

## Government audit: Managing contractor risk in a changing regulatory environment

The reduction of fraud, waste, and abuse in government contracting has long been a goal of government officials.



Due to the wars in Afghanistan and Iraq, the US Department of Defense (DoD) budget and spending on defense contracts increased exponentially. Along with the surge in spending came the need for rapid award and performance of contracts, which increased opportunities for wasteful and fraudulent activities. As the initial phase of the wars began to wind down in the late 2000s, the President, Congress, and federal agencies began to reemphasize the elimination of

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fraud, waste, and abuse in government contracting. These efforts resulted in several regulatory and legislative updates that altered the landscape for the compliance efforts of government contractors, as well as the enforcement efforts of government auditors such as the Defense Contract Audit Agency (DCAA).

On November 12, 2008, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council implemented a final rule in the Federal Acquisition Regulation (FAR) updating the requirements for a contractor code of business ethics and conduct, an internal control system, and mandatory disclosure to the government of certain violations of criminal law

or contractor misconduct.<sup>1</sup> Specifically, the rule updated FAR 52.203-13(c)(2)(F) to require timely disclosure whenever a contractor has credible evidence that a principal, employee, agent, or subcontractor of a contractor has committed a violation of federal criminal law involving fraud, conflict of interest, bribery, gratuity, or a violation of the civil False Claims Act.

President Obama signed into law the Fraud Enforcement and Recovery Act (FERA) on May 20, 2009. This legislation increased funding for federal agencies to combat financial fraud and expanded the reach of federal law. The FERA substantially broadened the False Claims Act, and its broadened scope has led to increased qui tam lawsuits and enforcement activity.

Reform efforts continued in 2012 when the DoD adopted a final rule in the Defense Federal Acquisition Regulation Supplement (DFARS) on contractor business systems administration.<sup>2</sup> The rule defined contractor business systems as the following: accounting systems, estimating systems, purchasing systems, earned value management systems, material management and accounting systems, and property management systems. The rule also implemented compliance enforcement mechanisms that include the ability for contracting officers to withhold a percentage of payments, under certain conditions, when a contractor's business system contains significant deficiencies.

The DoD's recent activity shows enforcement of the contractor Business System Rule is a top priority. In order to improve and ensure contractor accountability for business systems, the DoD has proposed amending the DFARS to allow contractors to self-certify compliance with accounting, estimating, and material management systems, and to utilize independent Certified Public Accountants (CPA) to audit contractor compliance.<sup>3</sup> This proposed rule is in response to a 2011 Government Accountability Office (GAO) publication, titled "Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions." The report noted, "Business systems — such as accounting and estimating systems — are the government's first line of defense against fraud, waste, and abuse. Because of its own workforce struggles, DCAA has lagged in completing a number of such audits and is currently focusing on other high-priority areas."<sup>4</sup>

These recent regulatory updates demonstrate that contractor business systems, internal controls, and compliance processes are at the forefront of government oversight efforts. Government audit effort on organizations receiving federal money is intense and escalating. Many contractors have come under increased scrutiny by the DCAA, with numerous audits resulting in disapprovals of contractor business systems, withholding of claimed costs, and disallowance of costs. Some recent and ever-present contract compliance exposure areas in government contracting are summarized below.

### Labor charging

The DFARS final Business System Rule made labor charging and timekeeping a significant focus. DFARS 252.242-7006, "Accounting System Administration," requires contractors to maintain a "timekeeping system that identifies employees' labor by intermediate or final cost objectives" and a "labor distribution system that charges direct and indirect labor to the

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<sup>1</sup> Federal Acquisition Regulation: Contractor Business Ethics Compliance Program and Disclosure Requirements, Final Rule, 73 Federal Register 67064, November 12, 2008

<sup>2</sup> Defense Federal Acquisition Regulation Supplement: Business Systems – Definition and Administration, Final Rule, 77 Federal Register 11355, February 24, 2012

<sup>3</sup> Defense Federal Acquisition Regulation Supplement: Business Systems Compliance, Proposed Rule, 79 Federal Register 41172, July 15, 2014

<sup>4</sup> US Government Accountability Office Report, GAO-12-83: "Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions," November 2011

appropriate cost objectives.” DCAA continues to focus on labor charging as an important area of audit concentration and fraud risk because labor represents the largest cost in many government contracts, and these charges are not typically supported by third-party documentation, making effective monitoring and system internal controls even more important to facilitate accurate timekeeping.

Often, when inadequate controls are weak with respect to labor reporting and charging, fraud risk is higher. Common examples of fraud risk considered by auditors include instances of mischarging based on contract type, the misallocation of direct and indirect costs, and diverting labor hours from contracts that are experiencing cost overruns or are approaching or exceeding cost ceilings. These types of practices can occur due to improper employee or supervisor training, lack of proper oversight, gaps in labor correction and adjustment controls, or any number of other control and process weaknesses.

### **Improper overhead charges — allowable and unallowable**

The FAR defines limits on allowable costs under government contracts and specifies that costs must be reasonable and allocable in order to be recoverable. Recent industry trends show DCAA is taking a more active approach in questioning the allowability of contractor-claimed costs during incurred cost audits. Examples of recent regulatory updates and DCAA audit guidance focus on compensation costs and professional and consulting service costs.

Compensation costs have long been a target of government cost-cutting efforts, and Congress has passed legislation seeking to limit the allowability of contractor compensation. This resulted in two recent FAR rule changes that affect the allowability of compensation. A May 2014 FAR final rule expanded the existing compensation cap to a broader group of contractor employees.<sup>5</sup> Additionally, a June 2014 FAR interim rule established a limitation on allowable annual compensation of \$487,000.<sup>6</sup> Accordingly, DCAA continues to take an active approach in questioning the allowability and reasonableness of compensation costs during audits of contractors’ incurred costs.

Additionally, DCAA released a Memorandum for Regional Directors (MRD) in December 2013 that focuses on professional and consulting services.<sup>7</sup> The MRD requires DCAA auditors to evaluate documentation defined by FAR 31.205-33(f), which states that professional and consultant service costs are allowable if evidence of the following documentation exists: (1) details of all agreements; (2) invoices or billings; and (3) consultant work product and related documents. A significant risk of cost disallowance exists for contractors that do not maintain sufficient levels of documentation to satisfy DCAA auditor requests.

### **Counterfeit parts**

A new focus area for Congress is the prevention of the acquisition and usage of counterfeit electronic parts on government contracts. A May 6, 2014 final rule amended the DFARS relating to the detection and avoidance of counterfeit electronics parts (see DFARS 252.246-7007).<sup>8</sup> The new rule establishes criteria for a contractor counterfeit electronic part detection and avoidance system, focusing on training, policies, procedures, and processes related to source selection,

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<sup>5</sup> Federal Acquisition Regulation: Expansion of Applicability of the Senior Executive Compensation Benchmark, Final Rule, 79 Federal Register 31195, May 30, 2014

<sup>6</sup> Federal Acquisition Regulation: Limitation on Allowable Government Contractor Compensation Costs, Interim Rule, 79 Federal Register 35865, June 24, 2014

<sup>7</sup> MRD Number 13-PAC-026(R), Audit Alert on Professional and Consultant Service Costs (FAR 31.205-33) and Purchased Labor, dated December 19, 2013

<sup>8</sup> Defense Federal Acquisition Regulation Supplement: Detection and Avoidance of Counterfeit Electronic Parts, Final Rule, 79 Federal Register 26092, May 6, 2014

traceability, and monitoring of counterfeit electronic parts at the prime and subcontractor levels. The final rule also updates certain DFARS purchasing system criteria to include detection and monitoring of counterfeit electronic parts (see DFARS 252.244-7001). Failure to have processes in place to comply with these new requirements can result in disapproval of a company's purchasing system and/or allegations of fraud.

### Defective pricing

A long-term requirement, but always a primary risk area, is compliance with the Truth in Negotiations Act. This law requires contractors involved in contract negotiations that are typically noncompetitive and above a certain threshold to disclose cost or pricing data to the government and to certify that this data is current, accurate, and complete as of the date of certification. If the cost or pricing data is overstated, and the contractor should have known this fact because current, accurate, and complete data was reasonably available, then the contractor may be subject to an allegation of defective pricing, and the government may be entitled to a retroactive price adjustment, plus interest. This means that not only should contractors avoid intentional certification of cost or pricing data that is not current, accurate, and complete, but also that the actions of a contractor that does not exercise due diligence before certifying cost or pricing data may also be considered fraudulent.

### Proactive approach to prevent fraud, waste, and abuse

Many contractors are taking proactive and tactical approaches with their responses to prevent fraud, waste, and abuse by strengthening their control environments in a manner that addresses their obligations as responsible contractors. To satisfy the requirements set forth by FAR 9.104-1 (d)<sup>9</sup> and (e)<sup>10</sup>, many contractors enhanced their internal control components (i.e., control environment, risk assessment, control activities, information and communication, and monitoring activities). Many contractors are taking a closer look at their existing internal control components using a different lens as a response to the confluence of regulatory changes noted above, as well as the heightened emphasis by the DCAA and the Defense Contract Management Agency (DCMA) on contractors' responsibilities, code of ethics, and internal controls. As a result, many contractors have:

- Renewed focus on the code of ethics and controls in the tone at the top
- Enhanced internal and/or external reviews and assessments of internal controls
- Improved monitoring activities
- Updated existing policies and procedures
- Implemented new policies to cover items such as mandatory disclosures
- Enhanced the code of ethics, conduct policies, and related training
- Emphasized the whistleblower hotline and educated the workforce of the purpose of such hotlines
- Expanded training

To address the requirements of the mandatory disclosure rule,<sup>11</sup> many contractors are taking an active approach to change the tone at the top. The tone at the top sets the guiding values and

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<sup>9</sup> FAR 9.104-1 (d) Have a satisfactory record of integrity and business ethics

<sup>10</sup> FAR 9.104-1 (e) Have the necessary organization, experience, accounting and operational controls, and technical skills, or the ability to obtain them (including, as appropriate, such elements as production control procedures, property control systems, quality assurance measures, and safety programs applicable to materials to be produced or services to be performed by the prospective contractor and subcontractors)

<sup>11</sup> Federal Acquisition Regulation: Contractor Business Ethics Compliance Program and Disclosure Requirements, Final Rule, 73 Federal Register 67064, November 12, 2008

ethical climate for an organization. An effective tone at the top, along with an effective organizational structure, are key elements to fostering a sound internal control environment that reinforces ethical behavior and builds strong defenses against fraud, waste, and abuse. It is critical that senior management emphasize the importance of ethical behavior, compliance with regulatory requirements, and the contractor's willingness to cooperate with regulatory agencies and maintain transparency.

Many contractors are also transforming their approach to managing their relationships with DCAA by performing self-assessments of their major business systems to assess risks, identify compliance gaps, and remediate when necessary. In addition, some contractors are augmenting their companies' technical resources in the compliance and liaison department (e.g., enable responsiveness to auditors, ensure current regulatory knowledge) and enhancing internal communications on ongoing audit activities (e.g., reporting to an executive committee or the board's audit committee). Raising the visibility of the compliance and liaison department within the organization and encouraging the performance of periodic internal and/or external compliance control assessments to identify potential gaps in current state, identify potential root causes, and remediate the future state are effective ways of demonstrating a strong tone at the top.

Additionally, to address industry trends of audit findings related to weak policies and procedures, many contractors are enhancing their existing policies and procedures or implementing new policies. One example is the creation of policies and procedures by contractors to provide guidance to employees on who is responsible for, and how to assess a matter to determine if, a mandatory disclosure should be made. Along with these internal documentation enhancements, we noticed a renewed emphasis and investment in companywide employee training on topics such as policies and procedures, time reporting compliance, code of ethics and conduct, and whistleblower hotline, as well as focused training on topics such as unallowable cost and procurement integrity to individuals responsible for such functions.

We also noticed a significant trend regarding companies using the Committee of Sponsoring Organizations of the Treadway Commission (COSO)<sup>12</sup> framework in connection with compliance with Sarbanes-Oxley Act Section 404 (SOX 404) and internal control over financial reporting (ICFR), extending its application to address the regulatory changes and resulting risks. Many contractors use the existing framework as a means to objectively reevaluate their internal controls, identify areas of improvement and synergies, and identify opportunities for systematically managing regulatory, operational, and reporting risks. When considering the proposed amendments to the DFARS to allow contractors to self-certify compliance with accounting, estimating, and material management systems, as well as to utilize independent CPAs to audit contractor compliance, as mentioned above, using the COSO framework could be a fruitful exercise.

We observed a visible uptick in contractors who perform internal compliance control assessments using their existing compliance groups, internal audit teams, or external resources to identify potential gaps in current state, identify potential root causes, and proactively remediate weakness in their controls. Use of such groups to perform the following types of reviews and assessments may demonstrate to the contracting officer that the contractor has a sound internal control environment:

- Extensive internal audits using an approach similar to what the DCAA or DCMA would execute to demonstrate that the contractor's business systems meet DFARS criteria and DCAA audit expectations

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<sup>12</sup> COSO is the Committee of Sponsoring Organizations of the Treadway Commission. In May 2013, COSO updated its Internal Control — Integrated Framework, which was originally issued in 1992.

- Performing risk assessments of the contractor's business systems using a government contracting spin, which typically includes understanding prior issues and DCAA findings across the applicable DFARS system criteria and risk rating sub-process areas
- Performing gap assessments to identify gaps between existing policies and procedures and the requirements of the Business System Rule and DCAA/DCMA audit expectations

In order to assist the compliance and internal audit function with maintaining a robust internal control monitoring system that is cost effective, some government contractors have turned to advanced data analytics. For example, some auditors use data analytics to assist with sampling, to take into account anomalies in transactions, and to identify high-risk items by taking into account various attributes, such as posting time after hours, the time of the month the journal entries were posted, dollar amounts, and rounding. Similarly, some compliance and internal audit functions use data analytics to monitor compliance. Below are a few examples of such monitoring activities:

- Timekeeping Compliance — Using data analytics to identify noncompliant employees, perform keyword searches to identify high-risk time correction comments, and identify high-risk trends of corrections (e.g., movement of hours from fixed-price to cost-type projects)
- Review of Unallowable Cost — Performing analysis of the general ledger by types of transactions and descriptions to identify coding errors
- Cost Transfers — Performing analysis of cost transfers using data analytics to identify poorly supported transactions, high-risk transfers based on type of project and timing of transfer, etc.
- To Address the Requirement Surrounding Counterfeit Electronic Parts — Using advanced data analytics to focus on high-risk shipments from particular vendors or parts for additional quality control testing

Additionally, there are instances in which some contractors use third parties and/or independent CPA firms to perform reviews of implemented corrective action plans or entire systems. These external assessments may include:

- Use of third parties to perform mock audits to proactively identify gaps between existing policies and procedures and the requirements of the new Business System Rule
  - In some instances, these are also performed under attorney client privilege, as needed
- Use of third parties to perform independent audits or management assertion assessments to yield reports that can proactively demonstrate that their business systems meet DFARS and DCAA expectations
  - These types of assessments are performed on systems that have preexisting reports prior to the new Business System Rule to demonstrate that findings have been addressed and their systems are ready to meet the Business Systems Rule's criteria

Based on our experience, it is critical that contractors identify one centralized resource to coordinate DCAA and DCMA audit requests and correspondence to ensure timely responses to such requests, provide current and up-to-date policies and procedures, ensure that audit questions are addressed only by those qualified to do so, and avoid overstepping by the auditors. It is also a prudent business practice to prepare for audits with the DCAA and DCMA by reviewing prior DCAA/DCMA audit reports to identify issues, reviewing policies and procedures to confirm that they are current, testing the internal control system related to the area that is the focus of the audit (consider sample testing), confirming that documentation (data) is current and available, and confirming that employees are trained and familiar with dealing with auditors.

## Conclusion

As described above, government contractors in the current environment are encountering new challenges as Congress, the DoD, and the DCAA place a renewed emphasis on compliance in an effort to combat fraud, waste, and abuse. In order to manage the risks inherent in this new environment, responsible contractors are enhancing their compliance and internal controls processes, systems, and policies. These efforts include updating internal documentation, such as policies and procedures; improving internal monitoring activities to bolster processes around the mandatory disclosure rule; and making internal process improvements, such as timekeeping compliance and screening of unallowable costs. By proactively making efforts to bolster their compliance programs, government contractors should be well positioned to respond to the risks inherent in today's environment.

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