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The President's Column
Susan Warshaw Ebner

Dear BCABA Members:

As our website says, "We are an association of judges, attorneys, legal assistants, and other professionals dedicated to supporting and improving the practice of law before the Boards of Contract Appeals of the Federal Government." I am honored to serve as the new President of the BCABA, and thank those that came before me for the work they undertook to develop and maintain this vibrant association.

As President, I hope to work with our Board members, Committee and Event chairs to bring news, events and training opportunities to you that truly support and improve our practice of government contracts law and that will inspire a new generation of government contracts practitioners to endeavor to do the same.

Becoming knowledgeable about government contracts is neither quick nor easy these days. We face increased challenges to stay up to date on the laws, rules, regulations and guidance that govern our practice area. Indeed, it seems as if some new, potentially sea-changing legislative or regulatory change is being proposed or implemented every day. These changes may affect the way government procurements are conducted, contracts are (*continued on page 3*)

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President's Column (cont'd):

administered, changes and other problems can be addressed, or the relief that may be granted. Through our activities and excellent publication, ***The Clause***, we will endeavor to impart knowledge of significant developments in our evolving practice and discuss their actual or potential significance to the world in which we practice. In addition to imparting knowledge, we will strive to offer training opportunities that teach or refine the skills of our practitioners and networking opportunities so that those who have practiced for awhile and those new to the area can find the resources they need to do their jobs. This edition of *The Clause* continues our efforts. Thanks to Pete McDonald for bringing to print another fine issue to educate and enlighten us.

With a significant number of the baby boomer generation eligible for retirement, there is need to ensure that those that practice and those newly entering our practice understand not just that there are thousands of rules comprising the Federal Acquisition Regulation and its agency supplements, but that there is an entire framework within which these and other rules are issued that guides how we are to interpret the contracts and agreements issued under them. To my mind, even more important, we need to pass on our understanding about what it means to be a government contracts practitioner to our existing and incoming members: It is more than knowing where to and how to read the thousands of rules and thousands upon thousands of interpretative decisions that comprise federal procurement law. It is understanding that this is a community of practitioners and that the art of practicing government contracts must be done with honesty and integrity.

In October of this year, we started down this road. Our Annual Conference covered some of the key changes in procurement law that are now or likely will affect our practice at the Boards: In the audit area, Mike Littlejohn, Nicole Owren-Wiest and John Russell talked about some of the significant changes in auditing as a result of DCAA's interpretation of the new FAR Mandatory Disclosure, compliance, and interview access rules. Our Ethics hour, led by Steve Epstein and Wallace Shipp covered ethical dilemmas now facing practitioners as a result of potentially disqualifying personal or organizational conflicts of interest. Chris Yukins and Peter Allegeier addressed socio-economic requirements under the Obama Administration and how this Administration's initiatives to reform procurement law may impact our practice. Both our luncheon speaker, RADM Kathleen Dussault, who commanded the Joint Contracting Command Iraq/Afghanistan, and our Battlefield Contracting panel including Jim McCullough, Mike Love and Doug Brooks talked about the continuing evolution of contractors on the battlefield and emerging issues facing these contractors. David Black and Judges Larkin, Shapiro, Somers, Thomas and Zischkau discussed practice before the Boards, with an emphasis on practical issues and procedures not expressly addressed by the rules.

At our next Board of Governors meeting, on December 17, 2009, we will be working on the calendar and events for this coming year, including the Spring Colloquium, Annual BCA (*continued on next page*)

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Judges reception, Executive Policy Forum, Trial Practice Program, and Annual Program in 2010. Please let us know if you have ideas for future programs, or are interested in being involved in our various activities or one of our committees. We are also looking for articles on important, new or emerging issues for ***The Clause***. Our Board of Governors meetings, starting with the December meeting, will be held quarterly at the offices of Buchanan Ingersoll & Rooney PC, 1700 K Street, NW, Suite 300, Washington, DC. We welcome your interest and participation and will alert you to upcoming events.

I hope to see you at many of our activities. Best wishes for a safe and joyful holiday season.

Best regards,

Susan Warshaw Ebner
President

Bored of Contract Appeals
(a.k.a. The Editor's Column)

by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

Leading this issue is the ASBCA's new guidance on motions for summary judgment, a matter of interest to most BCABA members. Then Anna Sturgis points out some pitfalls in assuming a commercial items acquisition is just like a commercial sale. The shorter GAO report on DCAA is next, followed by two CBCA decisions imposing sanctions for failing to cooperate in discovery (practitioners note). Rick O'Keefe then sagely analyzes the process in executive compensation reviews and provides worthwhile guidance. Finally, Dave Nadler, Andrew Jackson and Joseph Berger address the latest False Claims Act case at the Supreme Court.

If you haven't heard from other sources, at the annual meeting on October 22nd Steve Feldman received the 2009 Writing Award. I was very honored to receive the President's Award, and Jim McCullough received the richly deserved Life Service Award.

The Clause will reprint, with permission, previously published articles. We are also receptive to original articles that may be of interest to government contracts practitioners. But listen, everybody: Don't take all this government contract stuff too seriously. In that regard, we again received some articles that were just not suitable for publication, such as: "Judge Daniels Ejected from Fantasy Baseball Game! ("My guy was safe — the ump is a jerk!"); "Judge Williams Receives Microsoft IT Certification ("I can't believe I did it!!"); and "Pete Completes Community Service!!!"

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As Revised 1 October 2009

GUIDANCE FOR SUMMARY JUDGMENT MOTIONS

(a) A motion for summary judgment or partial summary judgment may be filed under Rule 5(b). To facilitate disposition of such a motion, the parties should be guided by the following recommended procedures: Where the parties agree that disposition by summary judgment or partial summary judgment is appropriate, they may file a stipulation of all material facts necessary for the Board to rule on the motion. Otherwise, the moving party should file with its motion a "Statement of Undisputed Material Facts," setting forth the claimed undisputed material facts in separate, numbered paragraphs. The non-moving party should file a "Statement of Genuine Issues of Material Fact," responding to each numbered paragraph proposed, demonstrating, where appropriate, the existence of material facts in dispute. The moving party and the non-moving party should submit a memorandum of law supporting or opposing summary judgment. The moving party may file a reply.

(b) In deciding motions for summary judgment, the Board looks to Rule 56 of the Federal Rules of Civil procedure for guidance. The parties should explicitly state and support by specific evidence all facts and legal arguments necessary to sustain a party's position. Each party should cite to the Rule 4 file and attach any additional evidence upon which it relies (*e.g.,* affidavits, excerpts from depositions, answers to interrogatories, admissions). The parties should not expect the Board to search the record for evidence in support of either party's motion. The Board may accept a fact properly proposed and supported by one party as undisputed, unless the opposing party properly responds and establishes that it is in dispute.

Isn't a Sale to the U.S. Government Just Another Commercial Sale?

by

*Anna M. Sturgis**

[Note: Reprinted with permission from the *Contract Management Journal*, National Contract Management Association, Contract Management, September 2009.]

In the 1990s, in search of increased efficiency and competition, Congress elected to incorporate free-market principles into the Federal Acquisition Regulation (FAR). These revisions encouraged both the use and acquisition of commercial items[1] by simplifying the government's regulations and drawing them closer to commercial contracting practices.[2] Specifically, FAR Part 12, "Acquisition of Commercial Items," and the corresponding definitions of FAR Part 2 were rewritten to exempt commercial item vendors from many burdensome regulatory provisions.

However, free markets and government procurement practices are fitful colleagues, and both Congress and the regulators have been unable to resist meddling with commercial principles. As a result, the commercial items rules have become increasingly onerous since these revisions, with both Part 12 and the definitions in Part 2 having been amended in favor of more exacting and restrictive regulations.

Because of this, the commercial item regulations have become increasingly difficult to navigate. They have been freighted with regulatory provisions designed to pursue collateral policies that have little to do with free market efficiency.[3] These competing goals produce a dichotomous tension that is difficult for market participants to interpret.

Most problematically, the current complexity of the rules limits contractors' ability to assess the risks and costs of commercial item procurements and thus reduces the overall amount of competition for contract awards.[4] This is plainly contrary to what Congress initially intended with the FAR revisions. Congress must now choose either to relinquish its original free market principles incorporated into the FAR or reinvigorate them.

Commercial Items Acquisition

Purpose and Structure: Exemptions to Government-Specific Requirements

Historically, commercial contractors have been forced to satisfy cumbersome regulations, such as the Cost Accounting Standards (CAS),[5] the Truth in Negotiations Act (TINA),[6] and the FAR Part 31 cost principles. Unfortunately, these regulations, theoretically

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designed to promote integrity and fair competition among contractors, tend to stifle the competition in actuality. Mandated compliance with these and a host of other government-specific requirements requires contractors to expend more on overhead and administration than their purely commercial counterparts, which causes contract cost inflation. The cost of implementing them and the risk of transgressing these complex rules results in industry reticence to engage in public procurement.[7]

For example, TINA's onerous terms generally require government contractors or subcontractors to submit and certify the currency, accuracy, and completeness of cost or pricing data for any nonexempt negotiated contract, subcontract, or modification expected to exceed $650,000.[8] What this effectively means is that, contrary to all commercial practices, the vendor must relinquish its most valuable bargaining advantage—i.e., holding its cost data closely—by disclosing all its cost or pricing data, including all facts that prudent buyers and sellers would reasonably expect to significantly affect price negotiations.[9]

The phrase "cost or pricing data" has been expansively interpreted by the courts and boards to include obvious cost data, such as vender quotations, to less obvious "facts," such as any data that supports make or buy decisions or any information bearing on management decisions that may have a significant effect on cost. Indeed, as a practical matter, the definition includes virtually any information that government auditors might imagine could have an effect on cost.[10] In turn, contractors must have systems, procedures, and personnel in place to identify, gather, and disclose such data.

The CAS, which were intended to lower acquisition costs by creating a uniform system of accounting practices for government contractors, instead established complex criteria for measuring, assigning, and allocating the indirect costs of federal contracts in excess of $650,000.[11] The CAS direct contractors on how to design their accounting systems and the manner in which they must account for certain types of costs.[12] These rules are difficult to understand, difficult to implement, and wholly different from the financial accounting systems used by purely commercial contractors. Developing and maintaining the special accounting and data collection systems required by CAS necessarily increases overhead costs and thus inherently threatens competition.[13] Further, the CAS provide the government with broad audit rights to monitor and enforce contractor obligations.[14]

Historical Context

In 1991, the Department of Defense (DOD) in response to congressional directives set forth in the Defense Authorization Act for Fiscal Years 1990 and 1991,[15] attempted to reduce barriers to commercial item acquisition in the Defense FAR Supplement (DFARS).[16] These regulations created a new definition of *commercial item* which are items "regularly used in the course of normal business operations for other than government purposes."[17] Following DOD's

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example, Congress enacted the Federal Acquisition Streamlining Act (FASA)[18] in 1994, which established a preference for commercial item acquisition. FASA also established a unified definition of "commercial items" across the FAR and DFARS, and continued the DFARS policy of exempting items that fell under this definition from TINA and CAS requirements. Indeed, as a result, the most significant exemption from TINA now arose when selling a commercial item.

In various ways, the regulations implementing FASA also reduced the application of other unique regulatory standards and requirements, decreased barriers to entry, and encouraged commercial companies to offer their products to the government.[19] The results of FASA included a decrease in overall procurement costs and the more efficient use of tax dollars.[20]

The FAR Councils implemented FASA in 1995, and in so doing expanded the definition of "commercial items" when they added standalone services as "commercial items."[21] Similarly, commerciality was broadened when the definition was changed to maintain an item's character as "commercial," even if there were modifications to it "of a type" offered in the commercial world (rather than requiring the exact modification).[22]

Congress adopted these regulatory changes and clarified the definition created by FASA with respect to the TINA exemption in the Clinger-Cohen Act of 1996, also known as the Federal Acquisition Reform Act of 1996 (FARA).[23] These changes, subsequently reflected in FAR Part 12, made it easier for commercial companies to compete in the previously inscrutable world of government contracts.

For example, FAR 12.301(b)(3) requires the insertion of clause 52.212-4, "Contract Terms and Conditions—Commercial Items," which, among other things, states that the contractor "shall not be required to comply with the Cost Accounting Standards or contract cost principles" in a termination for convenience. FAR 12.302(c) prevents contracting officers from tailoring contract conditions or adding terms and conditions that are "inconsistent with customary commercial practice for the item being acquired," unless a written waiver is granted by the agency.[24]

Furthermore, FAR 12.504(b) limits the applicability of TINA regulations, which in turn generally exempts commercial items from TINA's reach. Nonetheless, the contracting officer can obtain data "other than cost or pricing data" in certain circumstances for assessing the price reasonableness of a commercial item, subject to the limitation that the contracting officer must "to the maximum extent practicable, limit the scope of the request for information relating to commercial items to include only information that is in the form regularly maintained by the offeror as part of its commercial operations."[25]

Competing Theories: Oversight vs. Commercial Freedom

Viewing these changes objectively, there are clearly two sides to the commercial item

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topic. Free market enthusiasts argue that commercial item procurement offers the opportunity for the government to "take effective advantage of market-driven innovations and commercial economies of scale to obtain the best value from a globally competitive national industrial base."[26] According to industry players, FASA has successfully reduced the application of special regulatory standards and requirements, decreased barriers to market entry for government contracts, and encouraged commercial companies to offer their products to the government.[27] Moreover, these decreased barriers provide "greater access to commercial technologies…[and] drive costs down."[28] Put differently, simplified acquisition regulations allow contractors the flexibility they need to engage in competition for government contracts, which in turn results in more efficient procurement overall. From this perspective, procurement based on discretion rather than rigid rules constitutes a "significant step" in procurement, and is not prohibitive to securing best value.[29]

The counter argument is that the administrative convenience of streamlined procedures actually limits competition and threatens recovery of best value because maximization of competition is not required.[30] On the other hand, the government's decision to exempt commercial items from TINA and the CAS demonstrates some commitment to free market efficiencies and, necessarily, its recognition of the limits of statutory and regulatory protections.[31] Although the government acts differently than private enterprise, and the courts have reinforced the distinction between government and private contracts,[32] federal policy directs the government to provide commercially available products or services if they can be economically acquired during the procurement process.[33]

In all events, both sides have pled their case to contracting officers because these officials possess a fair amount of discretion in choosing how to conduct a procurement. It is also difficult to hold government employees accountable for their actions or to prove that discretion has been abused; thus, the exemption of "commercial items" from TINA and CAS requirements remedies this potential imbalance through supplanting statutory protection with free market efficiency.[34] Nonetheless, government officials have lobbied to cut back more on commerciality, urging the need to maintain broader governmental policies. But these policies can override free market interests that commercial item exemptions were meant to foster.

To be sure, differences do exist between the government and private industry, and must be recognized, although with an even hand. Most importantly, the government is not driven by the profit motive or accountability to shareholders; rather, the government's use of public funds obligates it to consider the public interest. Indeed, the need for transparency in the procurement process necessitates the need for the government to retain unique policies, solicitation provisions, required clauses, and other legislatively mandated requirements that prevent it from acting as a true commercial purchaser.[35] Thus, legislation mandates that the government provide equal opportunities for contractors to compete and the contractor to perform a contract despite directed changes or changed conditions that may require additional time or cost to the contractor.[36]

Further, restraints prevent the government from completely adopting private industry
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commercial practices for several reasons, which include:

- The government and commercial buyers have different responsibilities;
- Legally mandated funding cycles limit the government's ability to consider assets and investment, similar to that of its private industry counterpart;
- Collateral policies inherent in federal procurement regulation[37]; and
- The need for military-specific goods and services.[38]

Because the federal procurement system furthers social policies, government officials must consider goals of congressional policy in addition to efficiency. On the efficiency side, one tangible benefit of commercial contracting includes a reduction in required socioeconomic programs inherent in public procurement law. For example, statutory contract clauses—which formerly required Buy America Act compliance regardless of purchase size, or the small business requirement for purchases under $2,500—have been eliminated in commercial item acquisition.[39] However, "No matter how commercial, competitive, or cost-effective the federal acquisition system becomes, it ultimately will still be governed by public policies—policies that are driven not only by economic objectives, but also by social and political considerations."[40]

Therefore, the question becomes whether, notwithstanding political pressures and social policy, the differences between government and commercial practice should be reconciled. Lately, this question has been answered adversely to the free market.

Diminishing Use of Commercial Item Acquisition

As previously noted, with the passage of FASA and FARA, Congress accepted reduced levels of competition and transparency in order to exempt commercial items from various requirements, including having to submit certified cost and pricing data and to make the government more efficient.[41] Ten years later, however, the pendulum has begun to swing the other direction. The following relates the direction of that swing.

Recommendations to Change the Definition of "Commercial Items"

Proposed FAR Changes

Recent recommendations threaten current commercial item exemptions by requiring a contracting officer to obtain "data other than certified cost or pricing data" when it is necessary for the government to determine whether it has received a fair and accurate price for the commercial item or service.[42] Previously, although contracting officers were authorized to request "other than cost or pricing data" from commercial item contractors for purposes of determining price reasonableness,[43] there was no definition of what this "other" data was. This led the regulators to believe that contracting officers might therefore not be able to get information sufficient to evaluate price reasonableness. Accordingly, they proposed a definition of "other than cost or pricing data" that is intended to be the equivalent to cost or (*continued on next page*)

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pricing data, but simply not certified:

> "Data other than certified cost or pricing data means any data, including cost or pricing data *and judgmental information necessary* for the contracting officer to determine a fair and reasonable price or cost realism, *where certification is not required*…."[44]

Although the proposed changes supposedly provide contracting officers and contractors with "clarification" regarding the contracting officer's authority, they do far more than that. They essentially require all commercial contractors to have full-blown systems and processes to identify, collect, and disclose "other than cost or pricing data" that are equivalent to those required by noncommercial contractors who have to disclose "real" cost or pricing data. Therefore, the administrative burden and cost meant to be eliminated by the commercial item exemption from TINA would be fully reinstated. There would also be no difference between the burdens faced by commercial versus pure government contractors. These proposed changes will increase indirect costs associated with data collection and storage. Small- and medium-sized businesses will disproportionately feel the impact of the proposed requirements if they do not have the necessary architecture in place for collecting and disclosing cost or pricing data.[45]

Statutory Changes

In a corollary enactment, Section 805 of the Defense Authorization Act for Fiscal Year 2008 applied similar requirements at DOD for commercial services "of a type" offered and sold competitively in substantial quantities in the commercial marketplace. That is, these commercial services may be exempt from TINA, but only if the contracting officer determines the offeror has submitted sufficient information to evaluate the reasonableness of the price for such services through price analysis.[46] This information reasonably includes the prices paid for the same or similar commercial services under comparable terms and conditions.

However, if the contracting officer finds this information insufficient to determine reasonableness of price, the contracting officer can require the contractor to submit "other relevant information regarding the basis for price or cost, including information on labor costs, material costs, and overhead rates."[47] Given that these categories of costs comprise virtually all costs incurred by a contractor, this enactment means that commercial service providers can be exposed to the full administrative burden of TINA.[48]

Recent FAR Changes

Congress also recently cut back on TINA's commercial item exemptions for modifications. Modifications to commercial items that, under FAR 2.101, did not change the item from a "commercial" to a "noncommercial" item had been and remain exempt from TINA for civilian agencies. This has changed for "noncivilian agencies." Specifically, cost and (*continued on next page*)

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pricing data is now required under contracts with DOD, the National Aeronautics and Space Administration (NASA), or the U.S. Coast Guard for modifications to commercial items that cost more than $500,000 or five percent of the total contract price, even if those modifications do not alter the commercial nature of the item.[49] Thus, commercial contractors are now responsible for ensuring the accuracy of cost and pricing data—as well as having the expense and risk associated with TINA compliance—for commercial items that are modified after the acquisition is complete, if the modifications exceed the thresholds.[50]

Other Government Policies Inhibiting Private Participation in Government Contracts

The Civil False Claims Act

Apart from these express changes to the commercial item regulations, the government also embraces other departures from the private sector that drastically alter the risks found in the commercial marketplace, but which are not found in FAR Part 12.[51] One of the most significant is the Civil False Claims Act (FCA). FCA liability arises when a corporation "knowingly presents, or causes to be presented, to [the government] a false or fraudulent claim for payment or approval" or "knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the government."[52] The term "knowingly" requires either "actual knowledge" that the claim or statement is false, or to have acted in "deliberate ignorance" or "reckless disregard" of the falsity of the claim or statement.[53] The FCA thus permits the government to pursue civil actions for the knowing submission of inaccurate or incomplete information submitted in relation to government contracts.

For example, the FCA creates civil liability for a person who knowingly submits a false claim for payment by the government, uses a false statement to induce payment from the government, or conspires to defraud the government to pay a false claim.[54] Liability under the FCA increases the risk that a "firm's failure to fulfill contractual agreements will be challenged as fraudulent and be subject to severe punishment"[55] if the contractor's disclosure of information is inaccurate or incomplete.[56] The term "knowing conduct" includes actual knowledge as well as reckless disregard for the truth; thus, liability under the FCA accrues if a commercial contractor makes a representation without bothering to discern the truth or accuracy of information submitted for payment.[57]

Regulatory and Statutory Restriction of Specialty Metals Acquisitions (Berry Amendment Requirements)

Another surprise and lurking risk for commercial contractors is the Berry Amendment.[58] Under these provisions, DOD is restricted from purchasing "specialty metals" — metals common in aerospace/defence manufacturing such as titanium or steel — unless the metals (*continued on next page*)

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were melted in steel manufacturing facilities located within the United States.[59] Additionally, neither federal statute nor the Berry DFARS clause contains a commercial item exemption.[60] This is problematic for companies because typical commercial practice does not trace the origin of the melt. Because resellers and distributors cannot ensure compliance just by purchasing from U.S. manufacturers, they must, as a result, keep a dual inventory of metals used in manufacturing—one for DOD and one for all other customers. This is a significant burden for commercial contractors. To make matters worse, although DOD could not acquire specialty metals previously, it could acquire end items containing specialty metals. Thus, DOD could simply accept and decrement for nonconforming components. However, with the passage of the National Defense Act for Fiscal Year 2008,[61] this changed—now the acceptance of end items that contain specialty metals is not allowed; the requirements now apply to commercial item procurements of end items.[62]

Conclusion

In summary, as exemplified by the specialty metals requirements, commercial enterprises that are in business with, or are contemplating getting into business with, the U.S. government must recognize that federal commercial item acquisitions are not the same as commercial transactions in the private sector. The risks are greater, the costs are higher, and the returns are lower. Commercial contractors are already required to have systems in place to handle the unique requirements of government commercial contracts, and those systems and procedures will have to be significantly expanded if the regulations on other than cost or pricing data are finalized. Moreover, if they are finalized, fewer commercial companies will be inclined to do business with the government. That is certainly not what Congress intended when it encouraged commercial contracting. But it is equally certain that this will be the result if something is not done to rethink the policies behind commercial item contracting.

A fresh, objective look is essential because the government contract procurement system is not geared toward or entirely comfortable with commercial enterprise. Proof of this is the push toward increasing access to cost data—data never provided in the private sector. Thus, only the administration at a high level or Congress has the ability to reverse the trend away from commercial contracting as it was originally meant to be. If no one is willing to address this issue, then the inertia of increasing regulations will stifle commercial contracting, which would be a disservice to all.

ANNA M. STURGIS is a recent graduate from the George Washington University Law School and works in the Washington, DC office of Jenner & Block, LLP. The author would like to thank Damien Specht, associate in Jenner & Block's Washington, DC office, for his editorial contributions. Send comments about this article to cm@ncmahq.org. To discuss this article with your peers online, just go to www.ncmahq.org/cm0909/Sturgis and click on "Join Discussion."

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Endnotes

1. For the definition of "commercial item," refer to FAR 2.101.
2. *See, generally*, "Federal Acquisition Regulation; Part 15 Rewrite; Contracting by Negotiation and Competitive Range Determination," 62 Federal Register 51, 224 (September 30, 1997) (suggesting the complex nature of regulations discourages participation in competition. For example, government specifications impede the use of commercial items and require the development of unique items, which results in increased contract costs).
3. *See* Steven L. Schooner, "Desiderata: Objectives for a System of Government Contract Law," Public Procurement Law Review, (2002): 108 (commenting that social policies that mandate compliance with labor laws, drug-free workplace requirements, and other similar requirements burden the procurement process).
4. *See, generally*, "Streamlining Defense Acquisition Laws," Acquisition Law Advisory Panel Report (1993) (arguing that standards which are unique to government procurement impose unattractive burdens on otherwise commercial contractors).
5. Cost Accounting Standards (CAS), Pub. L. 104–106, 110 Stat. 186 (1996), codified at 41 U.S. Code (U.S.C.) §422(F)(2)(B).
6. The Truth in Negotiations Act (TINA), Pub. L. 98-861, 98 Stat. 494 (1984), codified at 10 U.S.C. §2306a and 41 U.S.C. §254b.
7. Ron R. Hutchinson, "The Government's Audit and Investigative Powers Over Commercial Item Contracts and Subcontracts," *Public Contracting Law Journal* (1998): 289.
8. TINA, op. cit.
9. FAR 15.401 and 15.403-1(c) provides guidance on when exceptions apply to regulations.
10. For instance, among the "factual" data within FAR 2.101's definition of "cost or pricing data" is such amorphous data as "estimated resources to attain business goals."
11. *See, generally*, FAR Part 30.
12. As per FAR 12.214, commercial item contracts are exempt from the CAS if they are "firm-fixed price or fixed-price with economic price adjustment (provided that the price adjustment is not based on actual costs incurred)."
13. *Ibid*.
14. 48 Code of Federal Regulations (C.F.R.) 30.604(h)(1) (2007).
15. National Defense Authorization Act for Fiscal Years 1990 and 1991, Pub. L. 101–189, §824(b), 103 Stat. 1352, 1504–05 (1989).
16. 48 C.F.R. 210, 211 (1991).
17. 48 C.F.R.7001(a) (1991).
18. The Federal Acquisition Streamlining Act (FASA), Pub. L. 103-355, 108 Stat. 3243 (1994), codified at 41 U.S.C. §403(12).
19. *See, e.g.*, FAR 12.503(a) (limiting the applicability of various socioeconomic laws, such as the Walsh-Healy Act and Drug-Free Workplace Act of 1988); FAR 12.403 (stating FAR Part 49 does not apply to terminations for convenience for commercial items contracts); and FAR 52.212-4(c) (ensuring bilateral contracting and requiring changes in commercial item contracts only "by written agreement of the parties").
20. *See* Steven Kelman, "Buying Commercial: An Introduction and Framework," *Public Contracting Law Journal* (1998): 250.
21. *See* 60 Fed. Reg. 48, 231, 48, 235 (September 18, 1995) (final rule).
22. *Ibid*.
23. The Federal Acquisition Reform Act of 1996 (FARA), Pub. L. 104-106, 110 Stat. 186 (1996). Congress has yet to address the FAR Council's addition of the "of a type" language. *See, generally*, Aerospace Industries Association, Contract Services Association, Electronic Industries Alliance, Information Technology Association of America, National Defense Industrial Association, Professional Services Council, "Multi-Association Comments on the Section 1423 Acquisition Advisory Panel's Final Panel Recommendations": Chapter 1, "Commercial Practice" (March 12, 2007).

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Endnotes (cont'd)

24. *See* Carl L. Vacketta and Susan H. Pope, "Commercial Item Contracts: When is a Government Contract Term or Condition Consistent with 'Standard' or 'Customary' Commercial Practice?" *Public Contracting Law Journal* (1998): 298–299.
25. FAR 15.403-3(c)(2)(ii).
26. Kelman, *supra* note 20.
27. *Ibid*.
28. *Ibid*.
29. *See* Steven L. Schooner, "Change, Change Leadership, and Acquisition Reform," *Public Contracting Law Journal* (1997): 480.
30. *See* Steven L. Schooner and Neil Whiteman, "Purchase Cards and Micro-Purchases: Sacrificing Traditional United States Procurement Policies At the Altar of Efficiency," *Public Procurement Law Journal* (2000): 148.
31. Schooner (2002), *supra* note 3.
32. *See*, e.g., *Krgoski Cons'crt. Co. Inc. v. United States*, 94 F. 3d 1537 (Fed. Cir. 1996), *cert. denied*, 117 S. Ct. 1691 (1997) (upholding termination for convenience provisions, which are rare in commercial contracts but required in government contracts).
33. *See, generally*, Office of Management and Budget Circular A-76 (stating that it is the general policy of the U.S. government to rely on commercial sources to supply products and services the government needs).
34. Schooner (2002), *supra* note 3.
35. F. Trowbridge Vom Baur, "Differences Between Commercial Contracts and Government Contracts," *American Bar Association Journal* (March 1967): 247.
36. *See, generally*, Schooner (2002), supra note 3 (identifying the most common objectives of a procurement system as: competition, integrity, transparency, efficiency, customer satisfaction, best value, wealth distribution, risk avoidance, and uniformity).
37. *See* Steven L. Schooner, "Commercial Purchasing: The Chasm Between the United States Government's Evolving Policy and Practice," *Public Procurement: The Continuing Revolution*, Sue Arrowsmith and Martin Trybus (eds.)(2003): 137 (arguing wealth distribution and promotion of social policies is an unnecessary, though significant, aspect of government procurement practices).
38. James C. Roan Jr., "Streamlining Government Acquisition (Or, 'Why Can't the Government Figure Out How to Use Commercial Practices?')," *Army Law* (May 1995): 58; *see also* Steven L. Schooner, "Impossibility of Performance in Public Contracts: An Economic Analysis," *Public Contracting Law Journal* (1986): 263; and Joshua L. Schwartz, "Liability for Sovereign Acts: Congruence and Exceptionalism in Government Contracts Law," *George Washington Law Review* (1996): 633.
39. Steven Kelman, "Remaking Federal Procurement," *Public Contracting Law Journal* (2002): 603.
40. *Procurement Round Table* 2000, "The Federal Acquisition System: Transition to the 21st Century" (December 1999): 6, *accessed at* www.contracts.ogc.doc.gov/cld/papers/ 21CentAcqn.pdf; *see*, e.g., Steven L. Schooner, "Buying the 'Black Beret': Balancing Customer 'Needs' and Socio-Economic Policies," *Government Contractor* (2001): 158 (noting the military's failure to procure black berets in the United States was because of a lack of consideration of the intent of procurement regulations).
41. *See* FAR 2.101(3).
42. *See, generally*, 72 Fed. Reg. 20092 (April 23, 2007) (proposed rule).
43. *As per* FAR 15.403-3(c).
44. 72 Fed. Reg. 20092, 20094 (April 23, 2007)(emphasis added).
45. In 2007, the Defense Procurement and Acquisition Policy office issued procurement integrity guidance (PGI) for contracting officers about obtaining information other than cost or pricing data (PGI 215.403-3). The PGI specifically directs contracting officers to request this information as necessary to determine an accurate price, even though they may not request certified cost or pricing data pursuant to TINA.
46. 2008 Defense Authorization Act, Pub. L. 110-181, Section 805(a)–(b)(1).

(*continued on next page*)

Just Another Commercial Sale? (cont'd):

Endnotes (cont'd)

47. *Ibid.* at (b)(2)(A). The *DFARS* regulation implementing this section, DFARS 215.403-3, refers one to PGI Sections 215.403-3 and 215.404-1(b)(iv). The new law also permits the very limited use of commercial time and materials contracts and labor hour contracts at DOD (*ibid.*, Section 805(c)).
48. *See* 48 C.F.R. 52.212-5(d)(1) (the government retains the right to examine a contractor's "directly pertinent records involving transactions related to this contract"); 48 C.F.R. 15.402(a)(1) and (2); *and* FAR 15.403-1 and 15.403-3(b) (granting contracting officers the discretion to obtain pricing information in order to determine price reasonableness when adequate competition is lacking).
49. FAR 15.403-1(c)(3)(ii)(B) and (C). *Compare with* FAR 15.403-1(c)(3)(ii)(A) (which exempts "noncommercial items modifications from cost or pricing requirements in acquisitions funded by agencies *other than* the DOD, NASA, or the Coast Guard" (emphasis added)).
50. *Ibid.*
51. In October 2006, for example, Congress required the U.S. Air Force to convert a multiyear contract for the C-130J Hercules aircraft from an existing FAR Part 12 procurement to a traditional military procurement under FAR Part 15 (Air Force Link, AFPN Washington, DC (October 25, 2006), *accessed at* **www.af.mil/news//story.asp?id=123029927**).
52. 31 U.S.C. §3729(a)(1) and (2).
53. *Ibid.* at (b).
54. *Ibid.* at (a) and (b). Also, under the FCA, a claim includes requests for payment of money or property where the federal government pays for the claim (*ibid.* at (c)).
55. William E. Kovacic, "The Civil False Claims Act as a Deterrent to Participation in Government Procurement Markets," *Supreme Court Economic Review* (1998): 239 (suggesting that contractors regard this "oversight as a costly, substantial burden of doing business with the government"); *see also* Schooner (2003), *supra* note 37 (suggesting that the FCA does not represent a significant barrier for entry by commercial firms).
56. 31 U.S.C. §3729(b).
57. *Ibid.*; *see also* 18 U.S.C. §1001(a)(1)-(3) (stating whoever willingly falsifies material facts, makes materially false misrepresentations, or uses any false writing or document shall be fined or imprisoned). Additionally, contractors can be debarred or suspended for submission of inaccurate data (*see, generally*, FAR 9.4).
58. The Berry amendment requires DOD to obtain certain specific items from domestic producers (10 U.S.C. §2533a).
59. DFARS 252.225-7014.
60. *Ibid. See also* 10 U.S.C. §2533b(h)(1)–(3).
61. 10 U.S.C. §2533b(a)(1) prohibits the DOD acquisition of "end items, or components thereof, containing a specialty metal not melted or produced in the United States."
62. *Ibid.* at (g).

United States
Government Accountability Office

Testimony
Before the Committee on Homeland Security and Governmental Affairs,
U.S. Senate

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DCAA AUDITS
Widespread Problems with Audit Quality Require Significant Reform

Statement of Gregory D. Kutz,
Managing Director Forensic Audits and Special Investigations
Gayle L. Fischer
Assistant Director Financial Management and Assurance

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss our recent audit of the Defense Contract Audit Agency's (DCAA) overall management environment and quality assurance structure. DCAA is charged with a critical role in Department of Defense (DOD) contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts.[1] DCAA's mission encompasses both audit and nonaudit services in support of DOD contracting and contract payment functions. DCAA audits of contractor internal controls in accounting, billing, estimating, and other key systems support decisions on pricing and contract awards. Internal control audits also impact the planning and reliability of other DCAA audits because DCAA uses the results of these audits to assess risk and plan the nature, extent, and timing of tests for other contractor audits and assignments.

Last year, we reported[2] the results of our investigation of allegations about certain DCAA audits at three locations in California, which substantiated claims that (1) audit documentation did not support the reported opinions; (2) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes; and (3) sufficient work was not performed to support the audit opinions and conclusions. At that time we were conducting a broader audit of DCAA's overall organizational environment and quality control system. Given the evidence presented at the Committee's September 2008 hearing, you requested that we expand our ongoing assessment. Our current report,[3] which the Committee is releasing today, presents the results of our DCAA-wide audit, including (1) an assessment of DCAA's management environment and quality assurance structure; (2) an analysis of DCAA's corrective actions in response to our July 2008 report and two DOD reviews,[4] and (3) potential legislative and other actions that could improve DCAA's effectiveness and independence.

1. DCAA also performs audit services for other federal agencies on a fee-for-service basis.
2. GAO, *DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, GAO-08-857 (Washington, D.C.: July 22, 2008).
3. GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, GAO-09-468 (Washington, D.C.: Sept. 23, 2009).
4. DOD reviews included (1) an Under Secretary of Defense (Comptroller/Chief Financial Officer (CFO)) tiger team review and (2) a Defense Business Board Study.

GAO Report No. 09-1009T (cont'd):

To assess DCAA's overall management environment and quality assurance structure, we analyzed DCAA's mission statement and strategic plan, performance metrics, policies and audit guidance, and system of quality control. We also reviewed audit documentation for 69 selected audits and cost-related assignments at certain field audit offices (FAO) in each of DCAA's five regions for compliance with generally accepted government auditing standards (GAGAS)[5] and other applicable standards. We selected 37 audits of contractor internal control systems performed by seven geographically disperse DCAA field offices within the five DCAA regions during fiscal years 2004 through 2006.[6] Our approach focused on DCAA offices that reported predominately adequate, or "clean," opinions on audits of contractor internal controls over cost accounting, billing, and cost estimating systems issued in fiscal years 2005 and 2006.[7] We did this because contracting officers rely on these opinions for 3 or more years to make decisions on pricing and contract awards, and payment. For example, audits of estimating system controls support negotiation of fair and reasonable prices.[8] Also, the FAR requires contractors to have an adequate accounting system prior to award of a cost-reimbursable or other flexibly priced contract.[9] Billing system internal control audit results support decisions to authorize contractors to submit invoices directly to DOD and other federal agency disbursing offices for payment without

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5. GAO, *Generally Accepted Government Auditing Standards*, GAO-03-673G (Washington, D.C.: June 2003) and GAO-07-731G (Washington, D.C.: July 2007).
6. Although our selection of the seven offices and 37 internal control audits was not statistical, it represented about 9 percent of the total 76 DCAA offices that issued audit reports on contractor internal controls and nearly 18 percent of the 40 offices that issued 8 or more reports on contractor internal controls during fiscal year 2006. Of the 37 internal control audits we reviewed, 32 reports were issued with adequate opinions and 5 reports were issued with inadequate-in-part opinions. In the case of follow-up audits, we also reviewed the documentation for the previous audit to gain an understanding of the scope of work and deficiencies identified in the prior audit. These were the most recently completed fiscal years at the time we initiated our audit.
7. In selecting the seven DCAA offices, we considered a 2-year history of internal control audit results. The seven DCAA offices we selected reported adequate opinions on 89 percent or more of the internal control reports they issued during fiscal year 2006. During fiscal year 2005, 4 of the 7 offices reported adequate opinions in 85 percent or more of the internal control reports they issued, and the other 3 offices issued adequate opinions in 50 to 69 percent of the internal control audit reports they issued.
8. DCAA *Contract Audit Manual* (CAM) 5-1202.1a and *Defense Federal Acquisition Regulation Supplement* (DFARS) 215.407-5.
9. FAR §§16.104(h) and 16.301-3(a)(1).

GAO Report No. 09-1009T (cont'd):

government review. Because DCAA uses the results of internal control audits to assess risk and plan the nature, extent, and timing of tests for other contractor audits and assignments, the conclusions and opinions in these audits impact hundreds of other DCAA audits. At the same seven DCAA field offices, we selected an additional 32 cost-related assignments for review, including 16 paid voucher reviews, 10 overpayment assignments, 2 requests for equitable adjustment audits, and 4 incurred cost audits that were completed during fiscal years 2004 through 2006. We reviewed supporting documentation for the cost-related assignments to determine whether DCAA auditors were identifying and reporting contractor overpayments and billing errors.[10] [11]

To assess DCAA corrective actions, we reviewed the status and analyzed several key actions that DCAA initiated as a result of our earlier investigation, including changes in performance metrics and policy and procedural guidance, as well as DCAA efforts in response to DOD Comptroller/Chief Financial Officer (CFO)[12] and Defense Business Board[13] recommendations. To identify potential legislative and other actions that could improve DCAA's effectiveness and independence, we considered DCAA's current role and responsibilities; the framework of statutory authority for auditor independence in the Inspector General Act of 1978, as amended;[14] best practices of leading organizations that have made cultural and organizational transformations; our past work on DCAA organizational alternatives; GAGAS criteria for auditor integrity,

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10. FAR §42.101 and DFARS §242.803.
11. Contractor overpayments can occur as a result of errors made by paying offices, such as duplicate payments and payments in excess of amounts billed, and contractor billing errors, such as using the wrong overhead rate, failing to withhold designated amounts on progress payments, duplicate billings, or billing for unallowable cost. Recoveries of overpayments can be accomplished through refunds, subsequent billing offsets, or other adjustments to correct billing errors.
12. Under Secretary of Defense—Comptroller, *Memorandum for Director Defense Contract Audit Agency*, Subject: Implementation of Corrective Actions (Washington, D.C.: Aug. 20, 2008).
13. Defense Business Board, *Report to the Secretary of Defense: Independent Review Panel Report on the Defense Contract Audit Agency*, October 2008.
14. Codified in an appendix to Title 5 of the United States Code (hereafter 5 U.S.C. App.).

GAO Report No. 09-1009T (cont'd):

objectivity, and independence; and GAO's Standards for Internal Control in the Federal Government[15] on managerial leadership and oversight.

Throughout our audit, we met with the DCAA Director and DCAA headquarters policy, quality assurance, and operations officials and DCAA region and FAO managers, supervisors, and auditors. We also met with DOD Office of Inspector General (OIG) auditors responsible for DCAA audit oversight and DOD OIG hotline office staff. In addition, we met with the former DOD Comptroller/CFO to discuss plans for the Office of Comptroller/CFO and Defense Business Board reviews, and we continued to meet with and obtain information from the new DOD Comptroller/CFO and his staff. We also met with the Comptroller's new DCAA Oversight Committee. We conducted our performance audit from August 2006 through December 2007, at which time we suspended this work to complete our investigation of hotline allegations regarding audits performed at three DCAA field offices. We resumed our work on the performance audit in October 2008 and performed additional work through mid-September 2009 to evaluate DCAA's quality assurance program during fiscal years 2007 and 2008, assess DCAA corrective actions on identified audit quality weaknesses, and consider legislative and organizational placement options for DCAA. We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for findings and conclusions based on our audit objectives. We performed our investigative procedures in accordance with quality standards set forth by the Council of the Inspectors General on Integrity and Efficiency (formerly the President's Council on Integrity and Efficiency).

Today, I will summarize the results of our audit.

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15. GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

GAO Report No. 09-1009T (cont'd):

Widespread Management Environment and Audit Quality Problems

We found audit quality problems at DCAA offices nationwide. Of the 69 audits and cost-related assignments we reviewed,[16] 65 exhibited serious GAGAS or other deficiencies similar to those found in our investigation, including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision. Although not as serious, the remaining four audits also had GAGAS compliance problems. In addition, while DCAA did not consider 26 of the 32 cost-related assignments we reviewed to be GAGAS audits, DCAA did not perform sufficient testing to support reported conclusions on that work. According to DCAA officials, DCAA rescinded 80 audit reports related to our prior investigation as well as the audit leading to today's report because the audit evidence was outdated, insufficient, or inconsistent with reported conclusions and opinions and reliance on the reports for contracting decisions could pose a problem. About one-third of the rescinded reports relate to unsupported opinions on contractor internal controls and were used as the basis for risk-assessments and planning on subsequent internal control and cost-related audits. Other rescinded reports relate to Cost Accounting Standards (CAS) compliance and contract pricing decisions. Because the conclusions and opinions in the rescinded reports were used to assess risk in planning subsequent audits, they impact the reliability of hundreds of other audits and contracting decisions covering billions of dollars in DOD expenditures.

A management environment and agency culture that focused on facilitating the award of contracts and an ineffective audit quality assurance structure are at the root of the agencywide audit failures we identified. DCAA's focus on a production-oriented mission led DCAA management to establish policies, procedures, and training that emphasized performing a large quantity of audits to support contracting decisions and gave inadequate attention to performing quality audits. An ineffective quality assurance structure, whereby DCAA gave passing scores to deficient audits compounded this problem.

Although the reports for all 37 audits of contractor internal controls that we reviewed stated that the audits were performed in accordance with GAGAS, we found GAGAS compliance issues with all of these audits. The issues or themes are consistent with those identified in our prior investigation.

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16. Of the 69 DCAA assignments we reviewed, 37 were audits of contractor systems and related internal controls and 32 were cost related audits and assignments.

GAO Report No. 09-1009T (cont'd):

Lack of independence. In seven audits, independence was compromised because auditors provided material nonaudit services to a contractor they later audited; experienced access to records problems that were not fully resolved; and significantly delayed report issuance, which allowed the contractors to resolve cited deficiencies so that they were not cited in the audit reports. GAGAS state that auditors should be free from influences that restrict access to records or that improperly modify audit scope.[17]

Insufficient testing. Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions. GAGAS for examination-level attestation engagements require that sufficient evidence be obtained to provide a reasonable basis for the conclusion that is expressed in the report.[18] For internal control audits, which are relied on for 2 to 4 years and sometimes longer, the auditors would be expected to test a representative selection of transactions across the year and not transactions for just one day, one month, or a couple of months.[19] However, we found that for many controls, the procedures performed consisted of documenting the auditors' understanding of controls, and the auditors did not test the effectiveness of the implementation and operation of controls.

Unsupported opinions. The lack of sufficient support for the audit opinions on 33 of the 37 internal control audits we reviewed rendered them unreliable for decision making on contract awards, direct-billing privileges, the reliability of cost estimates, and reported direct cost and indirect cost rates. For example, we found that:

- For many controls, DCAA did not perform any testing at all. For example, audits of contractor accounting systems do not include any transaction testing. Instead, these audits focus on a review of the adequacy of contractor policies and procedures. At least six of the nine accounting audits we reviewed did not include procedures for confirming contractor segregation of allowable and unallowable cost.

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17. See GAO-03-673G, §3.19, and GAO-07-731G, §3.10.
18. GAO-03-673G, §6.04b.
19. AICPA *Statements on Auditing Standards*, AU 350 and *Audit and Accounting Guide: Audit Sampling*, §§3.14, 3.29-3.34, 3.58, and 3.61.

GAO Report No. 09-1009T (cont'd):

DCAA issued an adequate opinion on the accounting system for a major DOD contractor after performing a walkthrough of the accounting process and interviewing two employees.

- In billing system audits we reviewed, DCAA auditors often tested only two, three, or sometimes five transactions to support audit conclusions on contractor systems and related internal controls. Further, the auditors performed limited procedures such as determining whether the vouchers were mathematically correct and included current and cumulative billed amounts. Twenty of the 22 billing system audits we reviewed did not include tests to identify duplicate invoices.

- DCAA auditors reported on the adequacy of a contractor's billing system based on tests of four vouchers, all issued on the same day.

- In an audit of controls over indirect and other direct cost for a business segment of one of the top five DOD contractors, DCAA auditors tested 12 out of about 22,000 transactions processed from May through July 2005.

We also found that reports did not adequately disclose the criteria used in performing individual audits. According to GAGAS, audit reports should, among other matters, identify the subject matter being reported and the criteria used to evaluate the subject matter. Criteria identify the required or desired state or expectation with respect to the program or operation and provide a context for evaluating evidence and understanding the findings.[20] None of the 37 internal control audit reports we reviewed cited specific criteria used in individual audits. Instead, the reports uniformly used boilerplate language to state that DCAA audited for compliance with the "FAR, CAS, DFARS, and contract terms." As a result the user of the report does not know the specific Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS), or contract terms used as criteria to test contractor controls. This makes it difficult for users of the reports to determine whether the reports provide the level of assurance needed to make contracting decisions.

Similarly, the 32 cost-related assignments we reviewed did not contain sufficient testing to provide reasonable assurance that overpayments and billing errors that might have occurred were identified. As a result, there is little assurance that any such errors, if they occurred, were corrected and that related improper contract payments, if any, were refunded or credited

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20. GAO-07-731G, §4.15.

GAO Report No. 09-1009T (cont'd):

to the government. Contractors are responsible for ensuring that their billings reflect fair and reasonable prices and contain only allowable costs, and taxpayers expect DCAA to review these billings to provide reasonable assurance that the government is not paying more than it should for goods and services. We identified the following problems with these assignments.

Paid voucher reviews. DCAA performs annual testing of paid vouchers (invoices) to determine if contractor voucher preparation procedures are adequate for continued contractor participation in the direct-bill program.[21] Under the direct-bill program, contractors may submit their invoices directly to the DOD disbursing officer for payment without further review. Although DCAA does not consider its reviews of contractor paid vouchers to be GAGAS engagements, it has not determined what standards, if any, apply to these assignments. In addition, for the 16 paid voucher assignments we reviewed, we found that DCAA auditors failed to comply with DCAA Contract Audit Manual (CAM) guidance.[22] Rather than documenting the population of vouchers, preparing sampling plans, and testing a random (statistical) sample, auditors generally did not identify the population of vouchers, did not create sampling plans, and made a small, nonrepresentative selection of as few as one or two invoices for testing to support conclusions on their work. The auditors performed limited procedures such as determining whether the vouchers were mathematically correct and included current and cumulative billed amounts. Based on this limited work, the auditors concluded that controls over invoice preparation were sufficient to support approval of the contractors' direct billing privileges. This is of particular concern because we determined that Defense Finance and Accounting Service (DFAS) certifying officers rely on DCAA voucher reviews, and they do not repeat review procedures they believe to be performed by DCAA.

Overpayment assignments. DCAA performs overpayment assignments to verify that contractors have billing procedures and internal controls in place to identify and resolve contractor billing errors and overpayments in a timely manner. DCAA guidance states that these engagements should be conducted in accordance with GAGAS to the extent applicable under the

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21. DCAA does not perform paid voucher reviews during the year that it performs an audit of the contractor's billing system internal controls.
22. CAM 6-1007.

GAO Report No. 09-1009T (cont'd):

circumstances.[23] However, none of the 10 overpayment assignments we reviewed were performed or reported as GAGAS engagements. We found that auditor judgments about the population and selection of transactions for these assignments did not provide a representative universe for testing and concluding on contractor controls over billings and payments received. For example, for the 10 assignments we assessed, the auditors selectively reviewed an accounts receivable aging report to identify overpayments and determine if they had been resolved. As a result, this work does not provide reasonable assurance that contractors have adequate controls in place to identify and correct overpayments and billing errors and make appropriate, timely refunds and adjustments.

Incurred cost audits. The purpose of incurred cost audits is to examine contractors' cost representations and opine on whether the costs are allowable, allocable to government contracts, and reasonable in accordance with the contract and applicable government acquisition regulations.[24] DCAA performs these audits as GAGAS attestation engagements. For the four incurred cost audits we reviewed, we found that the auditors did not adequately document their judgments about control risk or the sampling and test methodologies used. In addition, we found that the auditors traced claimed pool and base costs (indirect costs) to the contractors' accounting books and records to determine their accuracy and allowability. However, the auditors did not perform sufficient, detailed testing of claimed indirect and direct costs. For example, the auditors traced and reconciled indirect costs to contractor accounting system data, but did not test a representative selection of direct costs. As a result, the scope of work performed was not sufficient to identify claimed costs, if any, that were not adequately supported or unallowable costs, if any, that should have been questioned.

Production environment and audit quality issues. DCAA's mission statement, strategic plan, and metrics all focused on producing a large number of audit reports and provided little focus on assuring quality audits. For example, DCAA's current approach of performing 30,000 to 35,000 audits and issuing over 22,000 audit reports with 3,600 auditors substantially contributed to the widespread audit quality problems we identified. Within this environment, DCAA's audit quality assurance

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23. DCAA, "Audit Program: Audit of Contractor Overpayments," (Activity Code 17310), April 2004, September 2007, and May 2008.
24. CAM 6-102.

GAO Report No. 09-1009T (cont'd):

program was not properly implemented, resulting in an ineffective quality control process that accepted audits with significant deficiencies and noncompliance with GAGAS and DCAA policy. Moreover, even when DCAA's quality assurance documentation showed evidence of serious deficiencies within individual offices, those offices were given satisfactory ratings. Considering the large number of DCAA audit reports issued annually and the reliance the contracting and finance communities have placed on DCAA audit conclusions and opinions, an effective quality assurance program is key to protecting the public interest. Such a program would report review findings along with recommendations for any needed corrective actions; provide training and additional policy guidance, as appropriate; and perform follow-up reviews to assure that corrective actions were taken. GAGAS require that each audit organization performing audits and attestation engagements in accordance with GAGAS should have a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and have an external peer review at least once every 3 years.[25]

DCAA officials advised us that going forward, DCAA will no longer rate an FAO's overall compliance with GAGAS and DOD policy. The officials told us that instead, DCAA headquarters plans to (1) report the detailed results of the audit quality reviews, (2) make recommendations to FAOs for any needed corrective actions, (3) conduct follow-up reviews for all FAOs with identified audit deficiencies to ensure that corrective actions are taken, and (4) provide training and policy guidance, as appropriate. If properly implemented, these procedures would help to assure an effective audit quality assurance program.

In addition, the DOD IG reported an adequate ("clean") opinion on DCAA's most recent peer review results although the reported evidence indicated that numerous audits had serious deficiencies in audit quality.[26] In conducting DOD's audit oversight review of DCAA audits, DOD IG audit oversight reviewers considered the same results of DCAA's internal audit quality assurance reviews that we analyzed and reviewed numerous additional audits, which also identified significant GAGAS noncompliance

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25. GAO-07-731G, §§3.50-3.52.
26. All 10 categories of recommendations in the DOD IG's report related to GAGAS compliance problems.

GAO Report No. 09-1009T (cont'd):

as evidenced by DOD IG peer review findings and recommendations. Although the DOD IG report contained evidence of significant, systemic noncompliance with professional standards throughout DCAA audits that OIG staff reviewed and the IG report included numerous findings and recommendations related to those issues, the DOD IG gave DCAA a "clean" peer review opinion,[27] concluding that for audits and attestation engagements performed during fiscal year 2006, "…the internal quality control system was operating effectively to provide reasonable assurance that DCAA personnel were following established policies, procedures, and applicable auditing standards…."

The overall report conclusion in the DOD IG report is inconsistent with the detailed observations in the report, which indicate numerous significant deficiencies in DCAA's system of quality control. Furthermore, of the 80 audit reports that DCAA rescinded, 39 of the rescinded reports were issued during fiscal year 2006—the period covered by the last DOD IG peer review. Therefore, we have concluded that DCAA's quality control system for the period covered by the last DOD IG peer review was not effectively designed and implemented to provide assurance that DCAA and its personnel comply with professional standards.

DCAA Is Making Progress, but Sustained Leadership and Oversight Is Needed

Although DCAA has taken several positive steps, much more needs to be done to address wide-spread audit quality problems. DCAA's production-oriented culture is deeply imbedded and will likely take several years to change. Under DCAA's decentralized management environment, there had been little headquarters oversight of DCAA regions, as demonstrated by the nationwide audit quality problems. DCAA's mission focused primarily on producing reports to support procurement and contracting community decisions with no mention of quality audits that serve taxpayer interest. Further, DCAA's culture has focused on hiring at the entry level and promoting from within the agency and most training has been conducted by agency staff, which has led to an insular culture where there are limited perspectives on how to make effective organizational changes.

DCAA corrective actions. DCAA initiated a number of actions to address findings in our July 2008 report, the DOD Comptroller/CFO August 2008 "tiger team" review, and the Defense Business Board study, which was

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27. DOD Inspector General, *Oversight Review: Review of the Defense Contract Audit Agency Quality Control System*, Report No. D-2007-6-006 (Arlington, VA: May 1, 2007).

GAO Report No. 09-1009T (cont'd):

officially released in January 2009. Examples of key DCAA actions to date include the following.

- Eliminating production metrics and implementing new metrics intended to focus on achieving quality audits.

- Establishing an anonymous Web site to address management and hotline issues. DCAA's Assistant Director for Operations has been proactive in handling internal DCAA Web site hotline complaints.

- Revising policy guidance to address auditor independence, assure management involvement in key decisions, and address audit quality issues. DCAA also took action to halt auditor participation in nonaudit services that posed independence concerns.

Further, DCAA has enlisted assistance from other agencies to develop a human capital strategic plan, assist in cultural transformation, and conduct a staffing study. In March 2009, the new DCAA Comptroller/CFO established a DCAA Oversight Committee to monitor and advise on DCAA corrective actions.

While these are positive actions, other DCAA actions have focused on process improvements, and DCAA has not yet addressed the fundamental weaknesses in its mission, strategic plan, audit approach, and human capital practices.

Although DCAA is making progress, we are concerned that DCAA actions to date evidence some of the past cultural problems that could limit their success. For example, DCAA identified the following six new performance metrics as focusing on the intended outcome-related goal of achieving quality audits that comply with GAGAS.[28]

1. Obtaining an unqualified DOD IG peer review opinion.

2. DCAA's internal quality assurance program results show that 100 percent of the audits reviewed reflected professional judgment.

3. Checklist confirmation that issued reports did not include serious deficiencies.

4. A goal that 45 percent of audit reports will have findings as an indication of the tangible value of the audit work performed.

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28. DCAA also established contracting officer sustention rates related to questioned cost and net savings as an informational goal to show return to the taxpayer.

GAO Report No. 09-1009T (cont'd):

5. A goal that 15 percent of the audits will use quantitative methods to measure the extent to which advanced level audit techniques are used.

6. A goal that auditors will meet 100 percent of their continuing professional education requirements on time.

Given the problems with DOD IG peer review results and DCAA's ineffective quality assurance program, for these metrics to achieve the intended audit quality goal, significant changes will be needed. DCAA also retained three performance metrics that address issuing reports within specified times to support contract awards and closeouts, for example:

1. A forward-pricing audit timeliness goal of 95 percent based on agreement with requesters.

2. Incurred cost audit timeliness goals of 90 percent of corporate audits completed within 12 months, 90 percent of major contractor audits completed in 15 months, and 95 percent of non-major contractor audits completed in 24 months.

3. An efficiency goal of cost per direct audit hour of less than $113.45 to be monitored at the agency level only.

It is critical that agreements with the contracting community on timeliness goals for forward-pricing and incurred cost audits allow performance of sufficient audit procedures to help contracting officers ensure that prices paid by the government are fair and reasonable, and that contract costs comply with applicable laws, regulations, cost accounting standards, and contract terms.

Risk-based audit approach. DCAA did not agree to develop a risk-based audit approach, as recommended by the Defense Business Board. DCAA lacks a risk-based audit approach to address how it will perform required audits with available audit resources, reassess the need to perform 30,000 or more audits annually and the appropriate level of audit resources, and establish priorities for performing quality audits that meet GAGAS within available resources. While resources are a key element of a risk-based planning approach, DCAA is performing the Defense Business Board recommended staffing study as a stand-alone effort rather than performing this study in concert with an effort to establish a risk-based planning process.

DCAA policy guidance. DCAA's new policy guidance on adequate audit documentation and testing does not contain sufficient instruction to assure that auditors (1) adequately document significant decisions affecting the audit objectives, scope and methodology, findings,

GAO Report No. 09-1009T (cont'd):

conclusions, and recommendations and (2) perform sufficient work to support decisions to approve contractors for direct-bill status. For example,

- DCAA's new policy on "Workpaper Documentation of Judgmental Selections"—requires a description of the universe (population) from which items are selected for testing, identification of items and attributes to be tested, and an explanation to support that the judgmental selection will result in adequate audit coverage.

  Emphasizing the requirement that audit documentation include a description of the population used for sampling and identification of items and attributes to be tested is appropriate. However, the requirement for an explanation in the audit documentation that the judgmental selection will result in adequate audit coverage needs to be sufficiently justified. GAGAS and AICPA standards require that auditors document significant decisions affecting the audit objectives, scope and methodology, findings, conclusions, and recommendations resulting from professional judgment.[29]

- DCAA's new policy on "Audit Guidance for Annual Testing of Contractor Eligibility for Direct Bill" is intended to determine whether continued reliance can be placed on the contractor's procedures for preparation of interim vouchers. This policy change clarified and consolidated audit steps related to the contractor's compliance with contract provisions, added audit steps for reviewing vouchers under time-and-material and labor-hour contracts, and removed the requirement to verify that the contractor's Central Contractor Registration is current. The policy memorandum states that this scope of work performed does not constitute an audit or attestation engagement under GAGAS.

While it is within DCAA's purview to determine whether these procedures constitute an audit, because direct-bill decisions present a risk of undetected improper contract payments, prudent decisions to continue a contractor's direct-bill authorization would necessarily be

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29. GAO-07-731G, §3.38 and AU §339.12.

GAO Report No. 09-1009T (cont'd):

based on testing a statistical sample of invoices[30] and include a review of supporting documentation, including documentation to confirm the government received goods and services noted on the billing invoice. We confirmed that Defense Finance and Accounting Service certifying officers rely on DCAA reviews and that they do not repeat review procedures they believe to be performed by DCAA.

In addition, DCAA's policy to eliminate the "inadequate-in-part" opinion for contractor internal control systems audits does not recognize different levels of severity of control deficiencies and weaknesses and could unfairly penalize contractors whose systems have less severe deficiencies by giving them the same opinion—"inadequate"—as contractors having material weaknesses or significant deficiencies that in combination would constitute a material weakness. DCAA would benefit from outside expertise to develop effective audit policy guidance and training on auditing standards.

Legislative and Other Actions Could Further Improve DCAA

In addition to correcting the fundamental weaknesses in DCAA's mission and overall management environment, we believe certain legislative measures as well as other actions could enhance DCAA's effectiveness and independence. For example, granting DCAA certain authorities and protections—similar to those offered to presidentially appointed inspectors general (IG) under the IG Act[31]—could enhance DCAA's independence. The IG Act contains provisions that enhance the independence of presidentially appointed IGs, including protections from removal without congressional notification, access to independent legal counsel, public reporting of audit results, rights to take statements from

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30. Disbursing officers are authorized to make payments on the authority of a voucher certified by an authorized certifying officer, who is responsible for the legality, accuracy, and propriety of the payment. 31 U.S.C. §§3325, 3527(c). DOD 7000.14-R, Department of Defense *Financial Management Regulation* (DFMR), Vol. 5, Ch. 11 (March 2009), paras. 110102, 110203. In general, certifying officers designated in writing by the agency are financially liable for any improper, illegal, or incorrect payment made, and each payment made must be audited (or "examined"). 31 U.S.C. §§3521(a), 3528(a). DFMR, Vol. 5, Ch. 33 (April 2005), para. 330303. However, 31 U.S.C. §3521(b) authorizes heads of agencies to carry out a statistical sampling procedure, within certain parameters, to audit vouchers when the head of the agency determines that economies will result. Further, 31 U.S.C. §3521(c) provides that certifying and disbursing officials are not liable for payments that are not audited if they were made in good faith under a statistical sampling procedure. See 68 Comp. Gen. 618 (1989); also see generally, GAO, *Policy and Procedures Manual for Guidance of Federal Agencies*, title 7, §§6.5, 7.4, and 7.5 (Washington, D.C.: May 18, 1993).
31. Codified in an appendix to Title 5 of the United States Code.

GAO Report No. 09-1009T (cont'd):

contractor and other personnel, and budget visibility. These provisions would enhance the important DCAA initiatives currently under way. In the longer term, Congress could consider changes in organizational placement after DCAA has had sufficient opportunity to effectively implement current reform efforts. However, moving DCAA as an organization would require careful analysis and planning before implementation. Continued monitoring and oversight will be essential to assuring the successful implementation of DCAA's management initiatives.

Our Recommendations and DOD's Response

Our report contains several recommendations to DOD as well as matters for congressional consideration intended to strengthen DCAA in fulfilling its contract audit responsibilities. Our report also discusses matters for congressional consideration that could enhance DCAA's effectiveness and independence. These recommendations and matters are discussed below.

We made 17 recommendations to improve DCAA's management environment, audit quality, and oversight, including 15 recommendations to DOD and 2 recommendations to the DOD IG regarding DCAA's last peer review. DOD fully agreed with 13 of the 15 recommendations, partially concurred on one recommendation and did not concur with one other recommendation. We view DOD comments as being generally responsive to the intent of our recommendations.

DOD partially concurred with our recommendation that DCAA consult with DOD stakeholders and engage outside experts to develop a risk-based contract audit approach that identifies resource requirements and focuses on performing quality audits that meet GAGAS. DOD stated that DCAA already has a risk-based contract audit approach that identifies resource requirements and focuses on performing quality audits that meet GAGAS. However, DOD stated that DCAA will coordinate with the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD (AT&L)) to assess DCAA audit requirements.[32] DOD expects to complete its assessment of stakeholder needs based on regulatory and statutory requirements by December 2010.

32. The USD (AT&L) is responsible under 10 U.S.C. §133 for establishing DOD policies related to the negotiation, award, and administration of contracts, such as those related to the use of contract audit services, and for coordinating contract audit activities within DOD.

GAO Report No. 09-1009T (cont'd):

We appreciate these steps; however, we remain concerned that DCAA's current approach of performing 30,000 to 35,000 audits and issuing over 22,000 audit reports with 3,600 auditors substantially contributed to the widespread audit quality problems we identified. Generating that many reports and doing that many audits with 3,600 auditors leaves very little time to perform in-depth, complex audits of contractors.

DOD did not concur on our recommendation to develop policies and procedures related to direct-billing decisions, stating that (1) the department believes that a review of the contractor's interim public vouchers is an integral function of DCAA's continued assessment of a contractor's billing system, (2) DCAA is in the best position to review and approve contract interim billings based on its thorough understanding of the contractor's system, (3) DOD believes that our concerns are mitigated based on comprehensive supervisory and audit manager reviews, and (4) DCAA does not believe that the approval of interim vouchers along with the approval for contractors to be on direct billing results in a lack of auditor objectivity.

We continue to believe that DCAA's management (nonaudit) responsibility to perform prepayment reviews of contractor vouchers for DOD and the auditor's decision-making role of approving contractors for direct-billing privileges based on its audit conclusions about the strength of the contractor's system of internal controls, create audit objectivity issues. Under normal circumstances, DCAA auditors must review contractor vouchers prior to payment—a management support function for DOD. By obtaining direct-billing privileges, however, contractors can receive payment for goods and services without a voucher review by DCAA prior to payment. Because we found that this situation created an incentive for DCAA to reduce its workload by recommending that contractors are placed on direct billing, we recommended that DCAA develop new policies and procedures to ensure a separation between staff reviewing vouchers and staff making direct-bill decisions. DCAA did not explain the basis for its belief that DCAA administrative staff have a thorough understanding of the contractors' systems. Further, we disagree with DOD's statement that our concerns are mitigated based on the comprehensive supervisory and audit manager reviews because this is not supported by our findings. The fact that DCAA approvals of contractor direct-bill privileges were not based on sufficient audit procedures as demonstrated by our work and DCAA's removal of over 200 contractors from the direct-bill program since

GAO Report No. 09-1009T (cont'd):

our July 2008 report[33] support our concern that the existence of such an incentive presents an objectivity impairment.

With regard to our two recommendations to the DOD IG, the IG concurred on our recommendation to reconsider the overall conclusions in its May 2007 peer review report on its audit of DCAA's system of quality control. However, the IG did not agree with our recommendation to determine whether the report should be rescinded or modified and did not take action to do so. The IG comments stated that the IG took alternative action that conformed to the intent of our recommendation, including notification of DCAA on August 24, 2009, that the May 2007 "adequate" opinion on DCAA's system of quality control would expire on August 26, 2009. In addition, the IG stated, "We have determined that it is not prudent to allow the adequate opinion from our May 2007 report to carry forward." However, peer review opinions neither "expire" nor "carry forward" beyond the period covered by the peer review. Based on the significant audit quality deficiencies identified in the IG peer review report, DCAA's decision to rescind 80 audit reports—39 of which relate to the period of the IG's peer review—and the findings in our audit, we concluded that DCAA's quality control system for the period covered by the DOD IG peer review was not effectively designed and implemented to provide assurance that DCAA and its personnel comply with professional standards.

DOD also provided comments on our matters for congressional consideration. Although DOD disagreed with the matters we discussed, we continue to believe these are valid matters for congressional consideration. The IG Act provides many important authorities and protections for IG's that could enhance DCAA's independence and effectiveness. Further, if DCAA is unsuccessful in addressing our recommendations for resolving fundamental weaknesses in its mission and the overall management environment under the current organizational placement, additional options would need to be considered.

Mr. Chairman and Members of the Committee, this concludes my statement. We would be pleased to answer any questions that you may have at this time.

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33. GAO-08-857.

<u>GAO Report No. 09-1009T (cont'd):</u>

Contacts and Acknowledgments

For further information about this testimony, please contact Gregory D. Kutz at (202) 512-6722 or kutzg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Major contributors to our testimony include F. Abe Dymond, Assistant General Counsel; Richard Cambosos; Jeremiah Cockrum; Andrew McIntosh; and Lerone Reid.

UNITED STATES
CIVILIAN BOARD OF CONTRACT APPEALS

GRANTED: April 22, 2009
CBCA 1073

OCWEN LOAN SERVICING, LLC,
Appellant,
v.
DEPARTMENT OF VETERANS AFFAIRS,
Respondent.

Gregory S. Jacobs, James P. Gallatin, Jr., and Lawrence S. Sher of Reed Smith LLP, Washington, DC, counsel for Appellant.

Dennis Foley, William Korth, Phil Kauffman, and Phillipa L. Anderson, Office of General Counsel, Department of Veterans Affairs, Washington, DC, counsel for Respondent.

Before Board Judges **DANIELS** (Chairman), **HYATT**, and **DRUMMOND**.
DANIELS, Board Judge.

Once again, the Board has thrown the respondent in this case, the Department of Veterans Affairs (VA), a lifeline, and the agency has used that rope to hang itself. The appeal is granted because, in response to the Board's request for a definition and explanation of the portion of the government claim which survives, VA has provided no definition or explanation whatsoever.

Background

The contract at issue here is for the performance of services involving the sale of real estate which comes into VA's possession through foreclosures on VA-guaranteed loans. The claim is for penalties which the contract specifies are to be calculated with reference to Return on Sale (ROS). A key component of ROS is the foreclosure appraisal values used by VA for the properties in question. VA refused to produce foreclosure appraisals for the vast majority of the properties -- first in response to discovery requests made by the contractor,
(*continued on next page*)

<u>Ocwen Loan Servicing, LLC, CBCA 1073 (cont'd):</u>

Ocwen Loan Servicing, LLC (Ocwen), and later in response to an order by the Board. In an earlier decision, the Board concluded that without the appraisals, the agency could not demonstrate that the penalties were reasonably premised as to these properties. We consequently granted the appeal as to that portion of the claim involving the properties.

We allowed the case to proceed as to the properties for which VA *had* produced foreclosure appraisals. In doing so, however, we stated:

> We are not certain . . . whether the agency can, without reference to the great bulk of appraisals, establish that any penalties may fairly be imposed on the contractor. The contract requires that an ROS be based on all properties sold during a particular period, and it is not clear whether, by eliminating properties from the universe from which an ROS might be calculated, it is possible to calculate an ROS. We therefore hold in abeyance a ruling on the remainder of Ocwen's motion [to grant the appeal]. VA is directed to provide to the Board and the contractor, within two weeks from the date of this decision -- by Thursday, April 2, 2009 [--] a proffer of the portion of the claim (if any) it believes survives the decision. If the proffer is that some of the claim survives, the proffer shall include a detailed explanation of how that amount is calculated and a complete list of the evidence which may be relied upon to support the amount. After reviewing this proffer, and considering Ocwen's comments on it, we will rule on the part of the motion as to which we have now held in abeyance.

Ocwen Loan Servicing LLC v. Department of Veterans Affairs, CBCA 1073 (Mar. 19, 2009), slip op. at 12.

VA filed on April 2 a statement it called "Respondent's Proffer and Request to Set Aside Sanctions and Motion for Protective Order." Notwithstanding the title, as Ocwen points out, this statement is not the proffer that the Board directed the agency to file. The statement does not include a definition of the portion of the claim VA believes survives our March 19 decision. Indeed, it does not cite a single dollar figure. Nor does the statement include a detailed explanation of how an amount is calculated. With the exception of a brief apology (for what is not made clear), the statement consists almost entirely of a request for reconsideration of the March 19 decision. The request argues that VA is "not obliged to retain or to provide pre-foreclosure appraisals" and that "Ocwen was contractually obliged to provide the . . . appraisals." Respondent's Proffer at 2, 3. Additionally, "Respondent protests it is being compelled to proffer its entire case for Board decision before any evidence is properly taken and before discovery is completed." *Id.* at 6.

<u>Discussion</u>

In issuing the interlocutory decision on March 19, the Board was uncertain whether

(*continued on next page*)

Ocwen Loan Servicing, LLC, CBCA 1073 (cont'd):

any of the Government's claim survived our rejection of most of it. We sought assistance, in understanding the dimensions of the remainder of the case, from the party which had made the claim. Our order was a commonplace direction in litigation: an effort to determine, from the party bearing the burden of proof, how the claim was constructed and whether any support for it existed. In response, VA has declined to provide any information at all. Because the party making the claim has failed to establish a prima facie case for going forward, we have no alternative but to conclude that the penalties are without foundation. The appeal is therefore granted, to the extent that it remained open on March 19.

The request for reconsideration is not well taken. VA still does not seem to understand that foreclosure appraisals must be produced to demonstrate that penalties based in large part on them are reasonably premised. Thus, our decision was reached not because VA disobeyed discovery orders (which it did), but rather, because the agency failed to meet its obligation to demonstrate that it had sufficient basis to support its claim. Some of the arguments made in the motion were previously made and rejected, and others could have been made on the basis of documents in the record but were not. Neither variety of argument is appropriately put before us now. Board Rule 26(a) (48 CFR 6101.26(a) (2008)) ("Arguments already made and reinterpretations of old evidence are not sufficient grounds for granting reconsideration"); *Watson v. United States*, 281 F. App'x 970, 971 (Fed. Cir. 2008) ("a new legal argument cannot be raised in a motion for reconsideration under RCFC [Rules of the Court of Federal Claims] 59(a)(1) when the plaintiff knew of the facts giving rise to the argument during the pendency of the case"); *National Westminster Bank, PLC v. United States*, 512 F.3d 1347, 1352, 1363 (Fed. Cir. 2008) (argument made on reconsideration but not presented during briefing stage held to have been waived).

Ocwen has presented an elaborate explanation showing that no penalties can be justified under the contract with regard to the properties for which VA has produced foreclosure appraisals. Appellant's Comments Regarding Respondent's Proffer at 4-8 & Attachment A. Because the penalties are a Government claim and VA has made no effort, in response to our March 19 order, to satisfy its burden of demonstrating that there is justification for them, we have no need to analyze whether Ocwen's explanation is valid. Similarly, because we have rejected VA's request for reconsideration, we do not analyze the agency's brand new -- and quite surprising, in light of the history of the case -- argument that Ocwen, not VA, was responsible for creating the foreclosure appraisals.

Decision

To the extent that this appeal was not resolved in the Board's decision of March 19,

(*continued on next page*)

2009, the appeal is now GRANTED. The appeal is consequently granted in its entirety. VA may not impose on Ocwen any of the penalties encompassed in the claim which is the subject of this case.

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STEPHEN M. DANIELS
Board Judge

We concur:

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CATHERINE B. HYATT	JEROME M. DRUMMOND
Board Judge	Board Judge

UNITED STATES
CIVILIAN BOARD OF CONTRACT APPEALS

MOTION TO DISMISS FOR FAILURE TO PROSECUTE DENIED; SANCTIONS IMPOSED: October 27, 2009
CBCA 1544

MEDTEK, INC.,
Appellant,
v.
DEPARTMENT OF VETERANS AFFAIRS,
Respondent.

Michael T. Farrell of Farrell Law Firm, Media, PA, counsel for Appellant.
Kate Gorney, Office of the Regional Counsel, Department of Veterans Affairs, Philadelphia, PA, counsel for Respondent.

Before Board Judges **DANIELS** (Chairman), **STEEL**, and **SHERIDAN**.
DANIELS, Board Judge.

There are consequences to an appellant's failure to comply with discovery orders, even where the party's actions demonstrate an interest in pursuing a case.

Background

Medtek, Inc. (Medtek) entered into two contracts with the Department of Veterans Affairs (VA) for the renovation of the third and fourth floors of the Philadelphia, Pennsylvania, Veterans Affairs Medical Center. With regard to the contract for renovation of the third floor, Medtek "claims that it incurred $410,000 in additional expenses to correct a design defect caused by [VA's] engineer, loss of revenue and the necessary legal expenses that [Medtek] had to incur to defend its position." Complaint ¶ 4. The contracting officer denied this claim, and Medtek appealed.

Specifically, Medtek lists the following elements of its claim:

-- Colonial Surety legal fee $117,917.53
-- Cohen & Seglas legal fee 97,620.55

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Medtek, Inc., CBCA 1544 (cont'd):

-- Nitti & Nitti legal fee 2,610.00
-- Medtek, Inc. loss 135,265.92
-- UPS transformer 20,586.00
-- CMS construction supervision fee 24,000.00
-- Jerry Smith Electrician 12,000.00

On June 17, 2009, VA sent to Medtek, then represented by counsel, written discovery requests. These requests included fifteen interrogatories, fifteen requests for admission, and ten requests for the production of documents. Each of these requests was designed to elicit information related to the elements of Medtek's claim. Under the Board's Rules of Procedure, any objection to any of these requests had to be filed within fifteen calendar days after receipt, or by July 2, 2009, and Medtek had to "fully respond to any discovery request to which it [did] not file a timely objection." Rule 13(f)(2) (48 CFR 6101.13(f)(2) (2008)). Also under the Board's Rules, those full responses had to be made within thirty days after Medtek received the requests, or by July 17, 2009. Rules 14(a) (interrogatories), (c) (requests for admission), (d) (requests for production of documents).

On July 30, government counsel wrote to the contractor's attorney as follows:

> I have not received any responses to the Agency's discovery requests that were served on you on June 17, 2009. Please send your responses to me as soon as possible. If I do not receive any response from you by August 7, 2009, [I] will have to contact the judge regarding this matter.

By August 24, no responses had been forthcoming. On that date, VA filed a motion to compel discovery. By this time, however, the attorney engaged by Medtek had ceased to represent the contractor in this case.

On September 2, Medtek's attorney, newly re-engaged, acknowledged in a telephonic conference that responses to the agency's discovery requests were tardy and promised to provide them no later than September 11. Government counsel said that if the responses were indeed provided by that date, she would not require a ruling on the motion.

On September 21, however, government counsel reported that she still had not received any responses to her discovery requests. The Board convened a telephonic conference on September 23 to discuss the matter -- this time with Medtek's president, since the attorney had for a second time withdrawn from the case. At this conference, the Board granted VA's motion to compel, directing Medtek to respond to the June 17 discovery requests -- as well as a second set of interrogatories, which had been sent on September 4 -- by October 7. We informed the parties that if the order was not complied with, we would look favorably on a motion by VA to dismiss the case for failure to prosecute.

Medtek did not comply with our September 23 order granting VA's motion to compel;
(*continued on next page*)

Medtek, Inc., CBCA 1544 (cont'd):

it did not respond to any of the discovery requests by October 7. On October 8, VA filed a motion to dismiss the case for failure to prosecute.

On October 9, Medtek sent to VA its responses to the agency's interrogatories and requests for admission. It did not send any documents responsive to the requests for production. Many of the responses were incomplete. For example, in response to an interrogatory which asked, "To the extent that you are claiming any damages based on not being able to take on new or additional work until this project was completed, please indicate what damages you are claiming," Medtek answered, "Medtek, Inc. loss in the value of $135,265.92," without providing any explanation of how that figure was constructed. Some other responses are unintelligible. For example, in response to an interrogatory which asked a series of questions about UPS equipment, Medtek answered, "Vygysguy."

On October 13, Medtek's attorney -- now back on the case for the third time -- filed an opposition to VA's motion to dismiss. He asked us to excuse his client's having failed to comply with the Board's September 23 order as "inadvertent" and resulting from the client's having "misunderstood the due date" and having proceeded pro se. Counsel also noted that responses to the discovery requests had been filed.

The Board convened a telephonic conference on October 14 to discuss VA's motion to dismiss. VA counsel asked for a ruling on this motion. Medtek's attorney opposed the request. He acknowledged that he had not yet seen his client's discovery responses and asked for an opportunity to cure the defects in them which were noted by agency counsel. The Board directed that complete responses be submitted to the agency, with a copy to the Board, by October 21.

On October 22, VA informed the Board that Medtek had not complied with the October 14 order. Counsel again asked for a ruling on the motion to dismiss, maintaining that the agency's ability to prepare adequately a motion for summary relief is prejudiced by the contractor's failure to answer the discovery requests. Medtek's attorney objected that granting the motion is excessive; he offered to accept as a sanction the inability to make any objection to any of the discovery requests. He again promised to send complete answers to the requests as soon as possible.

Discussion

Board Rule 33(c), Sanctions, provides:

> When a party or its representative or attorney . . . fails to comply with any direction or order issued by the Board (including an order to provide or permit discovery), or engages in misconduct affecting the Board, its process, or its proceedings, the Board may make such orders as are just, including the imposition of appropriate sanctions. The

(*continued on next page*)

Medtek, Inc., CBCA 1544 (cont'd):

sanctions may include:

> . . . .
> (3) Refusing to allow the disobedient party to support or oppose designated claims or defenses;
> (4) Prohibiting the disobedient party from introducing in evidence designated documents or items of testimony;
> . . . .
> (6) Dismissing the case or any part thereof;
> . . . . ; or
> (8) Imposing such other sanctions as the Board deems appropriate.

As this rule makes clear, the Board has the power to dismiss a case for failure to prosecute. This sanction has been described as "harsh" and "severe," however, so we employ it sparingly. *Kadin Corp. v. United States*, 782 F.2d 175, 176 (Fed. Cir. 1986); *Griffin & Dickson v. United States*, 16 Cl. Ct. 347, 351-52 (1989) (opinion by Judge Rader); *Rowe Inc. v. General Services Administration*, GSBCA 14136, 98-2 BCA ¶29,951, at 148,183; *Old Dominion Security, Inc. v. General Services Administration*, GSBCA 12974, 95-1 BCA ¶27,442 (1994). It is reserved for egregious situations, where parties have repeatedly failed to comply with the tribunal's orders. Willful disobedience of orders and prejudice to the opposing party have generally been found as reasons for dismissing a case for failure to prosecute. *McZeal v. Sprint Nextel Corp*., 2009 WL 1706576 (Fed. Cir. June 18, 2009) (applying law of 5th Circuit); *Adkins v. United States*, 816 F.2d 1580, 1582 (Fed. Cir. 1987); *Griffin & Dickson*, 16 Cl. Ct. at 352; *Corners & Edges, Inc. v. Department of Health & Human Services*, CBCA 1322, 09-1 BCA ¶34,051.

Medtek has repeatedly failed to comply with the Board's orders, has made unpersuasive excuses for its delinquencies, and has confused the proceedings by its on-again-off-again relationship with its attorney. Nevertheless, the contractor has provided some responses to VA's discovery requests. While those responses have been tardy, and some have been incomplete or unintelligible, they have manifested some interest in continuing to move the case toward a resolution on the merits. Accordingly, we believe that dismissing the case for failure to prosecute would be an excessive sanction at this time.

Although Medtek's actions are not worthy of dismissal of the case, they have delayed progress toward resolution of the matter and have not materially assisted VA or the Board in understanding the basis of the claim. These actions (or inactions) do merit consequences. The sanction proposed by the contractor's attorney, restricting the ability to object to discovery requests, is meaningless; the time for making such objections passed long ago, on July 2, 2009. (We do appreciate counsel's predicament, however; he has been trying to satisfy the Board's orders, but his client has made representation extremely difficult.)

(*continued on next page*)

Medtek, Inc., CBCA 1544 (cont'd):

Decision

We impose instead the following sanctions:

1. Because Medtek has not responded to any of VA's requests for the production of documents, notwithstanding the Board's order compelling such responses, Medtek may not introduce into evidence any documents which may be responsive to those requests.
2. Because Medtek has not revised its answers to VA's first set of interrogatories and VA's requests for admission, notwithstanding the Board's direction that it make those answers complete and intelligible, Medtek may not present any evidence which is in significantly greater detail than the answers it provided to those interrogatories and requests.
3. Because Medtek has not responded to VA's second set of interrogatories, notwithstanding the Board's order compelling such responses, Medtek may not present any evidence which would be responsive to those interrogatories.

As stated above, VA's **MOTION TO DISMISS FOR FAILURE TO PROSECUTE IS DENIED.**

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STEPHEN M. DANIELS
Board Judge

We concur:

____
CANDIDA S. STEEL
Board Judge

____
PATRICIA J. SHERIDAN
Board Judge

Compensation Is Not a Four-Letter Word: Coping With a DCAA Executive Compensation Review

by

*Richard B. O'Keefe, Jr.**

[Note: "Compensation Is Not a Four-Letter Word: Coping With a DCAA Executive Compensation Review ," by Richard B. O'Keefe, Jr., 2009, *The Procurement Lawyer* 45.1; © 2009 by the American Bar Association. Reprinted with permission.]

> "[President Obama has] been very clear that he shares the outrage that most Americans feel about the spectacle of gaudy bonuses . . . for executives at firms that are getting extraordinary assistance from American taxpayers. It's not right."[1]

Some might say that 2009 is precisely the wrong time to write an article that is even remotely critical of any government efforts to prevent the reimbursement of "unreasonable" compensation of contractors' executives. Some might think that the spirit of the times would automatically applaud the manner by which the Defense Contract Audit Agency (DCAA) conducts contractor executive compensation reviews (ECR's), the primary tool by which contracting officers make judgments regarding the allowability of the quantum paid by contractors to their top executives. But this article has nothing whatever to do with corporate jets, over-the-top corner office makeovers, or "gaudy bonuses" of any kind. It has everything to do with small– and medium sized businesses, struggling to turn a profit in a hyper-regulated marketplace, dealing with the vagaries of federal cost allowability rules, and the DCAA ECR methodology. As a practical matter, in our experience,[2] the amount typically recommended for disallowance pursuant to an ECR ($100,000 to $300,000 in a given fiscal year) is large enough to be a significant "hit" to the contractor's balance sheet, but also too small to make pursuing the matter through the "Disputes" clause[3] under the Contract Disputes Act (CDA)[4] a good business decision. This is the DCAA's "sweet spot," which perhaps explains why there have been so few fully litigated ECR disputes and reported decisions in recent decades.

Yet the DCAA ECR method is fundamentally flawed from an objective or "scientific" standpoint, and too narrow in its consideration of subjective or judgmental considerations properly affecting the reasonableness of executive compensation. This commonly leads to situations in which contractors sense that they are being ill-used, but believe there is not much they can do about it except to push back with their own unassisted and unlearned efforts. In that posture, little headway can be gained in the face of the government's relatively unfettered ability to enforce collection of amounts determined to be unallowable, and seemingly inexhaustible capacity to resist contractor claims in the costly and time-consuming contract disputes process. Because the remedies available to many contractors facing an adverse ECR recommendation are so inadequate , it is critical that they understand the "rules of the game" as played by the DCAA and the contracting officer, and what they can do to put themselves in the best position to obtain a good result from the ECR process, and, where necessary, to be in a strong position to pursue a dispute in the most cost-effective manner possible. The DCAA has every incentive, regardless of the merits of the underlying issue (i.e., whether executive

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compensation is reasonable), to pursue those companies who show a weak will or an inability to resist. Knowledge is power in the ECR process, and active and continual engagement in the process of setting and defending executive compensation is the only way to even the odds.

This article is intended to convey such knowledge, and explain why early and active engagement in the ECR process is critical. It will have three major sections: (1) What is the legal basis for an ECR review? (2) How does the DCAA conduct ECRs; what are the principal flaws in the process; and, how can they be disputed? and (3) What should contractors do in order to head off trouble in the first place, and make disputes easier and quicker to resolve?

Background and Overview of Executive Compensation Rules

The FAR Standard. The ECR process focuses on whether executive compensation is reasonable as an element of allowability with respect to indirect costs incurred on cost reimbursement contracts. FAR Part 31 sets the general standards for assessing cost reasonableness, as follows:

> (a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of a competitive business. Reasonableness of specific costs must examined with particular care in connection with firms or their separate divisions that may be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.[5]

The FAR reasonableness standard, by concentrating on costs that "would be incurred by a prudent person in the conduct of a competitive business," invites auditors, when conducting ECRs, to look at market forces, and what other businesses are incurring with respect to individual cost elements such as executive compensation. In this context, the result has been that the ECR process has become very heavily, if not exclusively, dependent upon commercially available executive compensation surveys.[6] Moreover, the FAR gives the government a significant advantage by imposing on the contractor the burden to prove reasonableness when an "initial review of facts" causes the government to challenge an incurred cost.

FAR 30.205-6 focuses more specifically on compensation for personal services. Executive compensation typically falls under the section that addresses compensation not covered by labor-management agreements, as follows:

> (b) *Reasonableness* —
> (2) *Compensation not covered by labor-management agreements*.
> Compensation for each employee or job class of employees must be reasonable for the

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> work performed. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provisions of 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms —
> (i) Of the same size;
> (ii) In the same industry;
> (iii) in the same geographical area; and
> (iv) Engaged in similar non-government work under comparable circumstances.[7]

This guidance is sparse, but does at least indicate to contracting officers the sorts of comparisons that are appropriate. FAR 31.205-6 also draws a distinction between companies that are subject to market forces, such as closely held firms, and those that are not, as follows:

> (6)(i) Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include:
> (A) Owners of closely held corporations, members of limited liability Companies, partners, sole proprietors, or members of their immediate families; and
> (B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.
> (ii) For those individuals, compensation must —
> (A) Be reasonable for the personal services rendered; and
> (B) Not be a distribution of profits (which is not an allowable contract cost).
> (iii) For owners of closely held companies, compensation in excess of the costs that are deductible as compensation under Internal Revenue Code (26 U.S.C.) and regulations under it is unallowable.[8]

These firms are deemed worthy of "special consideration," although the nature of such consideration is not spelled.

Case Law. There are few reported decisions concerning the reasonableness of executive compensation. As noted above, the amounts in issue appear to fall typically in the contractor's "dead zone," somewhere between a nuisance, and enough to make the costs of litigation a necessity. However, inasmuch as it has had the biggest influence over DCAA ECR policy and practice, the leading case in this area is the Armed Services Board of Contract Appeals decision in *Techplan Corp*.[9] In *Techplan*, the contractor was a high technology services company with revenues between \$10.5 and \$13.8 million for a three-year period (*continued on next page*)

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(1986-1988). At issue was the reasonableness of the total compensation of the company's chief executive officer (CEO), who was also the company's chief operating officer, chief financial officer, controlling shareholder, and chairman of the board of directors. After a full hearing, the board ruled heavily in favor of the company, sustaining the appeals in part, and remanding the case to the parties for quantum settlement.[10]

At the hearing, both parties presented expert witnesses who advanced their own views on the reasonableness of the Techplan CEO's executive compensation package. While the parties' positions differed dramatically on some points, they generally agreed, and the board found that:

> Subject to any controlling criteria such as regulatory criteria, experts in the compensation field would generally accept taking the following steps (not necessarily broken out in exactly this manner) to evaluate the reasonableness of executive compensation;
> (1) Determine the position to be evaluated
> (2) Identify survey(s) of compensation for the position to be evaluated which match the company in terms of revenues, industry, geographic location and/or other relevant factors
> (3) Update the surveys to a common data point for each year through the use of escalation factors
> (4) Array the data from the surveys for the relevant compensation elements at various levels of compensation such as the average (mean) or selected percentiles and develop a composite number for each
> (5) Determine which of the numbers to use for comparative purposes
> (6) Apply a range of reasonableness such as 10% to the number or numbers selected
> (7) Adjust the actual total cash compensation for lower than normal fringe benefits
> (8) Compare the adjusted compensation to the range of reasonableness[11]

The board generally favored Techplan's expert testimony. In addition, at the hearing, Techplan also put on two fact witnesses, including the CEO, who gave unrebutted evidence that company's performance during the year's in issue was superior. This was done to support the company's contention that it was entitled to pay executives at the upper end of the scale, that is, at the seventy-fifth percentile. This testimony established the qualifications of the CEO, the company's standing in its industry, and its long-term financial success. The board ruled that Techplan was justified in paying above average salaries as argued.

The other leading executive compensation decision was published a year after *Techplan*, in the *Information Systems and Networks* appeal.[12] The decision in this appeal went largely against the appellant, and little if significant precedential value came from the board's opinion. However, as discussed below, the DCAA has misread the decision in a way that continues to skew ECRs to this day.

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<u>Compensation Is Not a Four-Letter Word (cont'd):</u>

The DCAA Process and How to Dispute It

DCAA Construction and Use of the *Techplan* and *Information Systems Networks* Decisions.

Despite the fact that the Techplan decision went against the government, the DCAA evidently viewed it, in one narrow sense, as the template for all future ECRs. However, while the DCAA incorporated much of what was done to evaluate the reasonableness of executive compensation in the *Techplan* case into its ECR method, it also misinterpreted what it took from the decision on one fundamental point, and entirely ignored a major element of the board's holding. Because of this, the DCAA ECR method is flawed, and should be challenged where the method is used as the basis for a disallowance recommendation.

The DCAA Contract Audit Manual (CAM) sets forth policy and procedure for auditors to follow. The CAM sections entitled "Review for Unreasonable Compensation" sets forth the blueprint for ECRs, and makes an explicit reference to *Techplan*, as follows:

> g. The Techplan ASBCA Case No. 41470, 96-2, BCA 28426, cited the steps to be taken to evaluate the reasonableness of executive compensation. The following process was the ASBCA's interpretation of how compensation experts would market price executive compensation. This process should be followed to the extent practical. The auditor should rely on the contractor's market pricing when available, unless the contractor used free internet surveys to develop labor costs as these surveys are not independent or objective. The auditor should ascertain that the contractor's market pricing is compliant with FAR 31.205-6 and the process cited in the Techplan Corporation ASBCA Decision.
> (1) Determine the position to be evaluated.
> (2) Identify survey(s) of compensation for the position to be evaluated that match the company in terms of revenues, industry, geographic location and/or other relevant factors.
> (3) Update the surveys to a common data point for each year through the use of escalation factors.
> (4) Array the data from the surveys for the relevant compensation elements at various levels of compensation, such as the average (mean) or selected percentiles, and develop a composite number for each. Note: Use of other percentiles is necessary only if the contractor's performance (see 6-414.4h below) is quantitatively and measurably above or below average. The Information Systems & Networks Corporation ASBCA Decision clarified that for companies with performance that was below average, below average levels of compensation could be utilized as the reasonable level of compensation for market pricing.
> (5) Determine which of the numbers to use for comparative purposes. In most cases average or median data will be utilized as an initial position prior to performing a detailed financial performance analysis.

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> (6) Apply a range of reasonableness, *such as 10 percent*, to the number or numbers selected. It is DCAA policy to use 10 percent as the range of reasonableness. A 10 percent range of reasonableness (ROR) was also supported by the ASBCA in the Information Systems & Networks Corporation ASBCA Decision.
> (7) Adjust the actual total cash compensation for lower than normal fringe benefits. (Calculate an offset.)
> (8) Compare the adjusted compensation to the range of reasonableness. Differences should be questioned as unreasonable.[13] [Emphasis added.]

DCAA misinterpreted and misused the *Techplan* decision by converting the board's *mere recognition* of the method used in that case into *mandates* for all future ECRs. As evidenced by this CAM section, there are two major problems with what the DCAA did with the *Techplan* decision. First, it incorrectly asserts that the board in *Techplan* held that these steps were "to be taken" — i.e., that they are mandatory. The board, however, did not go that far. Rather, the board simply ruled, after listening to parties' experts, that "experts in the compensation field *would generally accept* taking" the eight steps listed.[14] The board in no way indicated that these eight steps, with their "survey-centric" focus, constituted the *only* permissible method for evaluating the reasonableness of executive compensation, or that these eight steps were all that was needed to be done in an ECR.[15]

Second, the *Techplan* decision merely accepted the parties' apparent agreement that a 10 percent "range of reasonableness" (ROR) was adequate, *in that case*, to account for the variability of the data in the compensation surveys proffered by the parties. The board stated only that compensation experts applied an ROR, "*such as* 10%." It did not rule that, regardless of the quality of the survey data used in the ECR, 10 percent was the appropriate ROR for all cases. However, the CAM added its own policy gloss to *Techplan* Step 6, stating that "[i]t is DCAA policy to use 10 percent as the range of reasonableness. A 10 percent range of reasonableness (ROR) was also supported by the ASBCA in the Information Systems & Networks Corporation ASBCA Decision."[16] There is no legal basis for the adoption of an invariable 10 percent ROR. The *Techplan* decision provides no basis for the adoption to do so, and certainly the FAR, in the 13 years since the publication of the *Techplan* decision, has not adopted any such rule. Moreover, the *Information Systems and Networks* decision, cited by the CAM, provides no meaningful support for an inflexible 10 percent ROR.[17] In the *Information Systems and Networks* case, the government's expert used a 10 percent ROR, and the board found his presentation to be more persuasive than that of the appellant's expert. However, there is nothing in the decision that amounts to a ruling that a 10 percent ROR is to be applied in every ECR case. In fact, the DCAA "policy" fails to account for a prior board decision in which a 30 percent ROR was advanced by an appellant in an ECR appeal. Because the 30 percent ROR was "unrebutted" by the government, the board, in sustaining the appeal, approved it.[18] Finally, as discussed below, the use of an invariable 10 percent ROR is statistically flawed.

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<u>Compensation Is Not a Four-Letter Word (cont'd):</u>

Beyond these misconstructions of the *Techplan* decision, the CAM also promulgates bad policy and bad law with respect to the way in which compensation is correlated with company performance. Use of compensation survey data in ECRs typically leads to a range of salaries in relation to company performance based on the (not unreasonable) assumption that better performing companies can reasonably pay their employees higher compensation. This range typically uses the quartiles 25 percent, 50 percent, and 75 percent. For many firms, the difference between a "clean" ECR and one with recommended disallowances is whether the company is "market priced" (i.e., authorized to be reimbursed) at the seventy-fifth rather than the fiftieth percentile. Thus, a prime source of disputes in ECRs is over the company's performance. The CAM addresses this issue as follows:

> h. Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. Above average levels of compensation are usually identified by percentiles, such as the 75th percentile. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry's average. The ASBCA, in their decision on Information Systems & Networks Corporation ASBCA No. 47849, "capped" executive compensation at the 75th percentile when justified by performance.
>
> (1) Examples of financial performance measures may include the following:
> - Revenue Growth
> - Net Income
> - Return on Shareholder's Equity
> - Return on Assets
> - Return on Sales
> - Earnings per Share
> - Return on Capital
> - Cost Savings
> - Market Share
>
> (2) The contractor must show that the measure chosen is representative of the executive's performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive's performance, and certainly there should be no extra compensation due to performance which results primarily from the contractor's status as a Government contractor. Performance is typically measured using more than one criterion of performance. For example, a contractor may have significant sales growth through acquisitions and mergers while

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> operating at a loss. In this situation, the contractor would not be considered to have superior performance based on the lone measure of sales growth.
>
> (3) Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable.[19]

There are several flaws with the way in which the CAM addresses "market pricing" in the context of an ECR, and the way in which ECRs are conducted. First, the CAM asserts that the ASBCA, in the *Information Systems and Networks* decision "capped" executive compensation at the seventy-fifth percentile "when justified by performance."[20] The board did nothing of the kind. Rather, it merely found, on the basis of the specific facts adduced in the appeal, that the government's compensation expert had capped appellant's executive compensation at the seventy-fifth percentile, stating as follows:

> 27. Mr. Keuch [the government's expert] next measured ISN's annual performance and the performance of the companies in the proxy sample, determining 25th, 50th and 75th percentiles for performance, and drew a comparison between ISN and peer companies (R4, tab 50; tr. 3/64-65). Where ISN was ranked at or above the 75th percentile among its peers for annual performance, Mr. Keuch recommended executive pay for ISN in the 75th percentile, which formed the "cap" for pay (R4, tab 20).[21]

The board subsequently found that "Mr. Keuch used an appropriate data base, applied the FAR properly, and used a consistent and logical methodology. We find his report and testimony persuasive."[22] As can be discerned from the board's opinion, the correctness of the seventy-fifth percentile "cap" as an invariable standard was not disputed in the *Information Systems and Networks appeal*, and we have no way of knowing how or why the government's expert arrived at that recommended "cap" based on the unique facts in that case. Under the circumstances, therefore, the CAM is not justified in its assertion that the board in *Information Systems and Networks* "capped" reimbursement for executive compensation at the seventy-fifth percentile. Nevertheless, based on this misreading of *Information Systems and Networks*, the seventy-fifth percentile "cap" is now a fixture of the DCAA ECR method. As a matter of pure mathematical logic, the seventy-fifth percentile cap cannot withstand scrutiny. It is undeniable that precisely 25 percent of all firms in a given class of businesses are in the top quartile. Thus, to "cap" reasonable compensation at the seventy-fifth percentile is arbitrary. While this "cap" may make the DCAA's job easier, it does make its practice reasonable.

In our experience, DCAA practice is to market price a company at the fiftieth percentile, and only to undertake a performance analysis if the company objects to a recommended disallowance.[23] Further, even when such an analysis is undertaken , any one-year downturn in
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financial performance can be deemed a justification for market pricing at a lower level. This practice is in conflict even with the CAM, which states that "[u]se of a particular measure to justify higher than average compensation should be applied consistently *over a period of years*, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable."[24] There is no reason to quarrel with the assertion that measures of performance should be applied consistently from year to year, and certainly it is reasonable to take into account longer term trends in financial performance when assessing the reasonableness of executive compensation in a given year. To our experience, however, the DCAA justifies this approach by reference to FAR guidance, which states that "[c]ompensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salary or wages."[25] This provision, on its face, does not support the DCAA's position, and should be challenged.

Moreover, the DCAA takes this approach without consideration of factors that may affect financial performance metrics in ways that do not reflect adversely on the performance whose compensation is under review. Thus, for example, if a company was uniquely affected by a major event, such as the 9/11 attacks, its financial performance, when compared to companies whose business was not so sensitive to the catastrophe, will suffer. But that is not a compelling reason to downgrade the value of the services performed by the companies executives. Consider, for example, two management consulting companies, one of which serves the travel industry; the other, the airport security screening industry. Both might be peers in a financial performance survey used by the DCAA in an ECR, and the financial performance of both would be affected by the 9/11 attacks. However, the impacts would be roughly reciprocal, with the travel consultant taking a dramatic bottom line hit for FY 2002, while the security company's financial performance would be expected to shoot up. Using potentially skewed financial performance metrics from a single year or two as a basis for an increase or decrease in reasonable executive compensation ignores the reality of the market for scarce high-performing executives. As a practical matter, short of a company-killing, long-term catastrophe companies are forced to pay what the market demands for top executive talent, and cannot make executive compensation decisions on the basis of short-term financial performance. Thus, not only is the DCAA's approach unreasonable and contrary to the CAM, it is also contrary to the FAR cost principle that "[a] cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of a competitive business."[26] In addition, it is contrary to the board's holding in *Techplan*. In that appeal, at hearing, the company's CEO testified, among other things, in regard to the company's long-term profitability as a factor in advocating for seventy-fifth percentile market pricing, as follows:

> The company has been profitable every year that I have led it, which is all the years of its existence; both companies (Techplan and TDS), and has [sic] grown significantly during the period that I have led it from zero. I can state unequivocally that I believe the growth rate on average through

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> 1990 was 23-1/2, 24 percent. The company has been essentially debt free since 1981.[27]

In ruling on the proper level to market price the company, the board in *Techplan* specifically relied on this long-term trend in finding that above average compensation was justified, stating:

> After eliminating the government expert's analysis, we are left with the unrebutted, credible testimony of appellant's CEO and vice-president, the financial data about the appellant set forth under the first heading of this opinion, which shows average growth in revenues of 14% and continued, although declining, net income, and the personal information about the CEO set forth under the second heading. This evidence supports the contention that the company could reasonably elect to set its CEO's compensation at an above average level. We conclude, therefore, that the CEO's compensation may be properly compared with the data for the 75th percentile rather than for the average.[28]

Thus, the shortsighted DCAA is subject to legitimate criticism and should be challenged when the company's long-term performance is inconsistent with a short-term downturn cited a s a basis for a DCAA demand for a drop in executive compensation.

A further flaw in the DCAA approach to market pricing is its exclusive reliance on financial performance. The CAM appears to ignore all nonfinancial performance evidence in the market price question and, in our experience, ECR practice is that auditors also ignore factors such as the company's standing in the industry. In *Techplan*, however, such evidence was proffered to and considered by the board, and was critical to the board's decision that Techplan was entitled to pay at an above-average level. The CEO testified as follows:

> Obviously, I do not think we are an above average company. We are a small business competing in a large group of small businesses. Many of them have similar skills. . . . 99.9 percent of our work is competitively awarded, which requires then that my company have stature in this community from a technical standpoint, and from a financial standpoint and from a cost effectiveness standpoint.
> * * * * *
> We always had one overriding consideration, however; and that is a small company cannot survive absent a significant level of credibility with its customer in terms of the quality of work it produces.[29]

The Techplan Vice President also testified on this point:

> Second, . . . we have name recognition in our customer community as a

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> high-quality provider of the types of services that we provide. . . . We also have name recognition in our marketplace of competitor contractors. . . . And on that basis, we are invited to join them in teaming where we will fill a nitch [sic] that they do not have covered in proposals that they are making to the Government.[30]

As noted above, the board found this unrebutted testimony to be persuasive.

Thus, the board considered not only financial performance data, but also testimony concerning the company's "standing" and "credibility" in the industry, as reflected by technical expertise, the ability to capture business in a competitive marketplace, and the excellence of its senior management. In our experience, the DCAA considers none of these factors in determining whether a company is entitled to pay (and be reimbursed for) above average compensation to its executives. This unduly cramped approach is not only illogical, but also runs counter to FAR 31.201-3(a) and the *Techplan* decision.

The DCAA Mid-Atlantic Compensation Team. The DCAA's ECR program is executed by the "Mis-Atlantic Compensation Team," (MACT), which is considered by DCAA to be an "Agency-wide Center of Excellence."[31] Organized under the DCAA Technical programs division, the MACT was composed of two "technical specialists" and four accountants as of November 2007. The stated goal of the MACT is to provide "team continuity and consistency in audit approach" through "team members trained and certified in the compensation area."[32] MACT members are trained by the "World at Work" organization (WAW), formerly known as the American Compensation Association, which provides certification in several specialties, including the designation "certified compensation professional"(CCP).[33] In our experience, despite the geographically limited team designation, the MACT provides ECR support to contracting officers agencywide.

"Generally Accepted Compensation Practices." various idiosyncratic DCAA ECR policies and practices are justified on the basis that they are supported by generally accepted compensation principles" (GACP). These principles, even the DCAA has admitted (in depositions), are not independently compiled, peer-reviewed, and updated on any kind of systematic or regular basis, but rather are drawn by DCAA auditors conducting ECRs from WAW teaching materials and from other random sources on an "as needed" basis. At a recent deposition, a DCAA auditor at an executive compensation appeal testified as follows:

> Q: And is that something you get from generally accepted compensation practices?
> A: Yes.
> Q: But, again, that's not written down anywhere that we can — we can look at?
> A: Well, that might be in a compensation answer book, a reference book. They might discuss it there, and then it's — it's, you know, probably taught at World at Work courses.

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DCAA auditors have testified that, according to GACP, executive compensation should be analyzed on a national basis, without taking local conditions into account. In other words, the reasonableness of executive compensation for someone working in Waycross, Georgia, is a fair comparator of an executive working in Boston, Massachusetts. The auditor testified as follows:

A: For executives, the appropriate geographic area is the national average.
Q: And —
A: That's the generally accepted compensation practice.
Q: And I've been dying to find out. Where — where can I read that?
A: There's — there's probably indus — you know, articles in industry, compensation articles on that topic.
Q: But as opposed to the GAAP, generally accepted accounting principles, there's nothing like that that says for executives it's — it's national?
A: Nothing formal, no.

In view of the amorphous nature of the GACP, which has been embraced by the MACT, companies facing adverse ECR recommendations should probe for and challenge the use of GACP.

Statistical Flaws in the DCAA/MACT ECR Method. The MACT approach to ECRs centers on the use of compensation surveys. A survey is, fundamentally, an attempt to produce an educated guess regarding the characteristics of a selected population on the basis of a sample of less than 100 percent of the population's members. "Statistics" is "[t]he mathematics of the collection, organization and interpretation of numerical data."[34] The use of surveys is thus a statistical exercise. The DCAA recognizes this fact through the use of a range of reasonableness and regression analyses to account for the inherent variability of survey data.[35] The DCAA's recognition that surveys are all about statistics is made clear by the NDIA presentation, which asks the question,"[w]hat are compensation surveys?" and answers that question in part by stating that they are statistical data presented (percentiles, regression analysis, buckets, etc.)."[36]

Yet despite the fact that statistical analysis is the core competency required to collect, organize, and interpret compensation survey data, our experience has been that DCAA auditors are completely untrained in statistical analysis. As a result, ECR results and recommendations are inherently unreliable and subject to attack.

We have found through review of DCAA work papers, and through discovery conducted in a contract appeal, that MACT members are untrained in statistics at anything approaching the level required to use compensation and financial performance survey data in a reasonable and reliable manner. For example, in a deposition taken in a contract appeal in which ECRs are the basis for the contracting officer's final decisions, the DCAA auditor testified as follows:

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> Q: Okay. So — and I just want to be complete here regarding regression analysis and the training courses. Are you familiar with the term "nonlinear regression analysis"?
> A: No, I am not.
> Q: How about "multiple regression analysis"?
> A: I — I've heard the term, but I — I don't know, you know, what it means.
> Q: And do you know how to interpret regression results?
> A: I'm not sure what you mean by that.
> Q: Okay. What is the coefficient of determination?
> A: Is that the R or the R-squared?
> Q: You tell me.
> A: I — I'm not 100 percent sure, but I think it's the comparison between your — your sales your — your pay, the relationship between sales and compensation.[37]

The deponent in this appeal testified that he was responsible for conducting hundreds of ECRs as a member of the MACT. Survey data are not uniformly helpful in decision making. Surveys can be skewed in many ways, and the number of observations, or sample size, dramatically affects the quality of the survey data (i.e., generally, the greater the number of observations, the more useful the survey results). The DCAA ECR method presumes that there is a direct relationship between corporate revenue and executive compensation (i.e, that, as revenue increases reasonable executive compensation increases proportionately). The terms with which the auditor was not familiar are standard statistical concepts used to collect, organize, and interpret survey data. The term, "coefficient of determination," by the way, is R^2, and it is the proportion of variability in a data set that is accounted for by the statistical model. This same auditor viewed survey data in which the R^2 was only .20 or better as acceptable for use in an ECR. In other words, for such a survey, a compensation datum for corporate revenue explained only 20 percent of the differences in executive compensation, leaving 80 percent of the variation unexplained. Despite this weak correlation between revenue and executive compensation, the auditor nevertheless considered the survey to be adequate for ECR usage. Moreover, there appears to be no uniformity among auditors regarding the reliability of survey data for ECRs. Another MACT member being deposed in the same appeal stated that any R^2 that was over zero was acceptable.

Not surprisingly, the lack of training and expertise in statistics by DCAA auditors introduces error into the statistics–driven ECR process. Beyond the use of data showing weak or no correlation between revenue and executive compensation, the MACT also commits a fundamental statistical error by treating all survey data equally, regardless of quality. Thus, a survey datum which is based on five observations (N=5) is considered equal to a datum based on 100 (N=100) observations. DCAA makes no effort to weight the surveys used in ECRs to account for such differences, resulting in significant skewing of results. There are other statistical and logical flaws in the DCAA ECR process that are beyond the scope of this article.
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Compensation Is Not a Four-Letter Word (cont'd):

Suffice it to say, however, that the lack of statistical analytical expertise by the MACT, as it engages in a fundamentally statistical exercise, coupled with the fact that the MACT ignores all other evidence that has a bearing on the reasonableness of executive compensation, leaves the DCAA ECR process wide open to attack and dispute.

ECR Working Papers. In our experience, we have also found that the MACT does not typically document its ECR process in a transparent way, or in a manner that permits easy defense of disputed judgments, actions, and decisions by the auditor. Among other guidance, auditors are required to adequately document decisions in regard to controversial issues. The CAM states as follows:

> In reports that question contractor proposed costs, explanatory notes should contain detailed information such that the contracting officer is able to understand clearly the basis for each element of cost, how the cost was evaluated, and the conclusions made on the basis of that evaluation.[38]

CAM Secs. 4-401 and 4-403 contain similar exhortations to auditors. These appear to be honored only in the breach by ECR auditors. This is both a blessing and a curse. It is a disadvantage to the contractor in terms of being able to understand what the DCAA did in any given case, but on the other hand, when the disputes process is invoked, it can increase the challenge to the government in defending executive compensation disallowances. In any event, the adequacy of the ECR working papers should be an important consideration in assessing the relative litigation risks of the parties.

How to Prepare for and Cope with the ECR Process

Incurred cost audits are unpleasant. Under the best of circumstances, they are no better than a painful way for a company to hold its own. And of course, everyone is busy running the company, and coping with myriad demands of their customers. However, ECRs can be a trap for the unwary, and the worst thing a company can do is to ignore the ECR process. Executive compensation in the context of an ECR is just like a tooth with a cavity in it — if you leave it alone, it will not go away. Prudent planning and attention to the company's executive compensation practices in general, and to ECRs as they occur in particular, can reduce the paid of an ECR to a minor, ephemeral ache. Here are some ideas on how to accomplish this.

Set Executive Compensation by Committee. Although most decisions are best when *not* made by a committee, executive compensation may be an exception. A chartered compensation committee, typically reporting to the board of directors, should perform a rigorous study of all relevant market data, and circumstances bearing on compensation decisions, if possible, with the assistance of independent external compensation consultants. Compensation committee meetings should have detailed minutes, and compensation decisions (*continued on next page*)

Compensation Is Not a Four-Letter Word (cont'd):

should be based on written criteria. Small, closely held companies often forgo such infrastructure; however, lack of documentation and rationale for questionable compensation decisions can be a red flag for the DCAA, especially in view of the FAR guidance that calls for "special consideration" for such companies.[39] Moreover, contemporaneous explanations for seemingly anomalous decisions are more persuasive than those that are made after costs have been challenged as unreasonable.

Maintain Accurate Position Descriptions. Based on GACP, the DCAA will, as a default approach, evaluate top division executives using divisional rather than company-wide revenue. Because compensation survey data have a rough direct relationship with compensation (i.e., the higher the revenue, the higher the reasonable compensation), so reasonable compensation will generally be deemed lower for executives with only parochial divisional responsibilities. However, if top division executives do have substantial company-wide responsibilities, these should be clearly documented so that when an ECR is performed, these executives will be evaluated using the more advantageous company-wide revenue amount. Consider the examples in Table A:

Table A

Position	Executive VP	Top Division Executive
Industry	Services	Services
Scope Variable	Revenue $75M	Revenue $16M
Compensation at 25th %	$354,000	$271,500
Compensation at 50th %	$412,000	$317,000
Compensation at 75th %	$463,000	$372,000

The executive vice president may have the same background, qualification level, and tenure in position as the top divisional executive, but if the company cannot demonstrate that the latter has company-wide responsibilities, the DCAA will evaluate the top division executive's compensation using the revenue for the division rather than the company as a whole. Where such an evaluation does not reflect the reality of the situation, the company should ensure that it can document any broader responsibilities, and these should be brought to the ECR reviewer's attention early in the process.

Compile Complete and Accurate Data on Company Performance. The DCAA may, if requested, analyze a company's financial performance to determine whether the company should be "marketed" at higher than the median or fiftieth percentile compensation level. In most cases, as in the example in Table A, there is a substantial difference in compensation level between companies at the fiftieth and seventy-fifth percentiles. Thus, companies should:

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<u>Compensation Is Not a Four-Letter Word (cont'd):</u>

• Assert, if accurate, that company performance is above the median. The DCAA will not undertake a performance analysis unless specifically requested to do so, and will otherwise use the fiftieth percentile as a default position. Therefore, companies must request that the DCAA evaluate financial performance.

• Be prepared to discuss financial performance with the DCAA to argue for marketing at higher percentiles. The DCAA typically looks at metrics such as sales growth, return on sales, return on assets, and return on equity, and compares the company to others in its peer group. It is essential that unique circumstances unrelated to company performance affecting any of these metrics in a given market be well documented, and that these be brought to DCAA's attention early in the process.

• Be prepared to furnish information on company performance other than financial data, such as was considered persuasive and decisive by the board in the *Techplan* decision. In addition, provide the auditor with mid- and long-term performance data to place any short-term declines into proper perspective. The auditor may not want to consider such information, but the company should insist that any such information go into the ECR working papers.

Be a Member of the ECR Team. The easiest way to get a bad ECR report is to treat the event as a nuisance, and simply hope that it will be over soon. Thus, companies should engage with the DCAA as early as possible in the ECR process, before the auditor begins to form firm impressions. Be aware of any areas of weakness in compensation practices or company performance, and be ready with explanations and supporting documentation to minimize the impact. Make sure that you give a complete in-briefing to the reviewer concerning the company overall, and any unique circumstances that might affect the ECR. Introduce the reviewer to the executives whose compensation is to be evaluated, and provide complete information regarding the executives' background, experience, and accomplishments. With assistance of legal counsel as appropriate, be responsive and timely with regard to all requests for information and documents. Insist on an out-briefing, and follow up to correct any misunderstandings or inaccuracies on the reviewer's part *before* he or she puts pen to paper on the ECR. Submit a complete and timely rebuttal to any preliminary findings that are inadequate or legally insufficient.

Engage the Contracting Officer. Ideally, the contracting officer can serve as a firewall between a bad ECR and a disallowance. However, recent DCAA guidance authorizes auditors to refer contract "mismanagement" to the DOD inspector general without first elevating such concerns through the contracting officer's management chain.[40] This means, we believe, that contracting officers will be less likely to resist DCAA ECR recommendations. Although the contracting officer is, by law, the decision maker on disallowance decisions, in practice, a contracting officer will rarely even be aware of an ECR until it is over and the report is on his or her desk. By then, however, it is often too late to sway the contracting officer with the facts and the most compelling analysis. As soon as an ECR is started, the company should be talking to the ACO in much the same way as it is engaging with the ECR reviewer. Where the (*continued on next page*)

Compensation Is Not a Four-Letter Word (cont'd):

DCAA's analysis is off track, this should be immediately (and diplomatically) brought to the ACO's attention, and any mistakes or misunderstandings should be corrected. That way, when the ECR comes in, the ACO may be predisposed to question the DCAA's views if a dispute comes up.

Summary and Conclusion

Executive compensation reviews are here with us to stay, and, in view of recent events that have given executive compensation a bad name, contractors cannot reasonably hope that ECRs will get any easier to cope with. However, there are a multitude of steps that any company, even those without an enormous investment in disputes litigation, can take to put itself in the best possible position in an ECR. Start with an understanding of the underlying legal principles, as well as the DCAA process and the flaws in it, and push back when necessary; know what is needed to maximize the company's performance profile, and do not be shy about sharing with the auditor; implement sound compensation practices, and then live up to them; and become a part of the ECR team, and stay in touch with the auditor and the contracting officer every step of the way. Executive compensation is not a four-letter word — do not let the ECR process cause you to use any four-letter words of your own.

* - *Richard B. O'Keefe, Jr., is of counsel in the Washington, D.C. office of Wiley Rein LLP.*

Endnotes

1. Comments made by White House advisor David Axelrod, interviewed in February 2009 on Fox News Sunday, discounting concerns that new stimulus plan limits on executive compensation would cause a "brain drain," *available at* http://www.cqpolitics.com/wmspage.cfm?docID=news-000003052604 (last visited April 1, 2009, copy on file with the author).
2. Our "experience" as referenced in this article is derived from ECRs conducted since 2001 for four separate client companies, one of which has resulted in a contract appeal before the Armed Services Board of Contract Appeals in spring 2009. In addition, William A. Roberts III, cochair of the Wiley Rein LLP Government Contracts practice group, was lead counsel for the *Techplan* appeal. As discussed below, the *Techplan* decision is seminal in the executive compensation field.
3. Federal Acquisition Regulation (FAR) 52.233-1, Disputes (July 2002).
4. The Contract Disputes Act of 1978, as amended, 41 U.S.C. §§601-613.
5. FAR 31.201-3(a).
6. David Durante, DCAA MACT supervisor, *Executive Compensation of Government Contracts: An Audit Perspective*, a slide-show presentation given to the November 14, 2007, National Defense Industrial Association [hereinafter "NDIA presentation," on file with author] at 18-25.
7. FAR 31.205-6(b)(2).
8. FAR 31.205-6(a)(6).
9. ASBCA No. 45387, 96-2 BCA ¶28426, 1996 WL 391461 (July 2, 1996).
10. 96-2 BCA ¶28426, at 13-14.

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Compensation Is Not a Four-Letter Word (cont'd):

Endnotes (cont'd)

11. *Id*. at 6.
12. ASBCA No. 47849, 97-2 BCA 29132, 1997 WL 381263 (July 7, 1997).
13. CAM, Sec. 6-414.4(g) (emphasis added).
14. 96-2 BCA ¶28426, at 6 (emphasis added).
15. This DCAA position persists. *See* NDIA presentation at 32, "Key Points, *Techplan* . . . Steps for evaluating reasonableness were established . . ." (emphasis added).
16. CAM, Sec. 6-414.4(g)(6). Durante's NDIA presentation established that this misreading of Techplan persists. In rehearsing the key points in the board's *Techplan* decision, Durante asserted that the board found that a "10% ROR is acceptable." NDIA presentation at 32.
17. ASBCA No. 47849, 97-2 BCA ¶29132, 1997 WL 381263 (July 7, 1997).
18. Lulejian & Associates, Inc., ASBCA No. 20094, 76-1 BCA ¶11880, 1976 WL 1917 (Apr. 27, 1976).
19. CAM, Sec. 6-414(h).
20. *Id*.
21. ASBCA No. 47849, 97-2 BCA ¶29132, 1997 WL 381263 (July 7, 1997).
22. *Id*.
23. These empirical observations are supported by the DCAA, which, in its NDIA presentation, only mentions evaluation of financial performance for the purpose of allowing higher than average compensation after the contractor has submitted a rebuttal. NDIA presentation at 16.
24. CAM, Sec. 6-414(h)(3) (emphasis added).
25. FAR 31.205-6(a)(1).
26. FAR 31.205-3(a).
27. 96-2 BCA ¶28426, at 9. The Techplan vice president also testified on this point as follows:

    I have many things that I would point to that I believe indicate that we are above average in our business. Number one, there are very few companies of our size that have been in business and been successful for the twenty or so odd years that we have been in business. . . .

    Also, we have had sustained sales growth for many years, and there are not very many companies that I'm familiar with in our market area who can make the same pronouncement. We've also had sustained profitability. There are not very many companies you can point to in our business that have a long history of consistent profitability.

    Id. at 10.
28. *Id*. at 11
29. *Id*. at 9-10.
30. *Id*. at 10.
31. NDIA presentation at 4.
32. *Id*.
33. NDIA presentation at 6-7.
34. Webster's II New College Dictionary (2001), at 1078.
35. NDIA presentation at 12-13.
36. NDIA presentation at 12-13, 18.
37. Deposition transcript on file with author.
38. CAM, Section 10-210.6(b).
39. FAR 31.205-6(a)(6)(i).
40. The DCAA Action Guidance Memo PAS 730.4.A.4, dated March 13, 2009, states as follows:

    Certain unsatisfactory conditions related to actions of Government officials will be reported to the Department of Defense Inspector General (DoDIG) in lieu of reporting the conditions to a higher level of management. The unsatisfactory conditions reported to the DoDIG will be those cases where DCAA determines an independent assessment and related actions are necessary due to the significance and/or sensitivity of the matter.

    Unsatisfactory conditions include actions by Government officials that appear to reflect mismanagement, a failure to comply with specific regulatory requirements or gross negligence in fulfilling his or her responsibility that result in substantial harm to the Government or taxpayers, or that frustrate public policy. *See* http://www.dcaa.mil/mmr/09-PAS-004.pdf (last visited April 10, 2009).

The False Claims Act Returns To The Supreme Court

by

*David M. Nadler, J. Andrew Jackson and Joseph R. Berger**

The U.S. Supreme Court is set to hear arguments on whether a state or local administrative report, audit or investigation triggers the False Claims Act public disclosure bar, in the case *Graham County Soil & Water Conservation District v. U.S. ex rel. Wilson* (No. 08-304). Arguments in *Graham County* are scheduled for November 30, less than three years after the Court ruled on the public disclosure bar in *Rockwell Int'l Corp. v. U.S.*, 549 U.S. 457 (2007).

Rockwell continues to inform increasing numbers of court decisions dealing with the FCA public disclosure bar, which was designed to prevent opportunistic lawsuits based on public information while allowing genuine complaints by an "original source" whistleblower (the "relator") to proceed based on "direct and independent knowledge." *Rockwell* addressed the original source exception to the public disclosure bar and clarified that the status of a relator as an original source is a jurisdictional issue.

The decision now on appeal from the U.S. Court of Appeals for the Fourth Circuit, *U.S. ex rel. Wilson v. Graham County Soil & Water Conservation Dist.*, 528 F.3d 292 (4th Cir. 2008), found that a *state* administrative report did *not* trigger the FCA public disclosure bar, standing in contrast to the decisions of other circuits.

Question Presented—The "Question Presented" to the Supreme Court in the petition for writ of certiorari was

> Whether an audit and investigation performed by a State or its political subdivision constitutes an "administrative … report … audit, or investigation" within the meaning of the public disclosure jurisdictional bar of the False Claims Act, 31 U.S.C. §3730(e)(4)(A).

At issue is an audit report prepared by an accounting firm in 1996 for Graham County, N.C., and transmitted to the county and to the state, concerning the county's use of federal assistance under the federal Emergency Watershed Protection program. The qui tam plaintiff, Wilson, was an employee of the Graham County Soil and Water Conservation District, who filed a qui tam action in 2001 concerning the operation of the soil and water conservation agencies in two counties. Among various allegations, she claimed that work under the federal program was required to be competed, but was subject to a conflict of interest and awarded without proper bidding. The accounting firm's 1996 audit report also contained this allegation, or similar findings. The petitioners state that the audit report was available to the Federal Government and to the public.

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The False Claims Act Returns (cont'd):

The district court ruled that the accounting firm's audit report constituted a public disclosure under the FCA. The court found that Wilson had based her complaint on the audit report and another state agency report, and was not an original source. The Fourth Circuit reversed the district court, adding to a circuit split on the issue of whether the public disclosure bar is triggered by state administrative reports, audits or investigations.

The Public Disclosure Bar—The FCA public disclosure bar, enacted with the 1986 amendments to the FCA, provides,

> (A) No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.
> (B) For purposes of this paragraph, "original source" means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this section which is based on the information.

31 USCA §3730(e)(4). The recent amendments to the FCA, in the Fraud Enforcement and Recovery Act of 2009, left the public disclosure bar intact and did not affect *Rockwell*.

The Fourth Circuit Decision—The Fourth Circuit stated that the statute "by its express terms does not limit its reach to federal administrative reports or investigations. In our view, however, examination of the relevant language in context and consideration of the structure of the statute" led to the court's conclusion that only federal administrative reports qualify as public disclosures under the FCA. 528 F.3d 292, 301.

The Fourth Circuit noted that "[o]f the three disclosure sources listed in clause two of §3730(e)(4)(A), the first and third are clearly federal sources—congressional or GAO reports, hearings, investigations, and audits." The Fourth Circuit then relied on the interpretative maxim *noscitur a sociis*, which provides that "a word is known by the company it keeps." 528 F.3d at 302. The maxim "is invoked when a string of statutory terms raises the implication that the words grouped in a list should be given related meaning." Id. The court found that,

> In our view, the placement of "administrative" squarely in the middle of a list of obviously federal sources strongly suggests that "administrative" should likewise be restricted to federal administrative reports, hearings, audits, or investigations.

Briefing for the Petitioners—In its brief on the merits, Graham County has argued that "the word 'administrative' is neither vague nor ambiguous. The term is commonly understood

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to refer to both state and federal administrative proceedings. ... Because the meaning of the word 'administrative' is clear, the Fourth Circuit erred in turning to the doctrine of *noscitur a sociis* to rewrite the meaning of this statute." Brief for the Petitioners at 13. Graham County pointed out that the phrase "administrative hearing" appears twice in the public disclosure bar, and argued that in the first clause, it has been interpreted to include state hearings. Id. at 15. The County argued that the statutory language is plain, the full list of items in §3730(e)(4)(A) is not restricted to federal materials and that the Fourth Circuit's reasoning departed from the plain language. Id. at 17–28.

Graham County also argued that the Fourth Circuit's decision creates anomalous results by encouraging "parasitic actions by strangers who have done nothing to facilitate a fraud investigation," making it less likely that true whistleblowers can facilitate an action due to the FCA's first-to-file rule, and making it less likely that states and local governments will investigate their management of federal programs. Id. at 29–32. The County also disputed the policy arguments set forth by the Fourth Circuit and lower courts that have agreed with the Fourth Circuit. Id. at 36–45. For example, the "Fourth Circuit's assumption that material from the news media is more readily accessible to the Department of Justice than state and local government reports is flawed." Id. at 41–43.

Briefing for the Respondent—Wilson, the respondent, in the brief on the merits, restated the "Question Presented" to address a "report by an accounting firm of its audit of a local government" (rather than an "audit and investigation performed by a State or its political subdivision," as stated by the County).

Wilson has argued that the word administrative is "susceptible to several different meanings," and that the Fourth Circuit "read it in context and observed that Congress had placed the public disclosure sources into three groups, or categories. The language at issue fell in Category 2—'a congressional, administrative, or [GAO] report, hearing, audit, or investigation.' " Further, the Fourth Circuit's construction was "supported by the exclusively federal focus of the FCA's overall scheme and structure." Brief of Respondent at 9–12. Wilson also argued, embracing the U.S. amicus brief at the petition stage, that "all of the governmental disclosure sources should be construed as exclusively federal, including those in Category 1" (a criminal, civil, or administrative hearing). Id. at 23.

Wilson discussed the history of the FCA's federal "government knowledge bar" enacted in 1943, replaced in 1986 with the "public disclosure bar." Wilson also noted the simultaneous passage of the Program Fraud Civil Penalties Act, which expanded federal administrative investigations. According to Wilson, the public disclosure bar is not triggered by state and local government reports in the possession of the Federal Government; only by "the federal *pursuit* of the fraud." Brief of Respondent at 9–12. Wilson focused on the history and purpose of the statute. Id. at 24–42.

Briefing for Amicus Parties—Several parties filed amicus briefs on both sides. Among the amicus curiae parties supporting Graham County are a collection of thirty states.
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The states explained their "interest of the amici" by arguing that federal law requires them to submit audits and reports of the programs they administer involving federal funds, and that these audits and reports are available to the public. Brief of [the states] at 1. The states focus on the Single Audit Act, the federal law that requires state and local governments that administer federal programs to submit audits and reports to the Federal Government.

The states argue that they "have an interest in having these materials declared 'public disclosures' under the False Claims Act, and thereby avoiding parasitical claims based upon them, because [the states] may themselves be qui tam relators if they uncover improper or fraudulent claims." Id. at 1. The Supreme Court ruled in *Vt. Agency of Natural Res. v. U.S. ex rel. Stevens*, 529 U.S. 765 (2000), that the states are not "persons" themselves subject to FCA qui tam actions.

The National League of Cities, U.S. Conference of Mayors, National Association of Counties and related organizations filed their own amicus brief, and pointed out in their statement of interest that, unlike the states and state agencies, local governments *can* be sued under the FCA, according to the Supreme Court ruling in *Cook County v. U.S. ex rel. Chandler*, 538 U.S. 119 (2003). So the issue now before the Court "will determine the circumstances in which local governments may be liable under the Act. Resolution of the question will also affect the consequences for local governments of conducting certain audits and investigations and, more generally, the conditions under which those governments administer federally funded programs." Brief of the National League of Cities et al., at 1.

The local governments therefore agree with the states and Graham County that a public audit report of a state or local government constitutes a public disclosure under the FCA. According to the amicus brief, local governments would be harmed in two ways by a ruling to the contrary:

> First, by allowing plaintiffs to piggy-back on the investigative efforts of local agencies, it would hinder local governments' ability to investigate wrongdoing in connection with federally funded programs. It would create disincentives for agencies to conduct audits and investigations, and create incentives for plaintiffs' lawyers to interfere with those audits and investigations once begun. Second, local governments would be compelled to divert increasingly scarce resources to pay for *qui tam* litigation initiated by opportunistic plaintiffs.

Id. at 2.

The U.S. was among the amicus parties supporting Wilson. The Department of Justice argued that the context of the clause at issue is "unambiguously federal in nature," a conclusion "confirmed by the exclusively federal nature of the FCA more generally." Brief for the United

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States at 7. DOJ also presented arguments concerning Congress' purposes. "The narrow class of public disclosures that trigger the bar reflects Congress's decision to preclude only lawsuits likely to be duplicative of the federal government's own enforcement efforts—i.e., those based on information publicly disclosed in a way suggesting that the federal government was already, or was likely to be, on the trail of the fraud." Id. at 7.

A Question of Interpretation—The Supreme Court will look first to the statute's language, as it did in its 2008 FCA decision, *Allison Engine Co. v. U.S. ex rel. Sanders*, 128 S.Ct. 2123 (2008). There, the Court found that "[t]he interpretation of [the FCA] that was adopted by the Court of Appeals ... impermissibly deviates from the statute's language." Id. at 2128. "In statutory drafting ... precision is both important and expected." Id. (*Allison Engine*, interpreting the statute's liability clauses, has remained applicable to pending cases in recent lower court decisions, based on their interpretation of the recent amendments to the FCA that apply to "claims" under the statute, pending at the time of that Supreme Court decision).

The Supreme Court may consider both the statutory language at issue and its context within the broader structure of the statute. In another decision stemming from Wilson's case, the Court, finding ambiguity in another section of the FCA, stated that "statutory language has meaning only in context." *Graham County Soil & Water Conservation Dist. v. U.S. ex rel. Wilson,* 545 U.S. 409, 415 (2005).

The Supreme Court will search for clear meaning in the statute, and examine its context and structure, before turning to other considerations. The Fourth Circuit stated that "[w]e would not be the first court to observe that the FCA's public disclosure bar is far from a model of careful draftsmanship." 528 F.3d at 305. But the Supreme Court has faced similar questions of statutory construction of disputed provisions in other cases in which "[e]ach side insists that the purpose of [the statute] bolsters its reading." *Cooper Indus., Inc. v. Aviall Servs., Inc.,* 543 U.S. 157, 167 (2004) (interpreting the Comprehensive Environmental Response, Compensation and Liability Act). If the Supreme Court finds that the text has clear meaning, then "there is no need to resolve this dispute or to consult the purpose ... at all. As we have said: '[I]t is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed.' " Id. (citation omitted).

Rockwell—In *Rockwell*, the Supreme Court decided that relator James Stone was not an original source. The Court held that Stone's knowledge did not amount to the "direct and independent knowledge of the information on which the allegations are based" required to qualify as an original source, and that, as a matter of statutory interpretation, the "information on which the allegations are based" referred to the relator's own allegations, as amended in the complaint. 549 U.S. at 457. The Court also found the Government's intervention did not provide an independent basis of jurisdiction for the relator. Id.

The Supreme Court stated that it was conceded that Stone's legal claims were "based upon publicly disclosed allegations." Id. at 466–67. But "whether the point [of original source

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status] was conceded or not ... we may, and indeed must, decide whether Stone met the jurisdictional requirement of being an original source." Id. at 470. The Supreme Court has long held that "every federal appellate court has a special obligation to satisfy itself not only of its own jurisdiction, but also that of the lower courts in a cause under review, even though the parties are prepared to concede it." *Mitchell v. Maurer*, 293 U.S. 237, 244 (1934).

"Based upon the Public Disclosure"—In *Graham County*, the Fourth Circuit noted that most circuits have held that "a qui tam suit is 'based upon' a public disclosure whenever the allegations in the suit and in the disclosure are the same, 'regardless of where the relator obtained his information.' " 528 F.3d at 308. "In this circuit, however, a *qui tam* action is based upon publicly disclosed allegations only if the *qui tam* plaintiff's allegations were actually derived from the public disclosure itself." Id. The Fourth Circuit remanded the case to the district court to make factual findings regarding whether Wilson's allegations were derived from one of the reports at issue. This aspect of the court's ruling was not appealed to the Supreme Court.

In July 2009, the Seventh Circuit joined the majority of circuits with its decision in *Glaser v. Wound Care Consultants, Inc.,* 570 F.3d 907 (7th Cir. 2009), overruling its previous holding in *U.S. v. Bank of Farmington*, 166 F.3d 853 (7th Cir. 1999). "Although the Fourth Circuit has agreed with our approach ... every other circuit to consider this question has adopted a different interpretation of §3730(e)(4). Under the majority view, a lawsuit is based upon publicly disclosed allegations when the relator's allegations and the publicly disclosed allegations are substantially similar." 570 F.3d at 915 (citing decisions in eight other circuit courts). The Seventh Circuit found that "the approach we adopted in *Bank of Farmington* is problematic because it essentially eliminated the 'original source' exception to the public-disclosure bar." 570 F.3d at 910. The Seventh Circuit decision, influenced by *Rockwell*, leaves the Fourth Circuit's interpretation of the public disclosure bar in the distinct minority.

The Seventh Circuit stated that "the Supreme Court recently implied in [*Rockwell*] that the main jurisdictional focus is on the 'original source' requirement." Id. at 919. While interpreting the original source requirement, the Supreme Court had assumed that the claims on which the relator, Stone, prevailed were "based upon publicly disclosed allegations." 549 U.S. at 467; 570 F.3d at 919.

The Seventh Circuit noted that the Supreme Court in *Rockwell* discussed a hypothetical relator who "has direct and independent knowledge of different information supporting the same [publicly disclosed] allegation," and concluded that such a relator would be an original source. 549 U.S. at 471–72; 570 F.3d at 919. This hypothetical relator would be an original source only if his or her allegations were "based upon" the publicly disclosed allegations, even though he or she had "different information" concerning those allegations. As stated by the

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Seventh Circuit, "the Supreme Court's discussion assumes that its hypothetical relator is subject to the public-disclosure bar, for otherwise there would be no need to address the original source exception at all." 570 F.3d at 919.

***Rockwell*'s Influence**—Reaching a similar conclusion, in a case originally filed in a district within the Fourth Circuit but transferred to multi-district proceedings in the D.C. district court, that court likewise found that "[w]hile the Supreme Court has not spoken directly to this issue, its recent opinion on the 'original source' prong of the jurisdictional bar, [*Rockwell*], strongly suggests that the D.C. Circuit's broader view of what constitutes a disclosure is correct." *U.S. ex rel. Hockett v. Columbia/HCA Healthcare Corp*., 498 F.Supp.2d 25, 39 n.6 (D.D.C. 2007).

The relator contended that "the public disclosure trigger is easier to trip in the D.C. Circuit," and that summary judgment should be decided under the law of the Fourth Circuit instead. Id. The D.C. district court decided the public disclosure issues under D.C. Circuit law. Id. at 40. The court found that a sealed qui tam complaint was not a public disclosure, but that a New York Times article, the result of a two-year investigation by the Times, was such a disclosure, reporting allegations similar to the lawsuit and triggering the bar under the statute. Id. at 46-47. The relator's lawsuit was "based upon" the similar allegations. Id. at 54.

According to this decision, *Rockwell* "reiterates that the public disclosure/original source bar is a matter of subject matter jurisdiction. This lends credence to those courts which have read the public disclosure prong broadly, as a quick trigger, and the original source prong searchingly, because this mode of analysis construes the jurisdiction under the statute narrowly, and jurisdictional provisions are to be construed narrowly." Id. at 44–45. As the Supreme Court has ruled, the federal courts are courts of limited jurisdiction, "having only those powers assigned to them by Congress or directly by the Constitution." Id. at 45.

Balance under the Public Disclosure Bar—Congress established, and *Rockwell* interpreted, a balance between the trigger of the public disclosure bar and its exception for an original source. A recent decision arising from the legal fallout of *Hurricane Katrina illustrates this balance. U.S. ex rel. Branch Consultants, L.L.C. v. Allstate Ins. Co.*, No. 06-4091, 2009 WL 3353314 (E.D.La. Oct. 19, 2009). In that case, the defendants are insurance companies and adjusters that were acting as agents of the U.S. in the adjustment of flood claims under the National Flood Insurance Program.

The plaintiff alleged that when defendants adjusted claims from Katrina, they "exaggerated the amount of money that the government should pay under the individual flood policies, which in turn reduced the amount that the insurance companies would themselves be obligated to pay under wind and rain policies." Id. at *1. The court went through a lengthy review of a large volume of public material, including congressional hearings, legislation targeting insurance fraud following Katrina, records from prior lawsuits and news media sources, and found the existence of public disclosures under the statute, even though the disclosures did not name the specific defendants in this case.
(*continued on next page*)

The False Claims Act Returns (cont'd):

The court found that "the public disclosures have placed the 'very essence of the allegations' into the public domain, and they are sufficient to identify particular defendants." Id. at *10. The court further found that "there is no doubt that the allegations in the public disclosures are substantially similar to those in Branch's complaint." Id. at *12. However, "Branch has pleaded facts that establish direct knowledge of the fraud because this knowledge was acquired through the relator's own efforts," which included reexaminations of insured property. Id. at *13. Therefore, this court found that Branch was an original source, entitled to pursue its lawsuit.

Conclusion—The Supreme Court could easily decide, based on the plain language of the statute, that a state audit report is an administrative report triggering the public disclosure bar. If the Court does reach this conclusion, a logical balance will remain in place between the trigger of the public disclosure bar and its exception for an original source.

The Court's pending decision will offer additional guidance on the proper interpretation of the FCA, in complement to *Rockwell* and *Allison Eng*ine. The range of issues filtering through the lower courts, the recent amendments to the FCA, and the increased amount of federal spending flowing through the economy makes it likely that the FCA will return to the Supreme Court yet again in the near future.

* - This Feature Comment was written for *The Government Contractor* by David M. Nadler and J. Andrew Jackson, partners, and Joseph R. Berger, associate, in the Government Contracts practice of the law firm Dickstein Shapiro LLP in Washington, D.C.