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WRITTEN TESTIMONY OF KAREN L. MANOS

Before the U.S. House Committee on Oversight and Government Reform

Subcommittee on Management, Organization, and Procurement

“The State of Federal Contracting: Opportunities and Challenges for Strengthening Government Procurement and Acquisition Policies”

June 16, 2009

Ms. Chairwoman and Members of the Subcommittee,

Thank you for inviting me to appear before your Subcommittee. I am pleased and honored to have the opportunity to submit this written testimony.

I have a deep and abiding interest in the state of Federal contracting, having worked in this area since I graduated from the Air Force Academy twenty-eight years ago. I hope that I am able to offer a balanced perspective. I spent fourteen years on active duty in the Air Force, first as a contract negotiator and later a judge advocate, and, for the past fourteen years, I have been an attorney in private practice. I am a partner in the law firm of Gibson, Dunn & Crutcher LLP, and Co-Partner in Charge of that firm’s Washington, DC office and Co-Chair of its Government and Commercial Contracts practice. My practice is devoted exclusively to the area of Government contracts, and my clients range from major defense contractors to bio-tech firms and non-profits. I believe I have a good understanding of the challenges currently facing government procurement. I have been ranked by *Legal Times* as one of the top twelve government contracts lawyers in the Washington, DC area, and nationally ranked by *Chambers USA* as one of the top three government contracts lawyers specializing in the area of Government Contracts: Costs Disputes. I currently serve as Chair Elect of the American Bar Association Section of Public Contract Law and Editor-in-Chief of both the *Public Contract Law Journal* and the *Cost, Pricing and Accounting Report*. I am also the author of the two-volume text, *Government Contract Costs & Pricing*, the second edition (and third volume) of which is scheduled for publication this summer by Thomson-Reuters. Last but not least, I am the Vice-Chair and Chair-nominee of the National Defense Industrial Association Procurement Policy Committee. I appear before you today both in my personal capacity and as a representative of NDIA.

I would like to take this opportunity to bring to the Subcommittee’s attention three of what I believe to be the most significant challenges facing public procurement today: (1) the Defense Contract Audit Agency, (2) the Government’s overworked, under-trained and under-appreciated acquisition workforce, and (3) the contract disputes system. The common theme underlying these challenges is that each adds to the cost, difficulty and uncertainty in doing business with the Government, and, for that reason, presents an opportunity for strengthening Government procurement.

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Defense Contract Audit Agency

Over the past several months, the Defense Contract Audit Agency (or “DCAA” as it is more commonly known), has adopted aggressive new audit policies that are wreaking havoc on the Government procurement world. DCAA, of course, has a very important mission of performing contract audits and providing accounting and financial advisory services to the Department of Defense and a number of other agencies. I do not take issue with that, and to the contrary, believe that DCAA should focus on its mission. However, DCAA has strayed far a field of its primary mission, and appears to be focusing its efforts on “systems” audits that are time-consuming and disruptive and often have little if anything to do with actually protecting the Government against unallowable costs.

On December 19, 2008, DCAA issued new guidance to its auditors on reporting audit opinions on contractors’ internal control systems. Internal controls are a component of DCAA’s standard audit programs for all of a contractor’s business systems, including, for example, accounting, billing, estimating and purchasing systems. Previously, it was DCAA policy to report a “significant deficiency” or “material weakness” in a contractor’s internal controls only when all of the following conditions applied: (1) the deficiency adversely affected the contractor’s ability to initiate, authorize, record, process or report Government contract costs in accordance with applicable Government contract laws and regulations, (2) the deficiency resulted in a reasonable possibility that unallowable costs will be charged to the Government, and (3) the potential unallowable cost is not clearly immaterial. Under the previous policy, even when a DCAA auditor identified a “significant deficiency” or “material weakness,” the auditor was still free to issue an audit opinion that the system under review was “inadequate in part” rather than “inadequate.”

The December 19th guidance requires auditors to report a significant deficiency/material weakness whenever the contractor fails to accomplish *any* control objective tested for in DCAA’s internal control audits, regardless of whether the control objective is directly related to charging costs to Government contracts, and even when the deficiency has not resulted in *any* questioned costs. In addition, the guidance states that whenever an auditor finds a significant deficiency/material weakness, the audit report *must* include an opinion that the system is inadequate. The guidance expressly prohibits DCAA auditors from issuing “inadequate in part” opinions.

There are a number of problems with this guidance. First, there is no statutory, regulatory or contractual basis for many of the “control objectives” that DCAA uses to conduct its audits. For example, DCAA’s “Internal Control Matrix for Audit of Billing System Controls” has a control objective for “Management Reviews” which includes an audit procedure for evaluating the contractor’s record of completed internal audits. In performing this audit step, DCAA auditors frequently demand access to internal audit reports, despite the holding in *United States v. Newport News Shipbuilding & Dry Dock Co.*, 837 F.2d 162 (4th Cir. 1988), that DCAA lacks authority to compel production of internal audit reports. The Fourth Circuit observed that, “Cost verification data, not the work product of internal auditors, is the proper subject of a DCAA subpoena. DCAA performs a critical auditing mission, but it is not running the company.” 837 F.2d at 170. As another example, DCAA’s “Internal Control Matrix for Control Environment and Overall Accounting System Controls” has a control objective for “Integrity and

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Ethical Values” which includes an audit procedure for verifying “that the contractor performs periodic reviews of company business practices, procedures, and internal controls for compliance with standards of conduct.” In performing this audit step, DCAA auditors frequently demand access to reports of internal investigations even when the reports are subject to the attorney-client privilege or attorney work product doctrine. A contractor’s understandable (and perfectly legitimate) refusal to provide access to this information is reported as a significant weakness/material deficiency in internal controls.

Second, many of DCAA’s control objectives are subjective, and reasonable minds can differ about what is or is not adequate. For example, there is a “Policies and Procedures” control objective in the “Internal Control Matrix for Audit of Billing System Controls” that includes the contractor’s policies and procedures for evaluating and monitoring subcontractors’ accounting and billing systems. Setting aside the fact that nothing in the Federal Acquisition Regulation (“FAR”) requires contractors to evaluate and monitor their subcontractors’ accounting and billing systems, there is no objective means of measuring whether the contractor’s policies and procedures for doing so are adequate. However, any inadequacy, no matter how trivial, could result in an audit opinion that the contractor’s billing system is inadequate.

Third, a DCAA opinion that one of a contractor’s business systems is inadequate can have serious consequences for the contractor. Perhaps most significantly, some Government officials have interpreted FAR 16.301-3(a)(1) to mean that a contractor with an “inadequate” accounting system is ineligible for award of a Government cost reimbursement contract. *See* 48 C.F.R. § 16.301-3(a)(1) (“A cost-reimbursement contract may be used only when – The contractor’s accounting system is adequate for determining costs applicable to the contract”).

Ultimately, DCAA is merely an advisor to the contracting officer, and the cognizant administrative contracting officer – not DCAA – has the authority to determine whether a contractor’s business systems are or are not adequate. Recently, however, DCAA has upset this system of checks-and-balances by issuing audit guidance that appears calculated to intimidate contracting officers. On March 13, 2009, DCAA published audit guidance on “Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials.” According to the audit guidance, “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.” It cites as an example a contracting officer “ignor[ing] a DCAA audit report and tak[ing] an action that is grossly inconsistent with procurement law and regulation.” The audit guidance instructs auditors to report these “unsatisfactory conditions” directly to the Department of Defense Office of Inspector General (“DoD IG”) rather than going through the Government official’s chain of command. Lest there be any doubt about the DoD IG’s view of the matter, on April 8, 2009, the DoD IG published its *Oversight Review: Defense Contract Management Agency Actions on Audits of Cost Accounting Standards and Internal Control Systems at DoD Contractors Involved in Iraq Reconstruction Activities (D-2009-6-004)*, which harshly criticizes administrative contracting officers for, among other things, disagreeing with DCAA audit reports containing internal control system recommendations and determining that contractors’ business systems were adequate without waiting for DCAA to complete a follow-up review.

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The net result of these new audit policies is that systems audits are consuming a tremendous amount of time and resources for both DCAA and contractors; contractors are trying desperately to avoid an audit opinion that their systems are “inadequate”; and contracting officers are afraid to disagree with DCAA – despite the fact that there is little if any discernable relationship between the systems audits and protecting the Government against unallowable costs. Moreover, widespread findings of inadequate accounting systems could seriously disrupt major procurements, and at the very least will provide a fertile source of bid protest issues. It would far better serve the taxpayers and strengthen Government procurement for DCAA to focus its efforts on performing high quality contract audits that enable the Government’s acquisition professionals to award, administer and close-out Government contracts in a timely manner.

Government’s Acquisition Workforce

The Government’s acquisition workforce is another major challenge facing our procurement system. Beginning with the Reagan Administration and culminating in the Clinton Administration, the Federal Government embarked on a laudable, bipartisan effort to increase the effectiveness and efficiency of Government procurement by reducing administrative costs and other burdens which the procurement system imposes on both the Government and the private sector. One result of this acquisition streamlining effort that in hindsight has proven a mistake was the significant cuts that were made to the acquisition workforce. It is no surprise to anyone that there are now too few Government acquisition professionals. Equally if not more problematic from industry’s perspective, many of today’s acquisition professionals are untrained, overworked and poorly motivated.

Acquisition professionals play a key role in ensuring that Government procurement runs smoothly. Administrative contracting officers in particular are critical to the success of our procurement system. I respectfully submit that funds appropriated to increase the number of agency IGs would be better spent – and our procurement system far better served – by hiring, training and nurturing a professional cadre of acquisition professionals.

Contract Disputes Process

The contract disputes process is in many respects broken. The Contract Disputes Act was intended to provide for a cost-effective and efficient means of resolving contract disputes. In exchange for this benefit, government contractors forgo have that private contract litigants take for granted, including the right to stop work or seek an injunction. However, the Contract Disputes Act has not fulfilled its promise; it is frequently neither cost-effective nor efficient. Whether one chooses to litigate at a board of contract appeals or the U.S. Court of Federal Claims, the process is far too slow. Not infrequently, the U.S. Court of Appeals for the Federal Circuit and its predecessor courts have likened government contracts cases to *Jarndyce v. Jarndyce*, the interminable case in Dickens’s *Bleak House*. See, e.g., *McDonnell Douglas Corp. v. United States*, 2009 WL 1515777 (Fed. Cir. June 2, 2009). The comparison is unfortunately an apt one – litigating a government contracts case often feels like being in Dickens’s Court of Chancery.

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Conclusion

Thank you again for the opportunity to appear before the Subcommittee. I would be pleased to answer any questions.

Respectfully submitted,

Karen L. Manos