determinations are different processes. Because of this lack of understanding, there is a major risk that COs will not award contracts to contractors that have received adverse audit opinions related to their internal control systems, even if those contractors would provide the best solution, at the best value, to the Government, warfighter and taxpayer. Indeed, we are already starting to see bid protests raising issues related to DCAA's business system audits.⁴⁴

A DCAA finding that a contractor's accounting or other internal control system is inadequate may also lead an ACO to impose arbitrary payment withholds even though the DCAA audit reports typically do not provide any basis for concluding that there is a risk to the Government warranting such withholds. If an ACO receives an audit report identifying a significant accounting system or related internal control deficiency, DFARS 242.7502(a)(4) requires the ACO to consider suspending a percentage of progress payments or reimbursement of costs proportionate to the estimated cost risk to the Government until the contractor submits a n acceptable corrective action plan and corrects the deficiencies. Despite this DFARS requirement, there is currently no contractual basis for the Government to withhold *contract* payments based on accounting system deficiencies.⁴⁵ With the exception of the MMAS clause, none of the FAR or DFARS clauses governing contractor business systems authorizes the Government to withhold payments. In the absence of a

contract clause, the prescriptive language in DFARS 242.7502 is unenforceable. In an analogous case, the U.S. Court of Appeals for the Federal Circuit held that the Armed Services Board of Contract Appeals erred in relying on FAR 32.503-5 as a contract requirement because the contract neither expressly nor impliedly incorporated that section of the FAR.⁴⁶ David Ricci, then the DCMA Executive Director of Contracts, acknowledged the unenforceability of DFARS 242.7502 in his Aug. 11, 2009 testimony before the CWC.⁴⁷ The CWC specifically asked Ricci if he believed DFARS 242.7502 was unenforceable. He replied, “That is our position. That is not a clause.”⁴⁸

Furthermore, DFARS 242.7502 instructs the ACO to consider suspending a percentage of progress payments *proportionate* to the estimated cost risk to the Government. This is consistent with the well-established rule that the Government can only withhold funds proportionate to its risk.⁴⁹ However, DCAA’s business systems audits generally do not provide any basis for making such a determination. As previously noted, DCAA’s current policy disclaims any requirement to show that the deficiency is likely to result in unallowable costs. Instead, DCAA simply assumes that all deficiencies will or could ultimately result in unallowable costs. The audit guidance states,

As further clarification, the contractor’s failure to accomplish any control objective tested for in DCAA’s internal control audits will or could ultimately result in unallowable costs charged to Government contracts, even when the control objective does not have a direct relationship to charging costs to Government contracts. For example, the control objective related to ethics and integrity is not directly related to charging costs to Government contracts. However, the contractor’s failure to accomplish the control objective creates an environment that could ultimately result in mischarging to Government contracts. It is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness. In addition, by limiting internal control audits to major contractors, DCAA only performs audits of contractor systems that are material to Government contract costs. As a result, internal control deficiencies identified in DCAA audits will generally have an impact or potential impact to Government contract costs that is material. Therefore, a contractor’s failure to

accomplish any applicable control objective should be reported as a significant deficiency/material weakness.

DCAA’s ipse dixit analysis does not provide any basis, let alone a reasonable basis, for making the type of determination required by DFARS 242.7502.

DOD’s controversial proposed rule on contractor business systems would, if published as a final rule, give ACOs contractual authority to suspend costs for accounting system deficiencies.⁵¹ The proposed rule would also avoid the issue of having to determine an amount proportionate to the estimated cost risk to the Government by requiring ACOs to withhold stated percentages regardless of the nature of the deficiency.

Another very likely consequence of an adverse accounting system audit is that DCAA will rescind the contractor’s direct billing authority. In fiscal year 2009 alone, DCAA removed over 300 contractors from the direct billing program.⁵² DFARS 242.803(b)(i)(C) allows DCAA to authorize direct submission of interim vouchers to the applicable disbursing office for provisional payment to contractors with approved billing systems. DCAA will not approve direct billing until it has audited the contractor’s billing system and deemed the system adequate. Additionally, it is DCAA policy that if a major contractor that has been approved for direct billing makes a significant change to its accounting system or billing system, DCAA will rescind the contractor’s direct billing authority until DCAA completes a billing system audit and determines that the revised or new system is adequate.⁵³ In the absence of direct billing authority, contractors must submit vouchers under cost-reimbursement contracts to DCAA for review, which typically increases the payment cycle by up to three days. In addition to delaying payment, DCAA review of each voucher increases the risk that costs will be disallowed.

Contractor Remedies

Ultimately, DCAA is merely an advisor, and the cognizant ACO—not DCAA—has the authority to determine whether a contractor’s business systems are adequate and compliant. For certain business systems, the regulations prescribe a specific process for resolving deficiencies identified in audit reports and determining the acceptability of the contractor’s cor-

rective actions. For example, DFARS 242.7502(a)(1) provides that upon receipt of an audit report identifying a significant accounting system or related internal control deficiency, the ACO will provide a copy of the report to the contractor and allow 30 days, or a reasonable extension, for the contractor to respond. If the contractor agrees with the audit report, the contractor has 60 days to correct any identified deficiencies or submit a corrective action plan showing milestones and actions to eliminate the deficiencies.⁵⁴ If the contractor disagrees, the contractor may submit a written response disputing the audit findings.⁵⁵ Although DFARS 242.7502 does not specifically require the ACO to make a determination if the contractor disagrees with an audit report, a DCAA audit finding that a contractor's accounting system is inadequate is a "reportable audit" under DOD Instruction 7640.02, which the ACO must resolve within six months after the date the audit report is issued.

In today's environment, however, it is often difficult for a contractor to persuade the ACO to overrule a DCAA audit finding. ACOs are afraid of DCAA, and the path of least resistance is simply to agree with the audit report. On March 13, 2009, DCAA published audit guidance on "Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials."⁵⁶ According to the audit guidance, "Unsatisfactory conditions include actions by Government officials that appear to reflect mismanagement, a failure to comply with specific regulatory requirements or gross negligence in fulfilling his or her responsibility that result in substantial harm to the Government or taxpayers, or that frustrate public policy." It cites as an example a CO "ignor[ing] a DCAA audit report and tak[ing] an action that is grossly inconsistent with procurement law and regulation."

The audit guidance instructs auditors to report these "unsatisfactory conditions" directly to the DOD inspector general rather than going through the Government official's chain of command. Two recent DOD IG reports have criticized ACOs for failing to follow DCAA audit report recommendations. On April 8, 2009, the DOD IG published *Oversight Review: Defense Contract Management Agency Actions on Audits of Cost Accounting Standards and Internal Control Systems at DOD Contractors Involved in Iraq*

Reconstruction Activities (D-2009-6-004), which harshly criticized ACOs for, among other things, disagreeing with DCAA audit reports containing internal control system recommendations and determining that contractors' business systems were adequate without waiting for DCAA to complete a follow-up review.⁵⁷ Even more recently, the DOD IG issued a report substantiating DCAA's allegations that, during two reviews of a contractor's EVMS, DCMA's EVM Center failed to (1) allow DCAA sufficient time to perform an audit of the contractor's system, (2) adequately resolve the DCAA findings, and (3) demonstrate independence and objectivity in fulfilling its oversight responsibilities.⁵⁸

Siding with the contractor is also administratively more cumbersome for ACOs because it is DCMA policy to require referral to a board of review before an ACO makes a determination contrary to a DCAA audit recommendation.⁵⁹ Furthermore, DCAA can now directly challenge an ACO's determination under an internal appeal process implemented in December 2009 by the Director of Defense Procurement, Acquisition Policy and Strategic Sourcing.⁶⁰

If, notwithstanding the contractor's written response, the ACO determines that a contractor business system is inadequate, the contractor may submit a Contract Disputes Act claim and demand a CO's final decision determining that its business system is adequate.⁶¹ If the ACO issues an adverse final decision, or fails to issue a decision within 60 days, the contractor may appeal the final decision or deemed denial of its claim to the applicable board of contract appeals or to the U.S. Court of Federal Claims. Unfortunately, both options are time-consuming and unlikely to resolve the immediate problem.

Conclusion

The net result of these new audit policies is that business system audits are consuming a tremendous amount of time and resources for both DCAA and contractors; contractors are trying desperately to avoid an audit opinion that their systems are "inadequate"; and ACOs are afraid to disagree with DCAA—despite the fact that there is little if any discernible relationship between the system audits and protecting the Government against unallowable costs. Moreover,

widespread findings of inadequate accounting systems could seriously disrupt major procurements, and at the very least will provide a fertile source of bid protest issues. It would far better serve the taxpayers and strengthen Government procurement for DCAA to focus its efforts on performing high-quality contract audits that enable the Government's acquisition professionals to award, administer and close-out Government contracts in a timely manner. As Jacques Gansler, former Undersecretary of Defense for Acquisition, Technology and Logistics, famously remarked, the "global war on contractors" must stop.⁶² DCAA is the tip of the spear in the global war against contractors, and dysfunctional business system audits are its current weapon of choice.

❖ Endnotes

- 1 Karen L. Manos is Co-Partner in Charge of the Washington, D.C. office of Gibson Dunn, and Immediate Past-Chair of the American Bar Association Public Contract Law Section.
- 2 See DFARS 242.7502(a).
- 3 The FAR supplements for the Department of Health and Human Services, Department of Commerce, and NASA also contain EVMS requirements.
- 4 See FAR 34.201.
- 5 See DFARS 252.234-7002(a)(1).
- 6 See DFARS 252.234-7002(b).
- 7 See DFARS 234.201(3).
- 8 See DFARS 215.407-5-70(b)(2).
- 9 See DFARS 252.215-7002(a).
- 10 See DFARS 252.215-7002(e).
- 11 See DFARS 252.242-7004(a).
- 12 See DFARS 242.7203(a).
- 13 See DFARS 242.7203(b).
- 14 See DFARS 252.242-7004(b).
- 15 See DFARS 252.242-7004(d).
- 16 See FAR 45.105(a)-(c).
- 17 See FAR 44.303.
- 18 See FAR 44.302.
- 19 See FAR 44.301.
- 20 See generally DEFENSE CONTRACT AUDIT MANUAL Ch. 5, *Audit of Policies, Procedures, and Internal Controls Relative to Accounting and Management Systems*.
- 21 DCAM ¶ 5-101.c.
- 22 DCAM ¶ 5-111.a.
- 23 Commission on Wartime Contracting in Iraq and Afghanistan Special Report No. 1, *Special Report On Contractor Business Systems: Defense Agencies Must Improve Their Oversight Of Contractor Business Systems To Reduce Waste, Fraud, And Abuse*, at 2 (Sept. 21, 2009).
- 24 See DCAA Memorandum for Regional Directors (MRD), "Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions on Internal Control Systems" (08-PAS-043(R)) (Dec. 19, 2008).
- 25 See Jerry J. Weygandt, *FINANCIAL ACCOUNTING* 316 (2009).
- 26 Testimony of April G. Stephenson, Director, DCAA, before the Senate Committee on Homeland Security and Governmental Affairs (Sept. 23, 2009) (emphasis added).
- 27 See, e.g., Government Auditing Standard 4.10 (July 2007) ("Auditors should design the audit to provide reasonable assurance of detecting misstatements that result from violations of provisions of contracts or grant agreements and could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives."); 5.12 (guidance on assessing the significance of an internal control deficiency).
- 28 *U.S. v. Newport News Shipbldg. & Dry Dock Co.*, 837 F.2d 162 (4th Cir. 1988).
- 29 837 F.2d at 170.
- 30 See Testimony of April G. Stephenson, Director, DDCAA, before the Senate Committee on Homeland Security and Governmental Affairs at 5–6 (Sept. 23, 2009).
- 31 See DCAA MRD, "Audit Guidance on Performing Internal Control Follow-Up Audits and Limited Scope Audits" (10-PAS-005(R)) (Feb. 18, 2010).
- 32 *Id.*
- 33 See Testimony of April G. Stephenson, Director, DCAA, before the Senate Committee on Homeland Security and Governmental Affairs at 11 (Sept. 23, 2009).
- 34 *Id.* at 3.
- 35 See Government Auditing Standards at 4.03.b (July 2007).
- 36 See DOD Directive 5105.36, Defense Contract Audit Agency (DCAA), at ¶ 3 (Jan. 4, 2010).
- 37 DCAA MRD, "Audit Alert on Reporting on Forward Pricing Rates in Pricing Proposals" (10-PSP-018(R)) (June 4, 2010).
- 38 See 48 CFR § 16.301-3(a)(1) ("A cost-reimbursement contract may be used only when—The contractor's accounting system is adequate for determining costs applicable to the contract").
- 39 Testimony of April G. Stephenson Director, DCAA, before the CWC at 5 (Aug. 11, 2009).
- 40 See *Celtech, Inc. v. U.S.*, 24 Cl. Ct. 269, 276–77 (1991).
- 41 See FAR 9.104-1(e).
- 42 See FAR 9.105-1(b).
- 43 *C.f.*, *Florida Engineered Constr. Prods. Corp. v. U.S.*, 41 Fed. Cl. 534 (1998) (rejecting contractor's argument that pre-award survey was a tacit approval of contractor's accounting system for progress payment purposes, and noting that the pre-award survey and postaward accounting system audit have different scopes and are performed for different purposes).
- 44 See, e.g., *McKissack + Delean JV II*, Comp. Gen. Dec. B-401973.2, 2010 CPD ¶ 28 (agency improperly rejected the proposal of a joint venture offeror for a cost-reimbursement contract because the indirect cost rate structure included in the JV's accounting system was considered unacceptable, where the agency provided no supportable or reasonable basis for its determination); *Contingency Mgmt. Group, LLC*, Comp. Gen. Dec. B-309752, 2008 CPD ¶ 83 (agency's evaluation of awardee's business systems under a management and evaluation factor as "outstanding" was of concern because agency's evaluation did not adequately account for negative comments by DCAA that were provided to the procuring agency as part of the proposal evaluation).
- 45 The Progress Payments clause authorizes the CO to reduce or suspend progress payments after finding on substantial evidence that the contractor failed to comply with a material requirement of the contract, including paragraphs (f) and (g) of the clause. See FAR 52.232-16(c)(1). Paragraph (f) of the clause requires the contractor to "maintain an accounting system and

controls adequate for the proper administration of this clause." FAR 52.232-16(f). Accordingly, depending on the nature of the deficiencies cited in DCAA's audit, the CO could potentially have a basis for suspending progress payments.

46 See *Aydin Corp. v. Widnall*, 61 F.3d 1571, 1577 (Fed. Cir. 1995).

47 Statement By David Ricci, Executive Director of Contracts, DCMA, before the CWC on Contractor Business Systems, at 9 (Aug. 11, 2009).

48 The CWC hearing testimony is available at www.wartimecontracting.gov/index.php/hearings/commission/hearing20090811.

49 See, e.g., *Columbia Eng'g Corp.*, IBCA 2352, 88-2 BCA ¶ 20595 (arbitrary and capricious for CO to withhold more than 10 times the amount supported by credible evidence); *Martin Marietta Corp.*, ASBCA 31248, 87-2 BCA ¶ 19875 (improper for ACO to withhold costs as a "club" to insure compliance with DCAA's demand for access to internal audit reports); *Norair Eng'g Corp.*, GSBGA 3539, 75-1 BCA ¶ 11062 ("The amount withheld must be justified by reasonable proof of the costs involved.").

50 See DCAA MRD, "Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions on Internal Control Systems" (08-PAS-043(R)) (Dec. 19, 2008).

51 See 75 Fed. Reg. 2457 (Jan. 10, 2010); 5 CP&A Rep. ¶ 23(c).

52 See Testimony of April G. Stephenson, Director, DCAA, before the House Committee on Armed Services Defense Acquisition Reform Panel at 6 (Oct. 15, 2009).

53 See DCAA MRD, "Audit Guidance on Approving and Rescinding Contractor's Authorization to Participate in the Direct Bill Program for Major Contractors" (09-PPD-006(R)) (April 15, 2009).

54 See DFARS 242.7502(a)(2).

55 See DFARS 242.7502(a)(3).

56 See DCAA MRD, "Audit Guidance on Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials" (09-PAS-004(R)) (March 13, 2009).

57 See DOD IG Report No. D-2009-6-004, "Report of Defense Contract Management Agency Actions on Audits of Cost Accounting Standards and Internal Control Systems at DoD Contractors Involved in Iraq Reconstruction Activities" (April 8, 2009).

58 See DOD IG Report No. D-2010-6-002, "Report on Allegation of Unsatisfactory Conditions Regarding Actions by the Defense Contract Management Agency, Earned Value Management Center" (July 28, 2010); 5 CP&A Rep. ¶ 51.

59 See DCMA Guidebook, "Contract Audit Follow Up."

60 See DCAA MRD, "Audit Guidance on Resolving Contract Audit Recommendations" (10-PAS-015(R)) (May 27, 2010); Director of Defense Procurement and Acquisition Policy Memorandum, "Resolving Contract Audit Recommendations" (Dec. 4, 2009).

61 See FAR 33.206; 41 USCA § 605(a).

62 See Jacques Gansler, " 'Global war' on contractors must stop," ExecutiveBiz Blog, <http://blog.executivebiz.com/tag/global-war-on-contractors>.