

TESTIMONY OF

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ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

BEFORE THE SENATE SUBCOMMITTEE ON CONTRACTING OVERSIGHT
OF THE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS

HEARING ON “IMPROVING FEDERAL CONTRACT AUDITING”

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Madame Chairwoman, and distinguished members of the Contracting Oversight subcommittee, thank you for inviting me to testify. My name is Sandy Hoe and I am a partner at the law firm of McKenna Long and Aldridge. I have been practicing government contract law on behalf of the contractor community for more than 37 years. Today, I am testifying on behalf of the United States Chamber of Commerce. The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region.

I understand the focus of today's hearing is government contract auditing and how it can be improved. I have been asked to address the challenges and experiences that government contractors have encountered with respect to audits and actions that could mitigate those challenges. First, let me affirm that government contractors understand and accept that by providing goods, supplies and services to the federal government in exchange for tax payer funds, they are agreeing to contract auditing requirements not found in the private marketplace, specifically, they recognize the necessity of auditing by their customer. There are sound public policy reasons for contract audits. The need for such audits is not being questioned. How the audits are conducted is something on which the contractor community has definite views.

Of the three auditing organizations present today, the U.S. Government Accountability Office ("GAO"), the Defense Contracting Auditing Agency ("DCAA") and the Inspectors General at various agencies, government contractors interface most frequently with the DCAA. The DCAA is an agency within the Department of Defense, under the authority of the Under Secretary of Defense (Comptroller). Its primary function is to perform contract audits for the Department of Defense and other government agencies at the request of military and civilian

acquisition organizations and the Defense Contract Management Agency (“DCMA”). In this role, DCAA audits approximately 9,000 contractors each year. In addition to performing contract audits, the DCAA also provides accounting and financial advisory services to Department of Defense Components responsible for procurement and contract administration.

I. CURRENT AUDIT ISSUES IMPORTANT TO CONTRACTORS

A. Role of the Auditor Versus the Contracting Officer

Recent developments have raised concern within the contractor community that auditors are being granted primacy over contracting officers (“COs”) in making certain contract decisions. Both traditionally, and by law, contracting officers have exercised authority to make decisions regarding the implementation and performance of government contracts.

A January 4, 2011 Defense Procurement and Acquisition Policy (“DPAP”) memorandum identifying steps taken to mitigate “DCMA/DCAA overlap” cited a policy change related to Forward Pricing Rate Recommendations (“FPRR”) and Forward Pricing Rate Agreements (“FPRA”). It stated: “where DCAA has completed an audit of a particular contractor’s rates, DCMA shall adopt the DCAA recommended rates as the Department’s FPRR position.” According to the memorandum, DCMA already has coordinated a draft policy reflecting this change. This action, however, conflicts with a uniform body of regulations and judicial decisions that place the final determination for items such as forward pricing rates squarely upon the shoulders of the contracting officer.

The FAR mandates that the corporate administrative contracting officer (“CACO”) is unilaterally responsible for determining a contractor’s proposal and billing rates, and for determining whether to accept an FPRA as being in the government’s interest, or, alternatively,

to issue an FPRR.¹ Decisional authority has further established that DCAA's role is to be advisory, and that the contracting officer may exercise discretion in deciding whether to follow DCAA audit recommendations. ELS Inc., B-283236, et al., 99-2 CPD ¶ 92, 1999 WL 993094 (Oct. 25, 1999); see also OAO Corp., B-228599.2, July 13, 1988, 88-2 CPD ¶ 42, at 6 ("DCAA audits are only advisory; the degree to which they are used is a matter for the contracting officer to decide"). This balance of authority is appropriate, given the contracting officer's authority to administer contracts and "make related determinations and findings," FAR § 1.602-1; § 2.101, as well as the contracting officer's "wide latitude to exercise business judgment" in requesting and considering the advice of audit specialists. FAR § 1.602-2.

The January 4 DPAP memorandum indicates that contracting officers will apparently now issue final rates as determined by DCAA without the contractor having the opportunity to demonstrate to the Administrative Contracting Officer ("ACO") why such rates may be unreasonable. Unless the contractor elects to contest the rates by submitting a claim under the Contract Disputes Act ("CDA"), it will, at a minimum, lose the ability to recoup the lost amounts allocated to fixed price contracts based upon the DCAA-determined rates. This approach would be unfair to contractors and directly conflict with established regulatory law.

The Chamber is also concerned with reports of Inspectors General encroaching on the role of the contracting officer. In a specific instance, during negotiations of a contract for a commercial item, the Inspector General's auditor repeatedly inserted themselves into the discussions between the contracting officer and the offeror and actually participated in the

¹ See FAR § 42.302 (negotiation of forward pricing rate agreements designated to the contract administration office), § 42.704 (the contracting officer shall establish billing rates for several categories of contractors including those business units of a multidivisional corporation under the cognizance of a CACO), § 42.1701 Administrative Contracting Officer ("ACO") responsible for FPRA or issuance of an FPRR in the absence of an FPRA), § 2.101 (ACO unilaterally sets the FPRR).

negotiation calls. In fact, after the company accepted the contracting officer's offer on the pricing, terms and conditions of the contract, due to pressure from the IG, the contracting officer called back and withdrew the offer. In the end, negotiations for the commercial item took 18 months. While this is one example of a difficult negotiation, stories of this type of interference are becoming more common.

B. Stridency in Application of Regulations

Some in industry have noted a sharp upturn in DCAA's reluctance to engage in rational discussion of audit issues since 2008 and 2009 about the same time when the Congress and the GAO demanded improvements to DCAA. While DCAA took many specific and warranted actions in response to the criticism, a less tangible response has been for DCAA to take a no risk approach to addressing audit issues.

The FAR cost principles and other cost and price compliance regulations are relatively explicit, but still cannot and do not cover every circumstance that may arise. Judgment often is necessary in applying the regulations to resolve issues. Unfortunately, since 2008/2009, DCAA seems to have lost its appetite for analysis of the intent of a regulation versus its literal application. Once it has applied the literal language, DCAA seems little moved by any argument that the result reached is nonsensical or that it could not have been what the drafters intended. This has confounded some in the contractor community who believe that the goal of the regulations, and of government contracting generally, is to reach rational results. Combining DCAA's recent stridency with the enhanced authority it is being given for FFPA's and FFPR's produces a potentially toxic mix for contractors.

II. IMPROVEMENTS TO CONTRACT AUDITING

An audit can have at least two perspectives. An audit can be forward-looking where the intent is to identify steps needed to assure that a contractor's systems, policies and procedures will comply with government contract requirements. A contract audit also can be backward-looking where its purpose is to test a contractor's actual compliance with contract and regulatory requirements. The former is affirmative, seeking to assure future compliance. The latter is more investigative and sometimes associated with the rooting out of "fraud, waste and abuse." One is the equivalent of the "carrot" and the other the "stick." Both will incentivize a contractor to be in compliance. However, the carrot is much more likely to achieve the goal.

This is illustrated by analogy to the manufacturing sector of the economy where the saying "You cannot inspect your way to a quality product," is often heard. The lesson from this is that quality needs to be built into a product upfront. "Inspecting in quality" is far less effective. Applying this to government contracting, an emphasis on compliance upfront, through system audits, is preferable to achieving compliance through the threat of possible cost disallowances or worse, e.g., penalties or prosecutions, from backward-looking audits. Focusing more government audit resources on the front-end rather than after-the-fact is likely to bring the government a much larger return on its auditing investment.

Currently, the DCAA has procedures for conducting audits of contractor internal controls, including internal control audits of a contractor's systems in the following areas: general IT, budget and planning, purchasing, material management and accounting, compensation, labor, indirect and other direct costs, billing and estimating. See DCAA Audit Manual at Chapter 5. The DCAA Audit Manual describes the purpose for such audits as "obtaining and documenting an understanding of a contractor's internal controls and for

assessing control risk as a basis for planning related audits.” Id., at 5-101a. The manual recognizes that the effort to conduct such audits may “be offset by reduced audit effort on other related audits.” Id., at 5-101c. Carrying the “upfront” system audit function forward as the DCAA recognizes has the potential to reduce the effort later to perform after-the-fact audits of contract performance.

Placing greater audit emphasis on system compliance can only be effective, however, if the audit is performed timely. Long delays in the performance and completion of audits whether at the front end as a system audit or the backend following contract performance is detrimental to government contracting generally. In some instances, contractors have waited years to obtain an audit and closeout of final indirect rate proposals, although contractors are charged with presenting their proposals within six months of contract completion. During the period rates remain open, contractors who submit proposals particularly on fixed priced work and contracting officers are without firm guidance from previous years’ rates that completed audits would provide. This may turn out ultimately to benefit the contractor or the government. However, it need not be an impediment with timely government audits. Additionally, business needs to move forward. Having unfinished audits that have financial impact on a contractor makes planning future business activities that much more difficult.