

# WMACCA Government Contractors Forum: The Key Word is “More”

- What DCAA's New Agency Culture Means For Your  
Government Contracting Business. -

May 23, 2012



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Government Contracting Business. -

**Moderator:** Scott Hommer, Partner, Venable LLP

**Panelists:**

- John Farenish, Partner, Venable LLP
- Arnold Morse, Senior Vice President and Chief Legal Officer, CACI International, Inc.
- Tom Tagle, Partner, Baker Tilly



# Biographies



**Scott Hommer**, Partner at Venable LLP, concentrates his practice in business counseling and litigation with an emphasis on technology companies and government contractors. He represents clients locally, nationally, and internationally on issues including negotiating contracts, acquisitions, protecting intellectual property rights, and successful litigation. Mr. Hommer also has significant experience in counseling clients who do business with the federal, state, and local governments and has represented clients on contract administration matters, contract claims and disputes, bid protests, contract terminations, teaming agreements, conflict of interest issues, intellectual property rights issues, government socio-economic programs, and small business matters.

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# Biographies



**John Farenish**, Partner at Venable LLP, focuses on federal, state and local procurement law. He counsels and represents clients on the applicability and interpretation of government contract-related case law, federal procurement statutes, the Federal Acquisition Regulation (FAR), and the Cost Accounting Standards.

Mr. Farenish has more than 30 years of experience in various regulatory, compliance and prosecutorial capacities with the federal government, beginning with the Army's Judge Advocate General Corps and including seven years with the Department of the Navy. Prior to joining Venable, he spent 13 years serving with the Defense Contract Audit Agency (DCAA), starting as deputy general counsel before becoming general counsel in 2003. He also spent several years with the DoD's Inspector General's office handling criminal matters related to federal acquisition policy.

Mr. Farenish has written and lectured extensively on aspects of government contracting work, including ethics, compliance, criminal investigations, and the conditions for contractor suspension and debarment.

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## Biographies



**Arnold Morse** brings over 15 years of service to CACI International Inc., including the position of Senior Vice President, Chief Legal Officer and Secretary from September 2006 – Present.

Prior to joining CACI International Inc., Mr. Morse served as General Counsel and Secretary of The Orkand Corporation from June 2001 – August 2004.

Mr. Morse received his JD from Boston College Law School in 2003 and a BA from Union College, Schenectady, NY in 1978.



# Biographies



**Tom Tagle**, a Partner in Baker Tilly Virchow Krause, LLP's Consulting Services Practice, has worked in government contracting consulting since 1993. He works closely with our clients on a wide range of accounting, financial reporting, and regulatory compliance issues. Prior to joining Baker Tilly, Tom worked for a global consulting firm, and spent the first nine years of his career with a global accounting firm.

## Specific experience

- > Assists government contractors with all phases of the federal government procurement cycle, including overhead rate design and implementation, contract cost impacts, preparation of incurred cost submissions, and settlement of contract claims.
- > Assists companies in the design and implementation of policies, procedures, and internal controls to improve critical business processes and help ensure compliance with applicable regulations such as the Cost Accounting Standards (CAS) and the Federal Acquisition Regulation (FAR).
- > Possesses extensive experience in a broad range of consulting, forensic investigations, and litigation support assignments for clients in a variety of industries.
- > Led financial statement audits of government contractors.

## Industry involvement

- > American Institute of Certified Public Accountants
- > Associate Member of the American Bar Association (Public Contract Section)
- > Association of Certified Fraud Examiners
- > Presenter for National Contract Management Association's audio seminar series

## Education

Washington & Lee University  
Bachelor of Science in Business Administration and Accounting



# Agenda

- Changing Business Environment
- DCAA & DCMA Mission
- DCAA Initiatives and Business Systems Rules
  - Contractor Response
- DCAA & DCMA Criticisms and Problem Areas
- Audits
  - Managing an Audit
  - Audit Tips
- Government Oversight: Macro and Micro-Level Perspectives



# Changing Business Environment

- Contractors need to take preemptive risk management steps to ensure compliance with Business Systems Rules.
- Factors to Consider:
  - Heightened scrutiny and audit oversight by DCAA
  - Strict compliance and disclosure requirements
  - Expansion of audit inquiries
  - False Claims Act
  - Lack of communication between contractor and Contracting Officer prior to payment withholds





## DCAA Mission

“The DCAA, while serving the public interest as its primary customer, shall perform all necessary contract audits for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all DoD components responsible for procurement and contract administration. These services shall be provided in connection with negotiation, administration, and settlement of contracts and subcontracts to ensure taxpayer dollars are spent on fair and reasonable contract prices. DCAA shall provide contract audit services to other Federal agencies, as appropriate.”



# DCMA Mission

The mission of DCMA is to “perform Contract Administration Services (CAS) for the Department of Defense, other authorized Federal Agencies, foreign governments, international organizations, and others as authorized.”

DCMA primarily works during two acquisition stages:

- **Pre Contract Award**

“DCMA provides advice and services to help construct effective solicitations, identify potential risks, select the most capable contractors, and write contracts that meet the needs of our customers in DoD, Federal and allied government agencies.”

- **Post Contract Award**

“DCMA monitors contractors’ performance and management systems to ensure that cost, product performance, and delivery schedules are in compliance with the terms and conditions of the contracts.”



# Interrelationship Between DCAA and DCMA

- DCAA plays an *advisory* role.
- DCMA, through its contracting officers and administrative contracting officers, *officially acts on behalf* of the DoD.
  - DCMA often uses DCAA audits when issuing pricing and cost allowance decisions.
    - However, DCAA and DCMA often conflict with each other when providing guidance to contractors.
    - DCAA has also claimed that its findings have been undermined by DCMA.



## DCAA Initiatives

- DPAP Memorandum (1/4/2011), “Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending; “Align DCMA and DCAA Processes to Ensure Work is Complementary”
  - Increased Thresholds for Price Proposal Audits
  - Forward Pricing Rate Agreements/Forward Pricing Rate Recommendations
  - Financial Capability Reviews
  - Purchasing System Reviews
  - Contractor Business Systems Rule
  - Ethics Compliance Reviews



# DCAA Initiatives: Business Systems

- The interim Business Systems Rule was issued on May 18, 2011 (76 Fed. Reg. 28856).
- The rule defines contractor Business Systems as the contractor's:
  - Accounting System (252.242-7006)
  - Estimating System (252.215-7002)
  - Material Management and Accounting System (MMAS) (252.242-7004)
  - Purchasing System (252.244-7001)
  - Property Management (252.245-7003)
  - Earned Value Management System (EVMS) (252.234-7002)
- The new Business Systems Rule generally applies to CAS covered contracts.
- The rule includes a contract clause that requires the Contracting Officer to apply a percentage of withhold (5%) when a contractor's Business Systems contain a significant deficiency.



# DCAA Initiatives: Business Systems

The Accounting System may include five individual subsystems (252.242-7006(a)(2)):

1. Indirect and Other Direct Costs
2. Compensation
3. Billing
4. Labor
5. General Information Technology

Identification of subsystems is important, because a significant deficiency in a single subsystem (i.e. Billing) can compromise the integrity of the entire Business System, causing it to fail.





# DFARS Rules: Business Systems – Definition & Administration

Final rule published on February 24, 2012 (77 Fed. Reg. 37).

## Key Points:

- Significant Deficiency: “a shortcoming in the system that materially affects the ability of officials of the DoD to rely upon information produced by the system that is needed for management purposes.”
  - What does “materially” entail?
- Payment Withholding Decisions: CO finds one or more significant deficiencies in a contractor’s Business Systems.
  - CO may withhold up to 5% for single Business Systems deficiencies, and up to 10% for multiple Business Systems deficiencies.
  - Applies to progress payments, performance-based payments, and interim payments per each covered contract.



# DFARS Rules: Business Systems – Definition & Administration

Corrective Action Plans: allows a contractor to implement a plan to address Business Systems deficiencies. If corrective, CO will reduce or release payment withholds.

- If contractor submits an “acceptable” plan within 45 days of the withholding notice, and CO finds the plan is effectively implemented to address significant deficiencies, the CO shall reduce withholding to 2 percent. If contractor thereafter fails to act in accordance with the plan, CO shall increase withholding amount.

## Correction of Business Systems Deficiencies

- If CO determines contractor successfully corrected deficiencies, CO will discontinue withholding and notify contractor as such in writing.
- If CO does not act upon contractor’s successful plan within 90 days, CO shall reduce withholding by at least 50 percent.
- If contractor thereafter fails to address deficiencies, CO may increase or reinstate withholding.





# The Roles of DCAA & DCMA

Section 893 of the Ike Skelton NDAA for FY 2011 provides that the program created to improve contractor Business Systems will “identify officials of the Department of Defense who are responsible for the approval or disapproval of contractor business systems.”

## Responsibilities Identified in the Interim Rule

### DCAA

- Accounting; Estimating; Material Management & Accounting System (MMAS)

### DCMA

- Purchasing; Property Management; Earned Value Management System (EVMS)
- DCAA & DCMA launched a Cost Recovery Initiative to address the buildup of audits awaiting resolution.
- Focus of resources on high risk proposals:
  - Cost-Type Proposals > \$100 million; Fixed-Price Proposals > \$10 million





## DCAA Initiatives: Business Systems

- DCAA will report on compliance with the criteria in DFARS 252.242-7005.
- DCAA Reports will identify significant deficiencies – defined by the interim Business Systems rule as
  - “Shortcomings in the system that materially affects the ability of officials of the DoD to rely upon information produced by the system that is needed for management purposes.”



# DCAA Initiatives

What this means to you:

- Increased Requests for Data
- Increased Access to Electronic Data
- Requests for Documents Not in the Ordinary Course of Business
  - Board of Director Meeting Minutes
  - Internal Audit Reports
- Access to Records Issues
- Development of New Record Systems
- Development of Internal Monitoring Systems
- Alternative to Internal Audit Mechanism



# Response to New Audit Environment

Contractors need to take preemptive steps in response to DCAA's increased oversight and compliance requirements:

- Increase effectiveness of internal compliance procedures, allocated resources, and communications regarding potential or ongoing audits.
- Increase communications with DCAA officials.
- Keep abreast of current regulatory regime to ensure effective compliance.



# Problem Areas with Business Systems Reviews

- Reviews are being conducted by inexperienced auditors, using vague guidelines with too much discretion.
- Auditors are taking a checklist approach to the compliance requirements, components, and system criteria.
- Auditors are taking a “black letter” pass/fail approach in interpreting the regulatory requirements.
- Auditors are requiring documentary support for each element.
- The corrective action plan review process is elaborate and time consuming.
- DCMA does not cite any regulatory or acquisition law to support its recommendations.



## DCAA Problem Areas

- Business System Reviews – Inexperienced auditors, vague terms, too much discretion
- Business System Reviews – Withholds and follow-on audits
- Internal Audit Reports
- Access to Records
- Attorney/Client Privilege Documents
- Ethics Internal Investigations – Summarized v. Unfettered Access
- Contractor Disclosures – Cooperation/Timing
- Disconnect between HDQS and Field Auditors
- Lack of Experienced Auditors



# DCAA Areas of Increased Emphasis

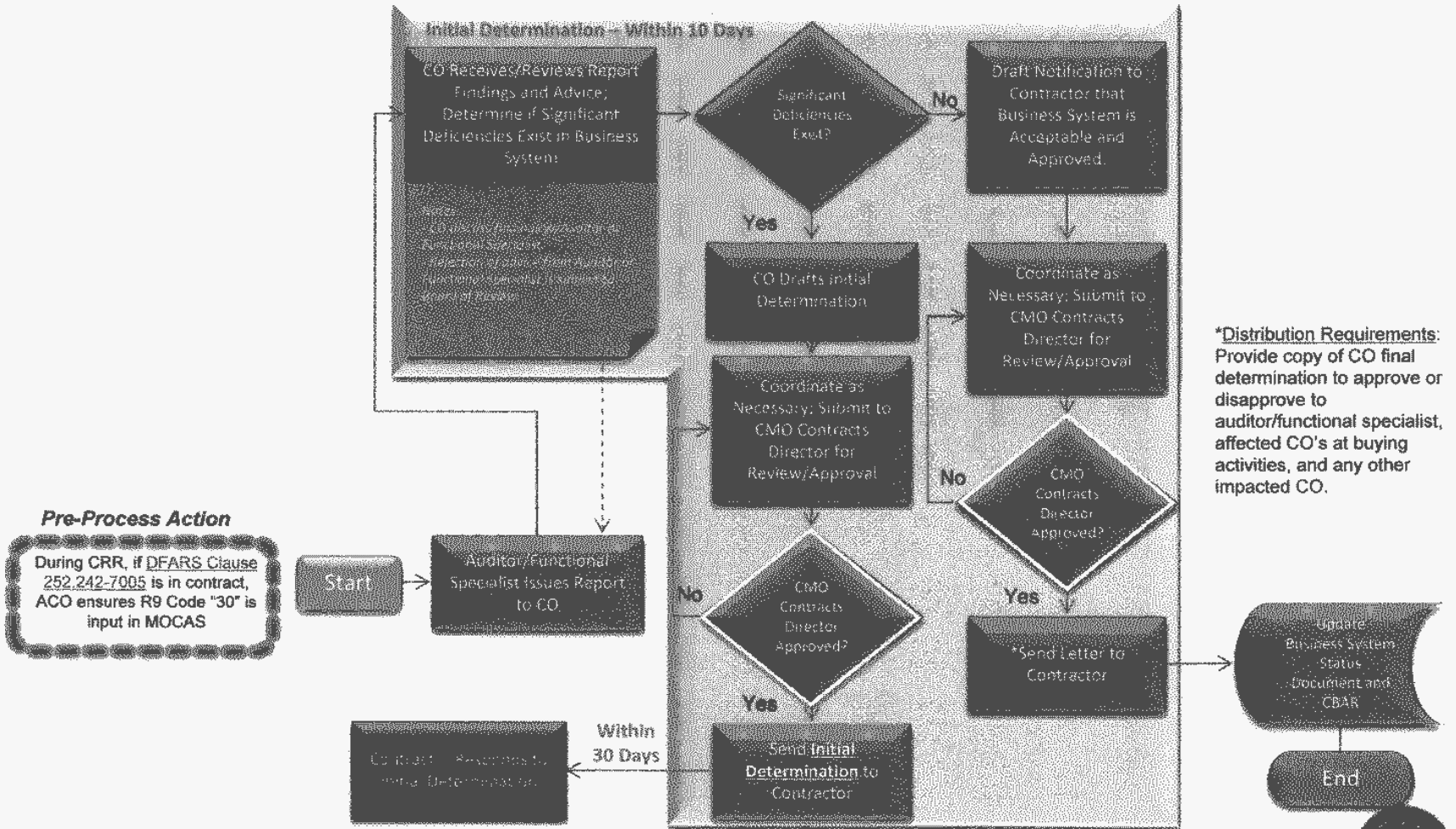
1. Business Systems, especially policies and procedures for accounting and billing.
2. Incurred costs audits going back 6 years.
3. Contractor proposals with increased requests for supporting documentation.
4. Forward pricing rate agreements / forward pricing rate recommendations accompanied by increased testing and sampling.
5. Financial capability reviews and requests for internal audit reports.
6. Ethics compliance reviews with unfettered access to internal investigations.





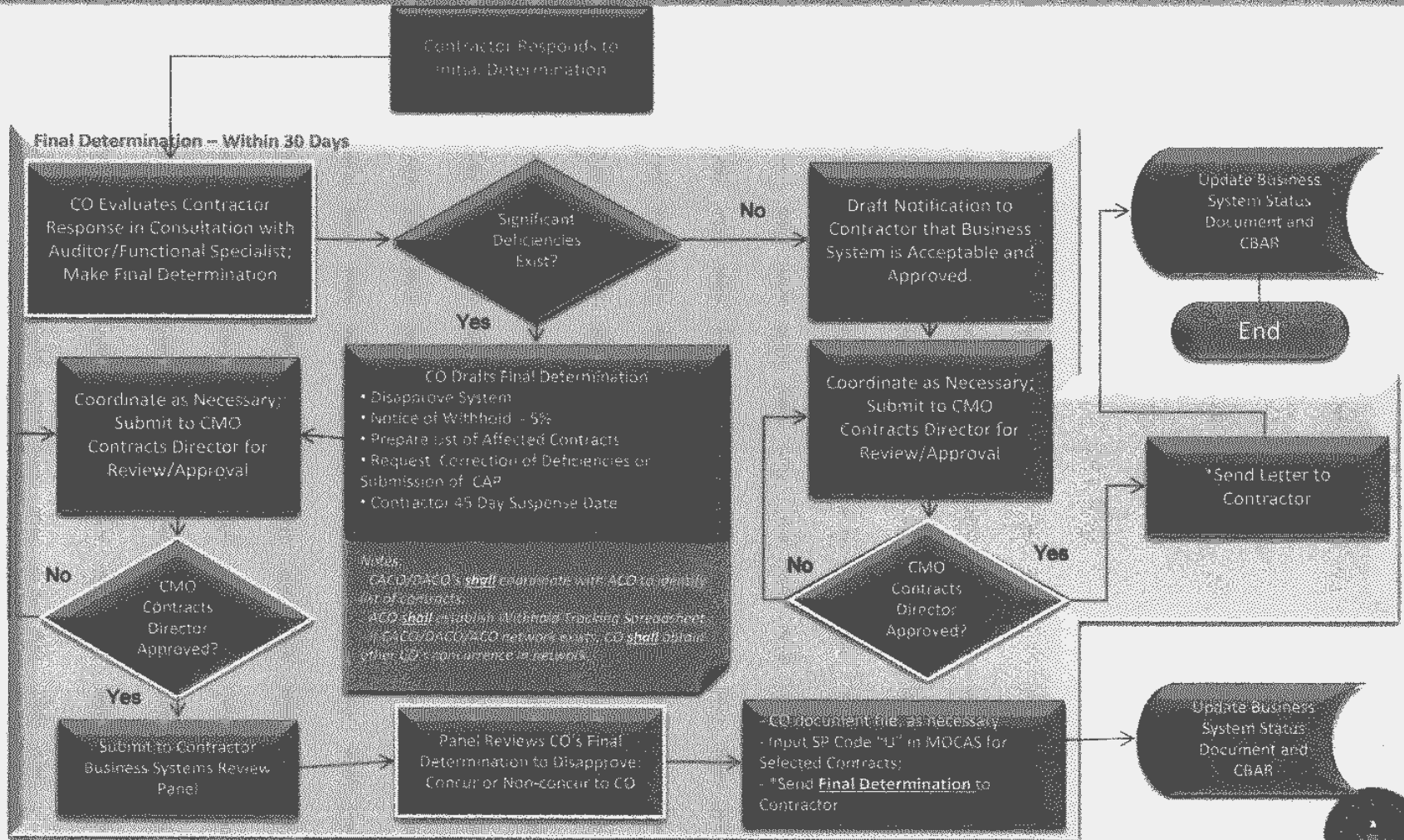
# Pre-Process / Initial Determination

Contract Review and Reporting (CRR) Process



**\*Distribution Requirements:**  
 Provide copy of CO final determination to approve or disapprove to auditor/functional specialist, affected CO's at buying activities, and any other impacted CO.

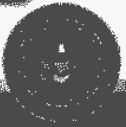
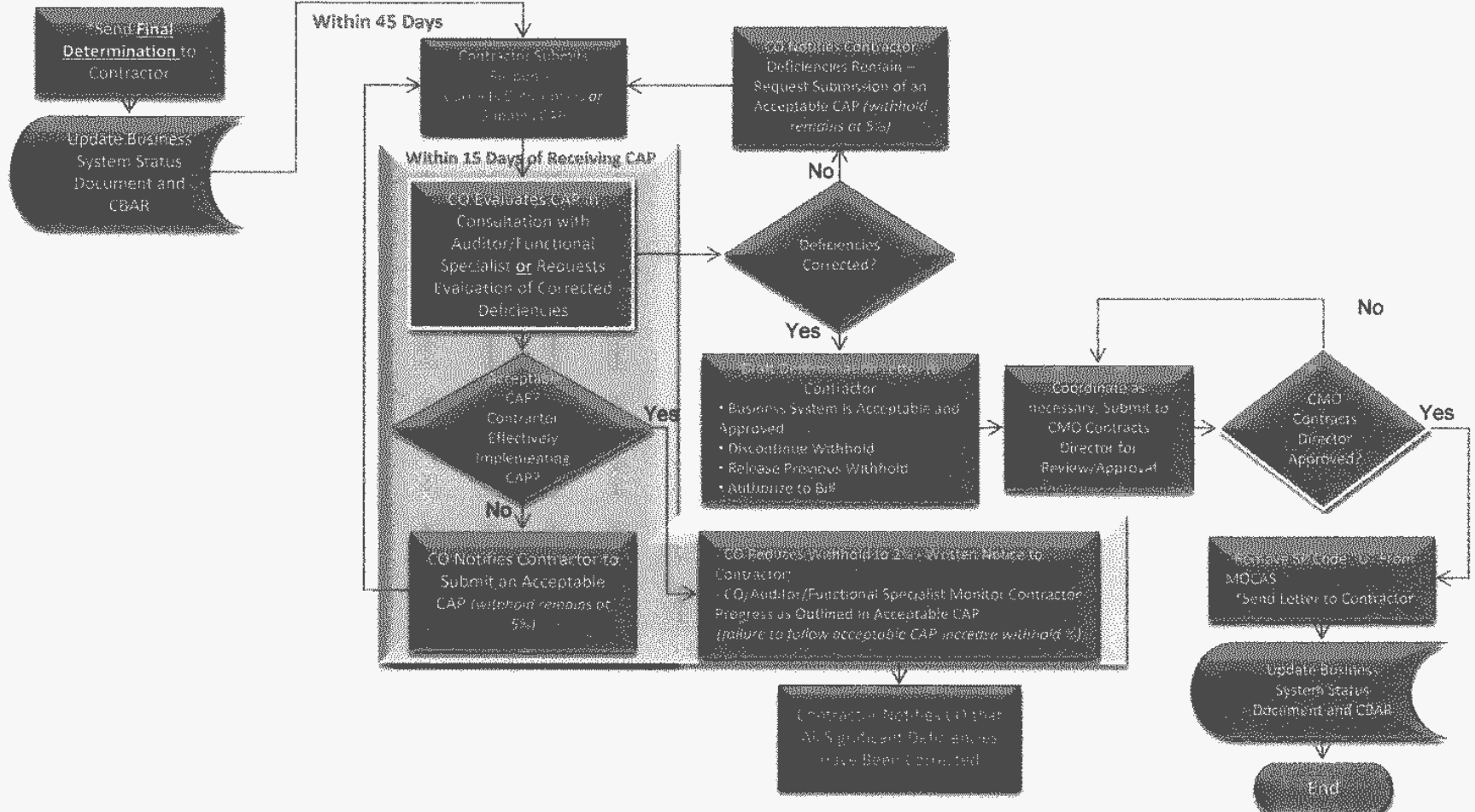


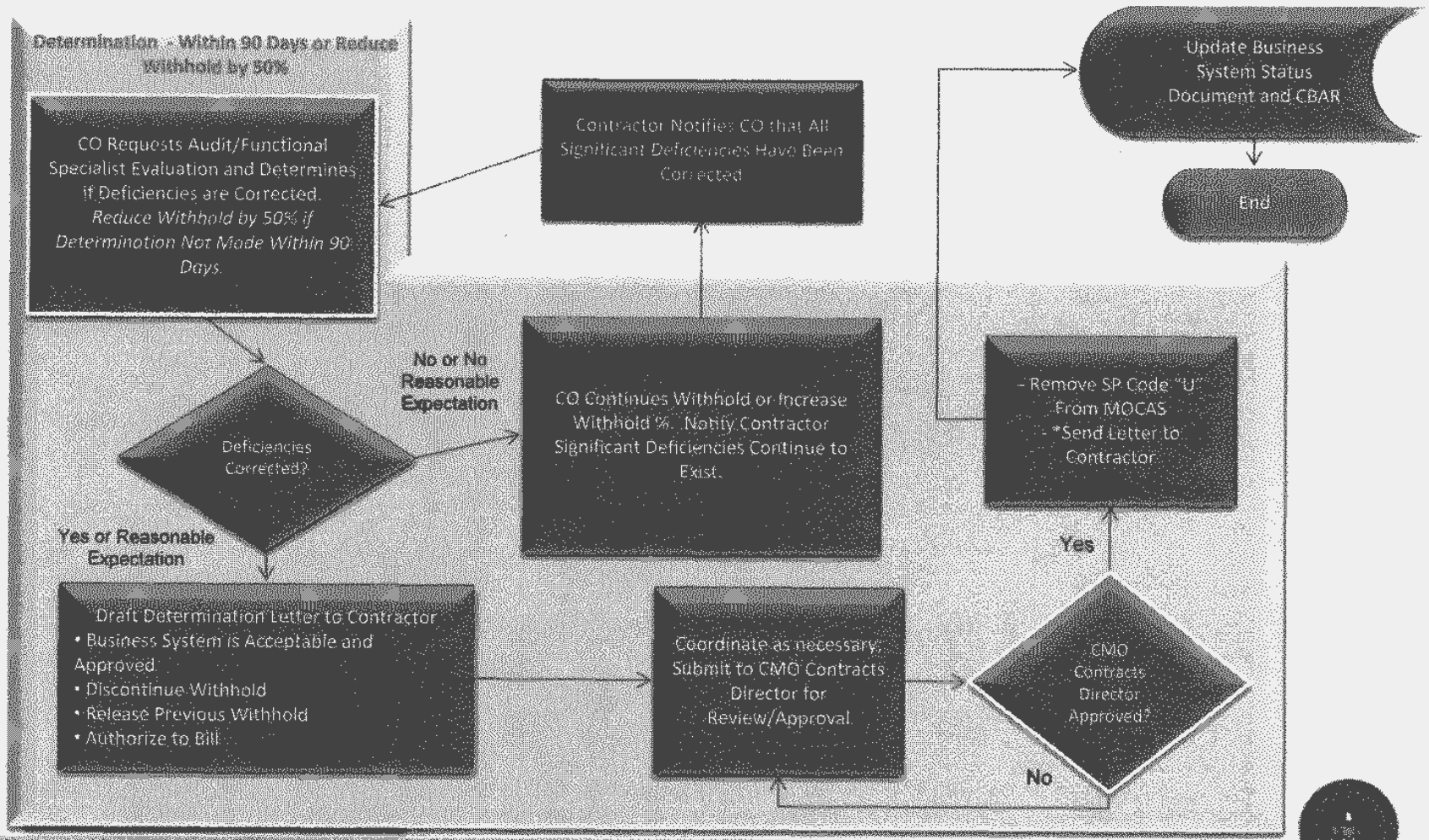




# Corrective Action Plan (CAP) and Payment Withhold

DEFENSE CONTRACT MANAGEMENT AGENCY





# Audit Tips

## How to Prepare for a DCAA/DCMA Audit:

- Review prior DCAA audit reports and identify issues.
- Review DCMA reviews and identify issues.
- Conduct contract walk-through.
- Review policies and procedures.
- Test internal control structure relating to area to be audited.
- Ensure documentation (data) is current and available.
- Ensure employees are trained.
- Ensure practices compliant w/ policies & procedures.
- Perform sampling of area to be audited.
- Select a liaison(s) to work with the auditors.



## Audit Tips (continued)

- Review the notification to understand scope of audit and determine whether you have enough time to prepare.
- If audit is with an OIG consider having counsel present.
- Explain your Business Systems during the entrance conference.
- Actively manage the audit throughout the process (GC and Internal Audit) – Internal Control Mechanism & Key POCs.
- Establish a document log for all incoming and outgoing correspondence.
- Document all questions, discussions, answers, disagreements, and misunderstandings with the auditors before, during and at conclusion of audit.
- Keep management informed.
- Draft a rebuttal to draft audit report.



## Audit Tips (continued)

- Develop a professional rapport with the auditors.
- Take notes on auditor's request for documents/request that the auditor put their request in writing.
- Listen to the auditor's questions/request that questions be put in writing.
- Provide documents that are requested in a timely manner and in the form requested (establish ground rules).
- Do not establish too many levels of review for release of documents.
- Ensure that the company liaison to the auditors has the knowledge and authority to release documents.
- Avoid deemed denial of access to records.
- Do not be afraid to ask questions and be prepared to answer questions.
- Document disputes.
- Take a deep breath – you will survive!



# Effective Management of an Audit

At the outset of an audit, contractors must internally communicate:

- Types of audits and risk assessment levels.
- How and why an audit occurs; the length and scope of an audit; resources needed for an audit.

In the interim, it is important to understand contractor data and relevant facts, and identify any omissions or mistakes.

At the completion of an audit, contractors should analyze and respond to the results within an auditor's draft report to account for any discrepancies.



# Government Oversight



Candor. Insight. Results.





# Government Oversight: A Disintegrating Process



Candor. Insight. Results.

- Time and cost of a DCAA audit is ever increasing (see DCAA Audit Trends handout)
- Business Systems rule will only increase time and cost:
  - RFPs may require adequate business system designations
  - DCAA may not be able to conduct follow-up audits for contractors who have implemented corrective action plans in response to business system deficiencies
- As a result, DCAA is taking longer to provide advice to COs
  - Average time between receipt of adequate ICS and DCAA's audit report was 965 days in FY11
  - FPR audits averaged 120 days in FY11
- Contracting Officers may not challenge assertions made by DCAA
- Contractors do not observe all communication between DCAA & COs
- Contractors may not be responding to DCAA & COs in timely manner

Number of Completed DCAA Audits<sub>1</sub>

Completed Audits	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11
Incurring Costs and Special Audits	30,373	27,746	28,316	26,480	26,360	23,697	22,519	19,956	12,826	5,166	3,886
Price Proposals	8,874	9,447	9,829	10,299	9,673	9,015	8,182	8,113	7,004	5,590	2,599
Cost Accounting Standards	2,689	2,322	2,353	2,340	2,426	2,413	2,648	1,927	1,292	916	874
Defective Pricing	721	627	615	586	562	485	452	356	154	59	31
Total Audits	42,657	40,142	41,113	39,705	39,021	35,610	33,801	30,352	21,276	11,731	7,390

GAO Report 7/22/08, 10 months into FY08

Number of Workyears<sub>2</sub>

Workyears	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11
Incurring Cost and Special Audits	2,110	2,016	2,027	2,033	2,061	2,043	2,098	2,104	1,935	1,765	1,955
Price Proposal	622	640	669	698	690	706	724	779	993	1,307	1,220
Cost Accounting Standards	107	107	102	96	99	99	100	100	120	160	212
Defecting Pricing	98	89	86	83	87	81	76	83	51	33	39
Other Direct Audit Effort	651	658	642	628	611	580	560	533	550	669	716
Total Direct Workyears	3,588	3,510	3,526	3,538	3,548	3,509	3,558	3,599	3,649	3,934	4,142

## Number of Audits Per Workyear

Audits per workyear	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11
Incurring Cost and Special Audits	14.4	13.8	14.0	13.0	12.8	11.6	10.7	9.5	6.6	2.9	2.0
Price Proposal	14.3	14.8	14.7	14.8	14.0	12.8	11.3	10.4	7.1	4.3	2.1
Cost Accounting Standards	25.1	21.7	23.1	24.4	24.5	24.4	26.5	19.3	10.8	5.7	4.1
Defecting Pricing	7.4	7.0	7.2	7.1	6.5	6.0	5.9	4.3	3.0	1.8	0.8
Other Direct Audit Effort											
Total Audits Per Workyear*	14.5	14.1	14.3	13.6	13.3	12.2	11.3	9.9	6.9	3.6	2.2

\* Total Audits Per Workyear excludes workyears recorded as "Other Direct Audit Effort"

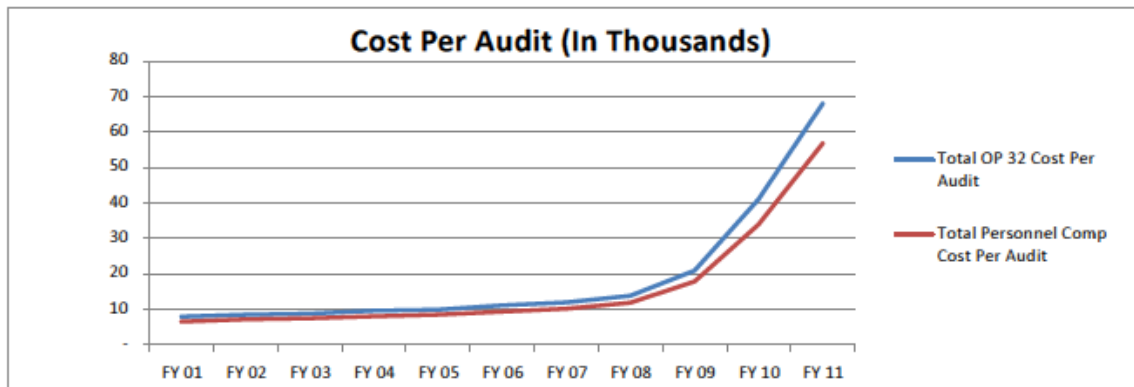
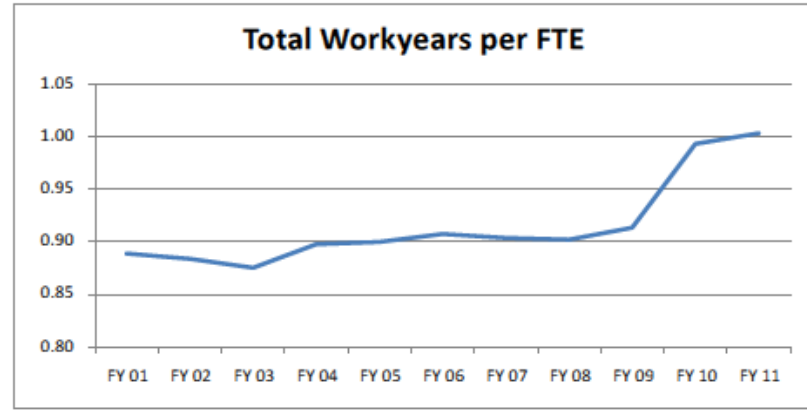
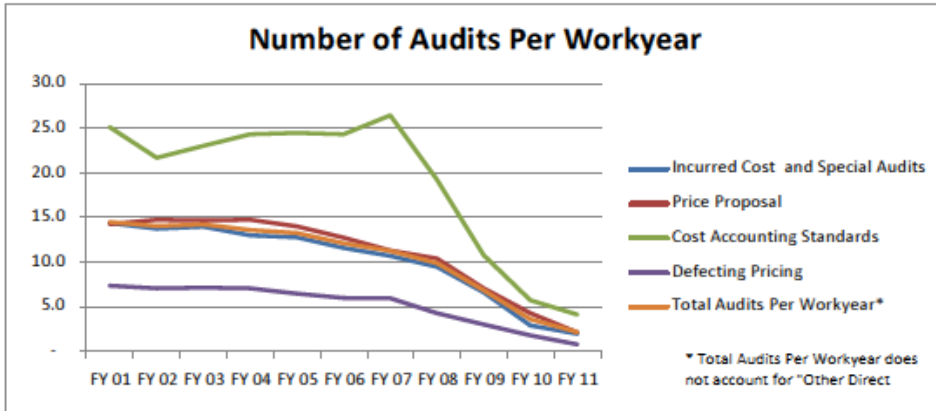
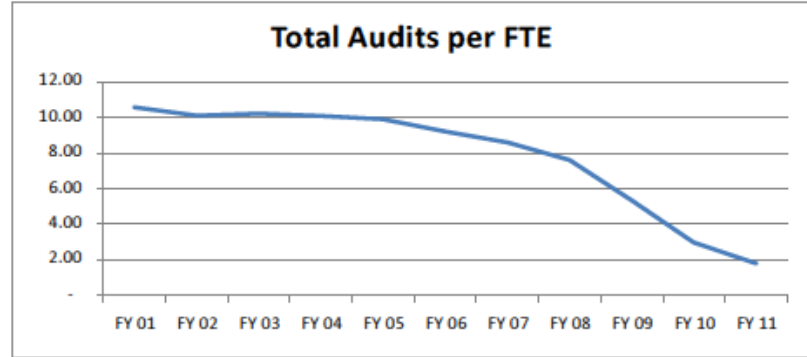
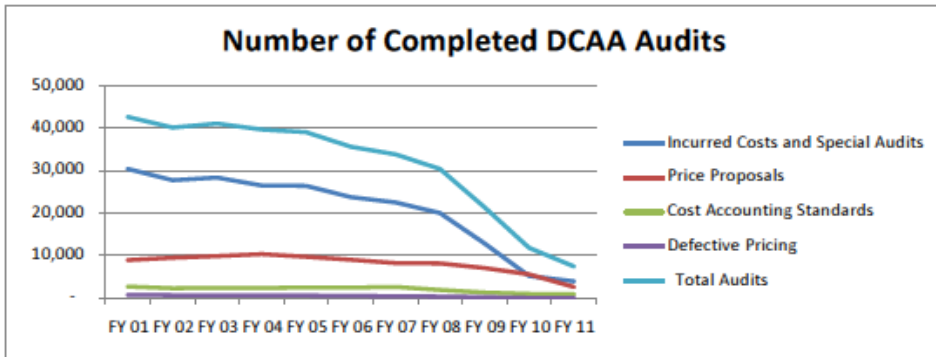
Number of Audits & Workyears Per FTE<sub>3</sub>

	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11
Total Civilian End Strength (heads at)	4,075	4,136	4,063	4,064	4,106	3,998	4,098	4,179	3,951	4,217	4,262
Total Audits per End Strength	10.47	9.71	10.12	9.77	9.50	8.91	8.25	7.26	5.38	2.78	1.73
Total Workyears per End Strength	0.88	0.85	0.87	0.87	0.86	0.88	0.87	0.86	0.92	0.93	0.97
Total Civilian FTE	4,037	3,971	4,028	3,941	3,942	3,867	3,937	3,989	3,994	3,960	4,128
Total Audits per FTE	10.57	10.11	10.21	10.07	9.90	9.21	8.59	7.61	5.33	2.96	1.79
Total Workyears per FTE	0.89	0.88	0.88	0.90	0.90	0.91	0.90	0.90	0.91	0.99	1.00

Cost Per Audit (Dollars in Thousands)<sub>4</sub>

	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11
Total OP 32 Cost	\$ 331,556	\$ 335,081	\$ 352,953	\$ 374,169	\$ 381,227	\$ 390,296	\$ 397,614	\$ 413,888	\$ 443,163	\$ 479,860	\$ 502,712
Total OP 32 Cost Per Audit	7.77	8.35	8.58	9.42	9.77	10.96	11.76	13.64	20.83	40.91	68.03

Total Civilian Personnel Compensation	\$ 272,363	\$ 283,011	\$ 299,779	\$ 314,406	\$ 324,197	\$ 327,845	\$ 339,434	\$ 354,926	\$ 376,221	\$ 396,552	\$ 419,492
Total Personnel Comp Cost Per Audit	6.38	7.05	7.29	7.92	8.31	9.21	10.04	11.69	17.68	33.80	56.76



<sup>1</sup> From DoD-IG Semi-annual Reports to Congress, Appendix D

<sup>2</sup> From DCAA Annual Budget Submissions

<sup>3</sup> End Strength and FTE from DCAA Annual Budget Submissions

# Government Oversight: Active Engagement Strategy



Candor. Insight. Results.

Actively engage with your ACO and DCAA:

- Hold monthly meetings with your auditors and ACO together
- Document meetings and agreements reached
- Use meetings with both parties to hold everyone accountable and ensure all parties are working with full information
- Measure and track key metrics:
  - Average length of time to fulfill an audit request
  - Number of requests (including those for audits ultimately cancelled)
  - Length of time of open audits
- Provide documentation/proof that you've been responsive

# Questions and Comments

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