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**“Evaluating the Defense Contract Auditing
Process”**

Subcommittee on Oversight and Investigations
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Introduction

Chairwoman Hartzler, Ranking Member Moulton, and Members of the Subcommittee, thank you for the invitation to testify on behalf of the Professional Services Council's (PSC) over 400 member companies and their hundreds of thousands of employees across the nation.¹ PSC is the voice of the government technology and professional services industry, representing the full range and diversity of the government services sector. I appreciate the opportunity to discuss with you the defense contract auditing process, an issue of critical importance to our membership, to the defense contracting community, and to the success of Department of Defense (DoD) missions.

Today I will make several specific recommendations on the roles and responsibilities of the Defense Contracting Audit Agency (DCAA) below. I will also offer some priorities and criteria that PSC would urge you to keep in mind as your subcommittee focuses on evaluating the defense contract auditing process, both in this hearing and in your future efforts. They include:

- defining proper materiality and relevance standards for contract audits,
- sustaining a robust contractor base,
- ensuring vendors remain interested in bidding, and
- helping the government's acquisition processes provide better access to innovation.

I believe these attributes will help guide you toward practical and productive reforms.

Contractors Provide Significant Value to the Government

The contractor community plays a vital role in assisting the government in providing services to the American people; in DoD, contractor work provides a wide range of goods and services to the warfighter, to the civilian employees of the Department, and to the National Command Authority. These contractor contributions are necessary and vital to maintaining government operations. Many of the capabilities that contractors provide do not exist within the government, and the government benefits from a strong,

¹ For over 45 years, PSC has been the leading national trade association of the government technology and professional services industry. PSC's over 400 member companies represent small, medium, and large businesses that provide federal agencies with services of all kinds, including information technology, engineering, logistics, facilities management, operations and maintenance, consulting, international development, scientific, social, environmental services, and more. Together, the association's members employ hundreds of thousands of Americans in all 50 states. See www.pscouncil.org.

diversified national interest business base to support its current and emerging requirements.

PSC Recognizes the Government's Central Role in the Contract Auditing Process

DoD is the largest single contracting department in the federal government, spending in Fiscal Year 2016 over \$296 billion on an incredible range of goods and services, with more than half of that (\$149 billion) on services. Overall, DoD spending on the purchase of goods and services decreased over 30 percent between fiscal years 2011 and 2015, but with much smaller rates of decline in services than in products.

Proper auditing and accounting practices are necessary for the government in its internal functions and for contractors in their contracting functions, to demonstrate that the government is spending taxpayer dollars in an efficient and effective manner. PSC recognizes the government's central role in the auditing process and as described below, believes many of the functions performed by DCAA should only be performed by federal employees. It matters a lot to know what the cost of performance is, whether by government or by contractors. Regrettably, while we have exquisite detail on the cost of contractors, neither the Congress nor the public has much hard data on the cost of government performance for most of its functions.

Defining the Roles and Responsibilities of DCAA

As you know, DCAA has the primary responsibility for auditing contractors doing business with DoD. Many DoD contractors also do work with the civilian agencies, and DCAA generally audits all of the work of those contractors, not just their DoD work. Up until the last fiscal year, when the Congress directed otherwise, DCAA also performed audits on contractors doing work only with certain civilian agencies, on a cost-reimbursable basis from those agencies.

DCAA needs a degree of independence in its work. But it should not, and cannot, function as an isolated activity. Its role has always been, and must clearly and solely remain, as an advisor to the decision-making responsibility of the contracting officer, who is warranted by the government to make decisions that are in the best interest of the government. DCAA also, where appropriate, serves as an advisor to the program officer, who is accountable for delivering the results to the warfighter or other DoD end-user.

Recently DCAA has assumed a primary and independent responsibility of "protecting the taxpayer interests." As a result, there is a concern among acquisition professionals within the government that can prevent them from reasonably questioning DCAA's methodology and data or justifying not following its advice.

As one of our member companies characterized it, DCAA should focus on being an auditing agency, not a collection agency. This is reflected, in part, in DCAA's annual Report to Congress on its Fiscal Year 2015 Activities which focuses on its "return on

investment” – for every dollar spent by DCAA, some significant amount of government spending was avoided and a portion of contractor spending was “questioned” – leaving the impression that the agency’s work is essential to fiscal responsibility. While it is easy for an auditor to “question” a contractor’s cost, as we see time and time again, “questioned” costs never equal “sustained” costs. Contractors will even agree to a “sustained” cost number simply because it is too expensive to continue to dispute it and to forego additional, undisputed payments on invoices for work already performed.

We see time and again cases where too many DoD contracting officers believe they have no real discretion to deviate from DCAA’s recommendations, even when there is a significant basis for disagreement with the data or the methodology. In cases like those, it may take the Armed Services Board of Contract Appeals, or a federal court, to make decisions when a contracting officer or a program manager can’t or won’t.

PSC believes that we need to restore the authority and confidence of the contracting officers and program managers to make the decisions that they believe are in the best interest of the government, based on the advice they receive from the multiple resources available to them, including DCAA.

DCAA’s Acquisition Lifecycle Responsibilities

Today’s hearing has a proper focus on incurred cost audits. To understand the issues around incurred cost audits and the impact of a backlog in completing those audits, it is useful to look at DCAA’s responsibilities through the entire acquisition cycle, not just at the end of a contract.

DCAA plays important roles throughout the contracting process and over the lifecycle of a contract. Contracting officers work with and consult auditors on the front end (before contract award), after a contract is awarded and while the work is being performed, and as the auditors review incurred costs. DCAA is engaged in reviewing contractors in all three major phases of the acquisition lifecycle.

First, under a set of six DoD regulations referred to as “business system requirements,” DCAA is responsible for reviewing certain DoD contractors’ compliance with three of those business systems: accounting, estimating, and earned value management. The Defense Contract Management Agency (DCMA), a sister DoD independent agency, has primary responsibility for assessing contractor compliance with the other three: purchasing systems, material management systems, and government property.

DCAA’s annual report states that 675 major contractors² require reoccurring audits of their business systems, typically every three years.

“To conduct business system audits at all of these companies on a cyclical basis, DCAA needs to do over 2,000 Business System audits over a three-year period.

² A major contractor is generally defined as a single contractor (including its subsidiaries) that has at least \$250 million in cost reimbursement contracts with the Department of Defense.

DCAA's approach is to do one business system per year at each contractor— a total of 675 business system audits per year—covering all three business system audits in a three-year period. Over the past several years, due to resource constraints, DCAA has averaged only 22 business system audits per year.”

Given the importance of these business system reviews both to DoD and to contractors, and with an average of 22 out of 675 needed reviews, DCAA could clearly use some help! This backlog also has significant implications in major contracting activities in both DoD and the civilian agencies. In our view, third party reviews of these business systems, which are quite common in the general commercial world and which often cover the same business systems, would also be beneficial.

Second, DCAA provides proposal audit support on major program solicitation responses submitted by contractors during the **pre-award** phase of the acquisition lifecycle. Their work is critical in support of the Department’s evaluation of price proposals during the competitive phase of the contracting process and can impact who wins a contract and on what basis. Here, timely and thorough recommendations are essential for the government’s pricing evaluation team in support of their award decisions.

Finally, DCAA has a well-known role in the post-award phase, primarily in auditing a contractor’s costs incurred during performance, leading to the closing out of a contractor’s annual billing cycle. DCAA also has a role in assessing a contractor’s rates that serve as the basis for future interim contract billings. These are known as “forward-pricing rates,” and they are evaluated based in part on looking back at the costs actually incurred by that contractor in previous billing cycles. For most contractors, the final determination of forward prices rates rests with the Defense Contract Management Agency, but this process depends on timely input from DCAA. Delays in that timely input harms the competitive situation for contractors, so it could also use some adjustment.

At the incurred cost stage, both the contractor and the government have an interest in moving rapidly. For the contractor, the government commonly withholds significant funds that should be reconciled and paid in a more timely manner. The government wants to be able to collect any money that might be determined to be due from the contractor, while there is still time and funds available to be collected. The government also wants to be sure that any money already invoiced by the contractor is correct and consistent with the terms and conditions of the awarded contracts. These are legitimate goals, but for the contractor, who paid their costs years earlier during the performance of the work under the contract in question, delays in making government payments results in additional costs to the contractor because they have to finance their own costs at their own expense, often for years until the incurred cost audits are completed.

Contractors must initiate the incurred cost audit process by submitting a timely and complete incurred cost proposal within the timeframes of the acquisition regulations – and the government is right to raise questions about any unexplained delay in

contractors meeting that obligation. However, contractors also have a reasonable expectation that the DCAA process will move along expeditiously and fairly.

The Incurred Cost Backlog

“Incurred costs” are the expenditures made by the contractor after the award of the contract and in support of that contract performance. Some costs are characterized as “direct” costs because they are specifically incurred in the performance of only the instant contract.

Other costs are characterized as “indirect” costs because the contractor incurs them in the performance of multiple contracts or in support of the contractor’s general and administrative business functions.

There are extensive regulations governing how contractors are required to account for and allocate those costs (called the “Cost Accounting Standards”) and how to treat the allowability of specific elements of cost (called the “cost principles”). The government only reimburses contractors for costs that are “allowable” under the cost principles and the terms of the contract.

The regulations require most DoD contractors to develop and follow this unique set of government cost accounting and cost allowable rules in the performance of cost-reimbursement contracts.³

DCAA’s FY15 Report to Congress showed an average completion time of 883 days from the time DCAA received an adequate annual incurred cost submission from a contractor to the date of its closeout. This is nearly two and a half years. That’s a long time to wait for payment on a contract.

DCAA sought to redefine the time for an audit by beginning their measurement from the date of the entrance conference until completion, which they note as averaging 124 days. That is still too long and misleading, as PSC’s members and others are adversely burdened by the more than two years of time that passes on average between their submission and DCAA’s completion.

PSC agrees with DCAA’s FY15 Report to Congress that states: “Getting current on incurred cost means that we can conduct audits closer to the year the costs were actually incurred, which will improve our ability to retrieve relevant records, ease

³ There are certain exemptions from the requirements to comply with the single, government-wide established Cost Accounting Standards. As the Congress, along with PSC and many other commentators have noted, the requirement for most contractors to comply with these government-unique cost accounting standards and specific allowable cost rules in performing cost-reimbursement contracts is typically cited as the number one barrier to companies’ willingness to do business with the federal government. This is particularly true for smaller businesses, those who largely sell commercial items, or those for whom the federal government is only a small share of their total business. But the time and cost burdens are also significant on those firms that are currently covered by such requirements.

contractor burden, encourage better compliance and identify issue[s] that may impact future audits.”

What the report does not say is that “getting current” will also make it more efficient and effective for the government in awarding new contracts for essential mission support work. It’s not just future audits that may be impacted, it’s future defense missions.

To “get current,” DoD and DCAA must address the incurred cost backlog in a broader framework and must better delineate and distribute the “roles and responsibilities” of DCMA, DCAA, and DoD program offices.

Negative Impact of the Backlog

The timeliness of completing contract incurred cost audits and contract closeout remains a top priority for PSC and our member companies. The negative implications of the backlog on contractors are wide-ranging and consequential:

- There is an impact on company cash flow because of government withholding of contractor funds;
- Contractors must pay administrative and carrying costs that are unallowable and therefore not recoverable from the government;
- There are significant and costly records retention requirements to maintain documents, well beyond general accepted accounting principles; and
- There is an impact on companies’ future business, through delays in establishing forward pricing rates and in the decrements that may be imposed after the fact on those future billing rates.

An example of costly record-keeping requirements, the FAR sets out the government’s record retention policy for various types of records for different oversight purposes. The insistence of audit staff that contractors keep and provide access to original documents long after the regulatory retention period has expired is inconsistent with the rules and does not align with the accepted modern commercial practice of digital record retention.

The government is also negatively impacted by the backlog. Lengthy delays in resolving incurred cost audits cause several problems, including:

- Making administrative contracting officers and program officers unsure of the financial condition of their programs;
- Risking government funds that may have been paid out in excess of or not in compliance with the terms and conditions of the contract;
- Delaying achieving the closeout of contracts.

None of those impacts help the government if they are years too late.

DCAA Multiple Year Auditing

One of the techniques DCAA has been using to help reduce incurred cost audit backlogs is to audit several years simultaneously. This holds out the hope that the audit work will be conducted once and yield results that will cover several “open” years of review. For most defense contractors who do not have DCAA auditors resident in their facility, they would prefer to address as many open issues as possible when their cycle arrives.

For too many of our member companies, including those who have DCAA resident auditors in their facilities, auditing of multiple years has only multiplied the annual request by the number of years to be covered. Rather than drawing a single sample from three years, for example, DCAA has been drawing the same sample size for each of the three years.

It should not be surprising that such an approach is not yielding any acceleration in the audit or the closing of open years. But it does add significantly to the amount of “questioned costs” because of the cumulative effect of the multi-year review. PSC believes that DCAA could dramatically streamline and accelerate their multi-year reviews, and we’d be happy to work with them on ways to do that.

Some DCAA Functions Are “Inherently Governmental,” And Some Are Not

Many of the functions performed by DCAA at each of these acquisition lifecycle steps are properly characterized as “inherently governmental,” and those functions and activities should be performed by federal employees. This includes providing the organizational structure for audits, governance and guidance on the application of the auditing standards, and setting performance standards and evaluating performance. Decisions on the final recommendations relating to the audit are also inherently governmental.

But it is important to note that the auditing activities themselves are not an inherently governmental function. As noted elsewhere in this testimony, third party auditors are already used extensively and quite successfully by other government agencies to perform identical work as DCAA performs for DoD.

No DCAA Auditors Need To Be Terminated

There is a concern raised by some that using the private sector to help reduce the backlog of incurred costs means that DCAA workload will drop and that auditors might have to be terminated. PSC does not share that view; we have no objective of reducing the size of the DCAA audit workforce. Given other backlogs and of the vital nature of making the right initial contract award decisions, we believe there are other areas of work where these experienced incumbent DCAA auditors can be used. As we noted earlier, these experienced staff can be assigned to high visibility proposal audits or to the more complex cases. They can also supervise and mentor junior DCAA staff and manage the work being performed by third parties.

Expanding the Use of Third-Party Audits Will Improve Acquisition Outcomes

In our view, expanding third-party audits will do more than free up experienced staff for more important functions. It will also help the government become a smarter buyer and will improve acquisition outcomes. No one benefits from unnecessary delays in any phase of the acquisition lifecycle. While each phase has its own, unique elements, there is an interdependence among them, and later phases of the acquisition process benefit from the on-time completion of earlier phases.

As we noted earlier, DCAA's advice can be the most impactful during the government's proposal evaluation phase of large, cost-reimbursement contracts, particularly when requirements and a limited vendor base mean those contracts must be solicited on a limited or sole-source basis. When the government understands how an offeror's pricing is derived, it can better negotiate final pricing and structure the contract award and expected performance based on that knowledge.

Stated another way, when the contract terms and conditions are clear and the contractor's basis for award is clear, there is a greater likelihood that the contractor's costs incurred in performance will align with the contract objectives. Each of these actions contributes to the government being a smarter buyer and increases the likelihood of improving acquisition outcomes. Everyone benefits from that: the government, the contractors, and the taxpayers.

Using Third-Party Audits Will Reduce the Incurred Cost Backlog

It makes good sense to expand the appropriate use of independent auditors, as an effective and efficient solution that can be implemented quickly and seamlessly to address not only the current incurred cost audit backlog, but also other aspects of government accounting. Here are some of those other aspects.

PSC remains concerned regarding the workforce turnover at DCAA, and the stability, experience, and morale of the workforce as a result. The President's hiring freeze and the residue from and fears of sequestration have compounded existing resource and staffing problems. It is timely to consider the use of alternative solutions, including the use of independent third-party auditors.

Private sector contract support can help address the demand for timely incurred cost reviews and contract closeouts without hiring, training and increasing federal staff. A benefit to using a strong independent contractor base is the ability to increase or decrease staff levels to address spikes and shortfalls and to respond quickly to auditing needs. Contractors can dial up as needed and dial down once the issue is addressed; many well-seasoned government accounting firms have an experienced and available workforce – often former DCAA staff – that can respond quickly. This way, the government only pays for what it needs, not for a permanent workforce.

The federal government already has and uses models to provide a seamless transition to making better use of independent auditors. For example:

- The General Services Administration (GSA) already has an existing Schedules program to quickly engage private sector auditors employed by firms on the Schedules to assist federal agencies. Many federal agencies have used these auditors to supplement or serve as their in-house resources. Their past performance record is superior and quite visible to the government.
- Organizations that receive federal grants (and that are subject to the audit requirements under the Office of Management and Budget's Circular A-133 for universities and other non-profit organizations) already rely on third-party accounting firms for their annual and closeout audits. Many of the requirements applicable to grants are similar (or identical) to the contracting regulations and make for an easy transfer of capability from one type of audit to the other.
- Publicly traded companies are required by the Securities and Exchange Commission, and the Sarbanes-Oxley law, to have independent accounting firms review their books and records and make recommendations relating to internal controls and proper accounting activity. For those publicly traded companies that are also covered government contractors, their outside auditors are already reviewing government transactions, including compliance with regulatory requirements.
- DCAA could additionally, should it be necessary or useful, qualify firms in advance (similar to DoD's Qualified Suppliers List for Manufacturers (QSLM) and Qualified Suppliers List for Distributors (QSLD)). In both these examples, the Department pre-qualifies manufacturers and/or distributors to supply certain items. PSC has recommended that DCAA could adopt a similar pre-qualification system to ensure that the third-party audit firms selected have the qualifications they believe are necessary to perform the work.
- DCAA could contract directly with qualified firms and assign those firms to work as they see fit, complementing and augmenting DCAA capability and dramatically reducing backlogs.

Over the long term, it is in the government's interest to align more closely the government-unique cost accounting standards with Generally Accepted Accounting Principles (GAAP). This is one of the specific requirements of Section 820 of the FY17 National Defense Authorization Act (NDAA). If this can be accomplished, it will significantly reduce the burden on government agencies to be familiar with unique government requirements and reduce the burden on contractors to create and follow accounting systems solely for the purpose of doing business with the government. It will significantly reduce the cost of compliance for government and existing contractors, open opportunities for non-traditional companies to enter the marketplace, and encourage more small business participation. It will also increase the pool of qualified auditing firms that can fulfill the government's auditing needs.

Additionally, DCAA could maximize the opportunity to utilize third-party auditors. Their approach does not have to be all or nothing – or forever or never. DCAA could choose which functions or types of audits to focus on and when, and for how long, it makes sense to focus on them. Rather than reduce their workforce, DCAA could retain

employees and reassign their best and brightest for higher priority activities, such as proposal audits or fraud investigations.

Allowing independent auditors to conduct incurred cost audits will establish a balanced policy to reduce the incurred cost and business systems backlogs and improve the timeliness of forward pricing rate determination in ways that improve effective government management of the government's total workforce and of its contractors.

The Defense CAS Board

Finally, I would like to call your attention to one issue included in the FY17 NDAA that PSC believes will be confusing and harmful to the contracting community and its government customers.

The government's Cost Accounting Standards Board was re-constituted in 1998 and has "exclusive authority" over establishing government-unique cost accounting standards. Its purpose is to achieve "uniformity and consistency in the cost accounting practices governing measurement, assignment, and allocation of costs to contracts." It is chaired by the administrator of the Office of Federal Procurement Policy and includes government representatives from the Defense Department (the DCAA director by designation), GSA, and the private sector.

For the past 34 years, there has been only one set of cost accounting standards to which the entire government contracting community has had to adhere. The Board must also follow a detailed statutory process when considering and proposing government-wide cost accounting standards. The CAS Board is not perfect; there have been gaps when there was no action (or even no functioning Board) and sometimes long delays in promulgating standards.

Section 820 of the FY17 NDAA sought to address some of these issues by directing the CAS Board to meet at least quarterly and take other actions. But the Act also created a new Defense-only CAS Board, with separate (but similar) membership and specific responsibilities. It requires DoD to establish an independent, specialized Defense Cost Accounting Standards Board with "exclusive authority" to establish cost accounting standards for DoD contracts. The provision does not take effect until October 1, 2018.

PSC expressed last year and remains concerned today about Section 820(b). It imposes a costly compliance burden on contractors with limited, if any, added value to the government. It could have the effect of subjecting contractors that do work at both DoD and at other federal agencies to two potentially divergent sets of accounting standards.

Currently, many outside, innovative companies do not have the systems in place to accommodate one – let alone two – separate and distinct government-unique cost accounting standards over and above their existing commercial accounting practices. To comply with the actions of this new Board, some companies will be required to

create and maintain at least one new system for government contracts. This will have a particularly burdensome impact on smaller firms and on those who only engage in limited contracting with DoD and the civilian agencies. It will hurt DoD access to innovation at a time when we need more of it, not less.

PSC expressed our concern to the Senate as it considered its version of this provision last year and shared our view again with the conferees on the bill. PSC believes there is simply too much risk associated with developing and implementing separate and distinct standards that will be confusing and contradictory in their implementation by government and in their application by contractors.

We continue to believe that the provision will do more harm than good. In response to the requests from the staffs from several committees, we will be making specific recommendations on ways to improve this provision. While we would prefer a repeal of the provision to create the new Defense CAS Board, our recommendations will include raising the dollar threshold for full CAS coverage at DoD and adding additional exemptions for coverage. That could reduce but will not eliminate the negative impacts.

Conclusion

On behalf of PSC and our members, I thank you for your time and consideration of these matters. As always, PSC is available at your convenience to address any questions or concerns the subcommittee has, now and in the future. I will try to answer any questions you may have.