

Government Contract Services

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DoD updates proposed rule on contractor business systems

On December 3, 2010, the DoD issued revisions to the proposed rule it published in the January 15, 2010, Federal Register.¹

The proposed rule, previously discussed in the October/November 2010 newsletter, provides for government oversight over certain contractor business processes that encompass:

- ▶ Estimating
- ▶ Purchasing
- ▶ Property management
- ▶ Earned Value Management System (EVMS)
- ▶ Material Management Accounting System (MMAS)
- ▶ Accounting

While the maximum withhold amount was reduced from 100% to a maximum compounding of 20%, there is still a troublesome arbitrary factor involving the amount of any withhold versus risk to the Government. That was made clear in the Government's comments as to the application of withholds for EVMS deficiencies that could have no impact on potentially billing unallowable costs on Government contracts.

DCAA contractor internal control reviews have been largely limited to "major contractors." The proposed Defense Federal Acquisition Regulation Supplement (DFARS) rule now makes clear the application of withholds will encompass small businesses as well, but with lower withholds assessed on them.

DCAA has started pilot audits involving billing systems and contractor control environment and overall accounting systems; we are monitoring this situation.

We do not believe this DFARS rule is going away and would expect some version of this DFARS rule to eventually be issued. Similar to preparation for SOX reviews, DoD contractors should, at a minimum, make sure that their policies and procedures are current and written with attention to Government contracting requirements (e.g., ethics training, flowdowns, etc.).

The deadline for the submission of comments on the revised proposed rule is January 10, 2010.

DoD launches efficiency initiatives

In August 2010, Secretary of Defense Robert M. Gates announced his "Efficiency Initiatives," an effort to make defense spending more efficient with the objective of saving \$100 billion over the next five years.

Under Secretary of Defense for Acquisition, Technology and Logistics (USD AT&L) Ashton B. Carter subsequently issued *Better Buying Power: Mandate for Restoring Affordability and Productivity in Defense Spending*² to Department of Defense (DoD) acquisition professionals. This implementation directive outlined the following five initiatives:

1. Target affordability and controlling cost growth
2. Incentivize productivity and innovation in industry
3. Promote real competition
4. Improve tradecraft in services acquisition
5. Reduce non-productive processes and bureaucracy

The implementation of these efficiency initiatives will affect a number of areas, as evidenced by discussion of contract type, profit, competition, contract financing, independent research and development (IR&D), and supplier incentives.

Contract type. There is substantial commentary regarding contract type. The guidance provides for:

- ▶ Phasing out award fee contracts in favor of fixed-price or cost-type incentive contracts with a 50/50 share line – the communications suggest that the Government would generally consider an overrun cap of 120% reasonable.
- ▶ Adjusting sole-source fixed-price contracts over time to reflect realized costs – although the communications are silent as to how that might reflect overruns.
- ▶ Increased use of fixed-price contracts for developmental efforts (using the KC-X tanker as an example).

- ▶ Phasing out time and materials (T&M) and sole-source ID/IQ contracts whenever possible for services acquisition – leaning toward firm fixed-price contracts whenever possible.

An initial concern is that the implementation guidance does not directly address the underlying issue of adequately defining program requirements. While experience would suggest that contractors with a robust change management discipline already in place will be best able to maintain profits in this environment, it is clear that such efforts, especially use of fixed-price development contracts, can represent substantial risks to contractors.

Profit. In an effort to improve the relationship of performance to profit, the DoD is reviewing the Weighted Profit Guidelines.

The Carter memos indicate that the use of a blanket profit rate is to be discouraged; instead, consideration should be given to subcontractor management and expense management. Guidance suggests limiting fees for subcontractor management to actual value provided (i.e., risk assumed by prime and continuous subcontractor risk reduction).

Expense management appears to refer to efforts to eliminate non-value-added activity; the communications call for identification and elimination of non-value-added overhead and G&A charged to contracts. It is not clear if these efforts will involve the return of DCAA operations audits. The guidance also suggests limiting bid and proposal (B&P) allowable costs on sole-source contracts.

Competition. When appropriate, an open systems architecture approach is prescribed, combined with pursuit of technical data rights, to ensure future competition. Contractor (and subcontractor) intellectual property rights and how to establish compensation for these rights are not addressed in the published guidance.

The communications also state that the basis for negotiations with all single bid offerors will be cost or price analysis. We believe contractors should expect an increasing number of requests for "non-certified" cost data. (See our October/November 2010 newsletter article on the Federal Acquisition Regulation (FAR) rule "clarifying" the definition of cost or pricing data.)

Contract financing. The DoD will be developing a cash flow model to be used by its acquisition professionals with the expectation that price reductions be sought when improved cash flows are provided to a contractor (besides customary progress payments). Flow-down provisions to subcontractors should also be considered.

Independent research and development (IR&D). With the objective of issuing a directive in March 2011, Gates has initiated efforts to study how firms spend their IR&D. These efforts include DCAA collection of financial data from all firms with allowable IR&D costs.

Rewarding excellent suppliers. The DoD will implement a Superior Supplier Incentive Program (SSIP) pilot emulating the Navy's Preferred Supplier Program. Despite the competition mandate, this program could dissuade companies from bidding on opportunities where a preferred supplier is in place.

The Gates communications embrace the terminology of lean manufacturing and Six Sigma process management, so contractors who have implemented those methods will be able to communicate their cost management efforts in alignment with the DoD expense management objectives. However, many contractors may not have processes that address the risks associated with some of the other aspects of the Gates communications, including:

- ▶ Use of fixed price contracts on development efforts
- ▶ Handling of intellectual property rights (prime as well as subcontractor) and compensation for such data

- ▶ Management of non-certified cost or pricing data

Contractors may wish to review their processes in relation to these aspects of the *Efficiency Initiatives* with the objective of minimizing risk and maximizing their profit opportunities.

DCAA rules of engagement

DCAA issued *Audit Guidance on Auditor Communications ("The Rules of Engagement")* on September 9, 2010.⁴ DCAA offices were advised to present the accompanying PowerPoint slides at a staff conference by December 31.

The memo summary states, "Auditors also need to communicate with the contractor throughout the audit to ensure that audit conclusions are based on a complete understanding of all the pertinent facts and should obtain the contractor's views of the audit conclusions and recommendations for inclusion in the audit report."

The DCAA guidance refers to the conduct of the audit with attention to generally accepted government auditing standards (GAGAS).

GAGAS 6.07 "requires that when planning the engagement, auditors should communicate in writing certain information to the contractor and individuals requesting the audit services to be performed."

GAGAS 6.44 and GAGAS 6.50 "address obtaining and reporting the views of contractor officials concerning findings, conclusions and recommendations."

Although not specifically referenced in the DCAA guidance (perhaps an inadvertent oversight), GAGAS 6.45 and GAGAS 6.46 provide for a contractor's perspective:

- ▶ GAGAS 6.45 – Providing a draft report with findings for review and comment by responsible officials of the audited entity and others helps the auditors develop a report that is fair, complete and objective. Including the views of responsible officials results in a report that

presents not only the auditors' findings, conclusions and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

- ▶ GAGAS 6.46 – When auditors receive written comments from the responsible officials, they should include in their report a copy of the officials' written comments or a summary of the comments received. When the responsible officials provide oral comments only, auditors should prepare a summary of the oral comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated.

We have noted some inconsistencies in the past as to how DCAA auditors communicate with contractors. In light of this guidance, the DCAA auditor should be expected to:

- ▶ "[Explain] the purpose and overall plan for performance of the audit" at the entrance conference
- ▶ Throughout the audit, "discuss preliminary audit findings (e.g., potential system deficiencies, potential FAR/CAS noncompliances, etc.) with the contractor"
- ▶ Hold an exit conference to discuss audit results and obtain the contractor's views

Contractors should also note that DCAA auditors are not precluded from attending meetings prior to receipt of an audit request.

With the expiration of the DoD Inspector General review of DCAA quality control systems, DCAA has not been able to state that its examination was conducted in accordance with GAGAS. This seems to have had an impact on DCAA issuance of audit reports. We continue to see a number of instances where draft audit reports are issued but have not been released as "final" reports.

DoD limits DCAA assistance on proposal audits

Effective September 17, 2010, DFARS, PGI 215.404-2(c),⁵ limits contracting officers' requests for DCAA audit assistance to fixed-price proposals exceeding \$10 million and cost-type proposals exceeding \$100 million, unless there are exceptional circumstances explained in the request for audit.

The DoD Comptroller has stated that effective October 1, the "highest priority audits" will be conducted in compliance with GAGAS. Given past experience, it is not clear how this will affect the DCAA conduct of these "prioritized" proposal audits.⁴

D.C. Circuit remands for consideration

False Claims Act decision

The U.S. Court of Appeals for the District of Columbia Circuit remanded for consideration the decision in *United States v. Science Applications International Corp ("SAIC")*, No. 09-5385, that had found SAIC violated the False Claims Act (FCA).

SAIC had entered into contracts with the Nuclear Regulatory Commission (NRC) to "provide technical assistance and expert analysis to support the agency's potential rulemaking." These contracts included provisions designed to identify and prevent conflicts of interest by imposing limits on "work for others." It was later found that SAIC had performed consulting services contrary to the conflict of interest provisions. The Government asserted that SAIC had submitted false claims (failed to disclose the conflicts of interest) when presenting invoices for payment.

In deciding against SAIC, it was recognized that no individual had "simultaneous knowledge" of the contract terms or conflicts of interest; however, the "collective knowledge" of the corporation was found adequate for ruling against SAIC. Importantly, the Court found the instructions provided the jury in that decision were flawed wherein the Appeals Court wrote:

"We nonetheless vacate the judgment as to FCA liability and remand for a new trial because the district court's 'collective knowledge' instruction conflicted with the FCA's scienter standard, the proper application of which is critical to ensuring that FCA liability attaches only for false or fraudulent claims and not for accidental or even negligent breaches of contract."

In rendering its decision, the Appeals Court wrote:

"To be sure, the district court did instruct the jury that for the government to satisfy its burden of proof, 'more than an honest mistake or mere negligence [on the part of SAIC] must be found.' Id. at 16. But by providing an alternate route to proof of scienter, the 'collective knowledge' instruction undermined the clarity of this separate 'no mere negligence instruction' and allowed the jury to impose liability for what is essentially negligence or mistake by another name."⁶

Terminations

Talk of reduced government spending requires attention to the potential for ensuing contract terminations. Recent discussions on spending reductions include:

- ▶ On August 16, 2010, the DoD Efficiency Initiatives (Gates memo) set forth substantive efficiency targets.⁷
- ▶ On November 10, 2010, the Presidential Commission on Fiscal Responsibility and Reform proposed reductions of more than \$100 billion in defense spending.⁸

To minimize the financial impact of possible contract terminations, contractors should ensure their processes consider maximizing cost recovery in event of termination.

Contractors should be monitoring contract funding with attention to the cost of termination (to include that of subcontractors) as Government liability can be limited to "funding."

If not already in place, companies may consider formally documenting layoff and transfer policies as the Government may question "informal" arrangements that often accompany major program changes.

Contractors also should consider the following steps:

- ▶ Ensure approval of major overhead and indirect expenditures is made with attention to the possible loss of rate base.
- ▶ Establish processes that ensure the timely handling of "stop work" orders, especially handling of major subcontractors.
- ▶ In event of termination, set up project and account codes to segregate and accumulate termination costs, as well as provide training and guidance to affected parties on using such codes.
- ▶ Establish requirements, if not already in place, for timely subcontractor submission of termination settlement proposals.

Endnotes

- ¹ *Federal Register*: December 3, 2010 (Volume 75, Number 232), http://www.acq.osd.mil/dpap/dars/dfars/c hangenotice/2010/20101203/FR_2010-30072.htm
- ² *Better Buying Power: Mandate for Restoring Affordability and Productivity in Defense Spending*, September 14, 2010, http://www.acq.osd.mil/docs/USD_ATL_G uidance_Memo_September_14_2010_FIN AL.PDF?transcriptid=4648
- ³ *Implementation Directive for Better Buying Power – Obtaining Greater Efficiency and Productivity in Defense Spending*, November 3, 2010, [http://www.acq.osd.mil/docs/USD\(AT&L\)_I mplementation_Directive_Better_Buying_P ower_110310.pdf?transcriptid=4648](http://www.acq.osd.mil/docs/USD(AT&L)_I mplementation_Directive_Better_Buying_P ower_110310.pdf?transcriptid=4648)
- ⁴ DCAA Guidance Memorandum, *Audit Guidance on Auditor Communications ("The Rules of Engagement")*, September 9, 2010, <http://www.dcaa.mil/mmr/10-PAS-024.pdf>
- ⁵ DFARS, PGI 215.404-2(c), http://www.acq.osd.mil/dpap/dars/pgi/pgi_ htm/PGI215_4.htm
- ⁶ *UNITED STATES of America, v. SCIENCE APPLICATIONS INTERNATIONAL CORPORATION*, No. 09-5385 2010 WL 4909467 (D.C. Cir. Dec. 3, 2010),
- ⁷ *Department of Defense (DoD) Efficiency Initiatives*, August 16, 2010, <https://dap.dau.mil/policy/Documents/Policy/OSD%2009637-10.pdf>
- ⁸ *\$200 BILLION IN ILLUSTRATIVE SAVINGS*, updated November 12, 2010, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf

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