ROLE OF INTERNAL AUDIT - BUSINESS SYSTEMS & SUBCONTRACT OVERSIGHT

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AGENDA

• Introductions

• The Role of Internal Audit
  – Business systems compliance
  – Subcontract management compliance
  – Contract clause compliance
  – Other key areas of involvement for internal audit as discussed in our 2019 GAUGE Report
OVERSIGHT OF BUSINESS SYSTEMS
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

According to the Charter Institute of Internal Auditors:

*The role of internal audit is to provide independent assurance that an organization's risk management, governance and internal control processes are operating effectively.*
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

What does this mean to my organization?

OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

Business System Elements

1. Policy and Procedures
2. Training (minimum annually)
3. Documentation
4. Internal Review/Audit
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

- DFARS 252.242-7005 Contractor Business Systems defines 6 different systems:

1. Accounting System DFARS 252.242-7006
2. Earned Value Management System DFARS 252.234-7002
4. Material Management and Accounting System DFARS 252.242-7004
5. Property Management System DFARS 252.245-7003
6. Purchasing System DFARS 252.244-7001
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

• DFARS 252.242-7005 Contractor Business Systems states:
  – “The Contractor shall establish and maintain acceptable business systems in accordance with the terms and conditions of this contract.”

Acceptable contractor business systems

• means contractor business systems that comply with the terms and conditions of the applicable business system clauses listed in the definition of "contractor business systems" in this clause.

Significant deficiency

• in the case of a contractor business system, means a shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

- DFARS 252.242-7005 Contractor Business Systems states:

  If significant deficiencies are identified:
  
  The Contractor shall respond, in writing, within 30 days to an initial determination that there are one or more significant deficiencies in one or more of the Contractor’s business systems.

  The Contracting Officer will evaluate the Contractor’s response and notify the Contractor, in writing, of the final determination as to whether the Contractor’s business system contains significant deficiencies. If the Contracting Officer determines that the Contractor’s business system contains significant deficiencies, the final determination will include a notice to withhold payments.
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

- DFARS 252.242-7005 Contractor Business Systems states:
  - Withholding Payments for
    - CAS covered contracts
      - Once significant deficiencies are identified, a 5% withhold can be assessed
      - You have 45 days to correct the deficiency or come up with a corrective action plan which will reduce the withhold to 2%
      - It will jump back up to 5% if you do not meet the CAP objectives.
      - If you have multiple system deficiencies, the withhold increases to 10%
    - Non CAS covered contracts
      - Delays in awards
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

DFARS 252.242-7005 Contractor Business Systems Recap

1. We defined the Internal Audit Function and how it fits into the Oversight of Business Systems.

2. We discussed the Business System Clause and what triggers compliance with the clause.

3. We listed the 6 types of systems and provided the DFARS references to each.

4. We defined an acceptable business system and a significant deficiency.

5. We provided an overview of what happens when significant deficiencies are found.

6. And the key take away...5% or potentially up to 10% of your payments could be withheld if your system is found lacking and can cause delays in awards.
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

<table>
<thead>
<tr>
<th>Business System</th>
<th>Criteria</th>
<th>DFARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting System</td>
<td>18 Criteria</td>
<td>252.242-7006</td>
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<tr>
<td>Earned Value Management System</td>
<td>32 Criteria</td>
<td>252.234-7002</td>
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<tr>
<td>Estimating System</td>
<td>17 Criteria</td>
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<tr>
<td>Material Management and Accounting System</td>
<td>10 Criteria</td>
<td>252.242-7004</td>
</tr>
<tr>
<td>Property Management System</td>
<td>10 Criteria</td>
<td>252.245-7003</td>
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<tr>
<td>Purchasing System</td>
<td>19 Criteria</td>
<td>252.244-7001</td>
</tr>
</tbody>
</table>
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

![Diagram and Table]

This is a slide developed by an organization to assess the potential vulnerability of business systems to external threats, such as theft or unauthorized access. The diagram outlines specific controls and procedures to mitigate these risks, including controls over access, monitoring, and physical security. The table provides a detailed overview of these controls, with columns for "Control" and "Implementation Considerations."
OVERSIGHT OF BUSINESS SYSTEMS

Business Systems Defined at DFARS 252.242-7005

What does this mean to my organization?

<table>
<thead>
<tr>
<th>Agency Responsible for Review</th>
<th>Business System</th>
<th>Frequency of Business System Reviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense Contract Audit Agency (DCAA)</td>
<td>Accounting</td>
<td>Every 3 years</td>
</tr>
<tr>
<td></td>
<td>Estimating</td>
<td>Every 3 years unless a risk assessment deems otherwise</td>
</tr>
<tr>
<td></td>
<td>Material Management and Accounting</td>
<td>Every 3 years unless substantiated evidence suggests that the contractor’s systems are adequate</td>
</tr>
<tr>
<td>Defense Contract Management Agency (DCMA)</td>
<td>Purchasing</td>
<td>Every 3-5 years based on an assessment of risk completed by DCMA administrative contracting officer</td>
</tr>
<tr>
<td></td>
<td>Property Management</td>
<td>Every 1-3 years based on a risk assessment competed by DCMA property administrator</td>
</tr>
<tr>
<td></td>
<td>Earned Value Management</td>
<td>Every 3 years based on results of annual surveillance; full system reviews are performed based on an administrative contracting officer’s determination or at the time of initial contract award</td>
</tr>
</tbody>
</table>

Source: GAO analysis of DOD policies and regulations | GAO-19-212
Let’s take a deeper look at the Accounting System Administration clause and how Internal Audit can set up a framework to monitor the system criteria.
## OVERSIGHT OF BUSINESS SYSTEMS

**DFARS 252.242-7006 Accounting System Administration**

### BUSINESS SYSTEM APPLICABILITY RULES

<table>
<thead>
<tr>
<th>SYSTEM</th>
<th>FAR, DFARS, PROVISIONS, and CLAUSES</th>
<th>CRITERIA</th>
</tr>
</thead>
</table>
| NON-DOD | FAR 16.301-3 Cost-Reimbursement Contracts - Limitations | 1. Does your company have a Government cost-reimbursement contract? - **AND** -  
2. Did the ACO determine a need for accounting system audit based on significant cost-reimbursement contracts, change in cost accounting practices, billing or invoicing issues, audit recommendation, or other rationale? |
| DOD | DFARS 242.7502(a)  
DFARS Clause 252.242-7006 | 1. Is your Company a DoD prime contractor or subcontractor?  
2. Does any prime contract or subcontract contain a similar DFARS clause or language requiring an adequate accounting system?  
3. Was the Company awarded or executed any of the following contract types:  
   (a) Cost-reimbursement contract (FAR 16)  
   (b) Incentive contract based on cost information  
   (c) T&M (Both Commercial FAR 12 and non-commercial FAR 15)  
   (d) Labor hour contracts  
   (e) Contracts with progress payments made on the basis of costs incurred or on % completion |
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

• An “Accounting System” is defined as:
  – The Contractor’s system or systems for accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions, and may include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.

• An “acceptable accounting system” means a system that complies with the system criteria in paragraph (c) of this clause (the 18 criteria) to provide reasonable assurance that—
  – (i) Applicable laws and regulations are complied with;
  – (ii) The accounting system and cost data are reliable;
  – (iii) Risk of misallocations and mischarges are minimized; and
  – (iv) Contract allocations and charges are consistent with billing procedures.
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

1. A sound internal control environment, accounting framework, and organizational structure;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

2. Proper segregation of direct costs from indirect costs;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

3. Identification and accumulation of direct costs by contract;
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DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

4. A logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

5. Accumulation of costs under general ledger control;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

6. Reconciliation of subsidiary cost ledgers and cost objectives to general ledger;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

7. Approval and documentation of adjusting entries;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

8. Management reviews or internal audits of the system to ensure compliance with the Contractor’s established policies, procedures, and accounting practices:
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

9. A timekeeping system that identifies employees’ labor by intermediate or final cost objectives;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

10. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

11. Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

12. Exclusion from costs charged to Government contracts of amounts which are not allowable in terms of Federal Acquisition Regulation (FAR) part 31, Contract Cost Principles and Procedures, and other contract provisions;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

13. Identification of costs by contract line item and by units (as if each unit or line item were a separate contract), if required by the contract;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

14. Segregation of preproduction costs from production costs, as applicable;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

15. Cost accounting information, as required—
   - (i) By contract clauses concerning limitation of cost (FAR 52.232-20), limitation of funds (FAR 52.232-22), or allowable cost and payment (FAR 52.216-7); and
   - (ii) To readily calculate indirect cost rates from the books of accounts;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

16. Billings that can be reconciled to the cost accounts for both current and cumulative amounts claimed and comply with contract terms;
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

17. Adequate, reliable data for use in pricing follow-on acquisitions; and
OVERSIGHT OF BUSINESS SYSTEMS

DFARS 252.242-7006 Accounting System Administration

System Criteria - The Contractor’s accounting system shall provide for:

18. Accounting practices in accordance with standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, Generally Accepted Accounting Principles.
OVERSIGHT OF BUSINESS SYSTEMS

Questions ???
OVERSIGHT OF BUSINESS SYSTEMS

Summary

1. We defined the Internal Audit Function and how it fits into the Oversight of Business Systems.

2. We discussed the Business System Clause and what triggers compliance with the clause using the Business System Applicability Chart from GovCon360.com.

3. We listed the 6 types of systems and provided the DFARS references to each.

4. We defined an acceptable business system and a significant deficiency.
OVERSIGHT OF BUSINESS SYSTEMS

Summary

5. We provided an overview of what happens when significant deficiencies are found.

6. Withholds for a significant deficiency are 5% or up to 10% if more than one system is deficient.

7. We walked through the Accounting System criteria and provided insights on what to consider in building your oversight plan.

8. We offered a 3 prong approach to oversight including Policies, Procedures, and Key Controls.
2019 GAUGE REPORT

Additional Resources

• If you haven’t already reviewed the 2019 GAUGE Report, visit us at https://www.cohnreznick.com/ and request your copy now.

• This year’s theme is internal control and it offers insights throughout the report to help you create a roadmap for establishing and managing internal controls within your organization.
OTHER CONSIDERATIONS

Things to think about???

1. Think about M&A situations - while you are focusing on SOX, who is looking at Government system implications?

2. What if your subcontractor blocks you from reviews?

3. Are you prepared for remediation?

4. Are you in the loop on IT controls?

5. Are you routinely visiting the DCAA website to review the audit programs to ensure that you have implemented appropriate oversight?
INTERNAL AUDIT ROLES RELATIVE TO SUBCONTRACTING PRACTICES
INTERNAL AUDIT ROLES REGARDING SUBCONTRACTS

• For government contractors, the importance of good controls over subcontracts can’t be overstated. Some areas for Internal Audit involvement include:
  – Subcontract Monitoring Controls
  – Subcontract Closeout Compliance and Control
  – Subcontract Audit Accomplishment
  – Subcontract Flow Down Clause Compliance
  – Regulatory Compliance Regarding Subcontracting Methods
**SUBCONTRACT MONITORING CONTROLS**

• Internal Audit evaluation of policies, procedures and actual practices related to subcontract monitoring can be an important focus area for Internal Audit groups of Government Contractors.

• Many government contractors have experienced negative consequences of not adequately monitoring subcontractors including:
  – Negative CPARS evaluation by government agency
  – Non recovery of costs incurred on subcontracts when adequate monitoring was not performed
  – Incurrence of cost to address work not properly completed by subcontractors
SUBCONTRACT CLOSEOUT RESPONSIBILITIES

• FAR 4.804-5; DD 1597 as applicable:
  • (1) Disposition of classified material is completed;
  • (2) Final patent report is cleared.
  • (3) Final royalty report is cleared;
  • (4) There is no outstanding value engineering change proposal;
  • (5) Plant clearance report is received;
  • (6) Property clearance is received;
  • (7) All interim or disallowed costs are settled;
  • (8) Price revision is completed;
  • (9) Subcontracts are settled by the prime contractor;
  • (10) Prior year indirect cost rates are settled;
  • (11) Termination docket is completed;
  • (12) Contract audit is completed;
  • (13) Contractor’s closing statement is completed;
  • (14) Contractor’s final invoice has been submitted; and
  • (15) Contract funds review is completed and excess funds deobligated.
CONSIDER QUICK CLOSE OUT FOR SUBS!

- Companies should consider if they should establish controls to identify subcontracts that can be considered eligible for quick close out.

- Consider the requirements of FAR 42.708, including the need to perform a risk assessment.

- Once approach is developed, coordinate with contracting officer to ensure they do not object to approach used to identify subcontracts eligible for Quick Closeout.

- Then, close out eligible subcontracts to avoid the need for further actions such as awaiting completion of audits..
Subcontract Closeout Responsibilities

• **What are the prime contractor’s responsibilities related to subcontract closeout?**
  - Prime contractor is responsible for essentially all of the requirements the Government has to close out prime contracts (see previous slide)
  • Cost-type subcontract FAR Clause 52.216-7, Allowable Cost and Payment, requires:
    o Determination of final indirect rates and allowable direct costs
    o Requires audit of subcontracts
    o Generally, the Government will not perform the subcontract audit unless the subcontractor is large and it already has an audit presence at the subcontractor
    o Therefore, generally this task falls to the prime contractor
• **AUDIT REQUIREMENTS**

- **Cost Plus Type Subcontracts**
  - Requires audit of direct and indirect costs

- **Time and Material (T&M) Subcontracts**
  - Requires audit of material/ODC markup
  - Requires audit of indirect rates if based on costs
  - Audit of labor hours may rely, to a great extent on monthly review of time charges
SUBCONTRACT CLOSEOUT AUDIT REQUIREMENTS

• T&M subcontracts have to be audited?

• FAR 52.216-7 (Allowable Cost and Payment Clause) is applicable to cost type and T&M contracts for other than commercial items.

• The clause requires contractors to submit a “schedule of direct costs by contract and subcontract and indirect expense applied at claimed rates.”
According to DCMA they do!

DCMA Instruction 135, Section 3.2.3.2.

“The prime contractor is responsible for auditing subcontractors and generally closes subcontracts using procedures similar to the Government. The functional specialist shall ensure that the prime has settled subcontractor costs before closing a contract/order. DCAA may issue a qualified indirect cost audit report indicating that audit of certain subcontract costs has not been completed. When the subcontract costs (direct or indirect) are considered to be immaterial, the functional specialist may proceed with contract closeout.”
SUBCONTRACT CLOSEOUT AUDIT REQUIREMENTS

But, we have over a 100 T&M subcontracts!

This is where we believe the prime must exercise judgment.

*Potential Risk Assessment Procedures:*

1. Grouping by dollar value
2. Grouping by known risks
3. Application of known findings to low to medium risk subcontracts
4. Reliance on monthly billing controls for hours and direct costs
5. Performance of audits of subcontracts classified as high risk

Note: This is one potential solution. Each CO may have a different perception as to whether this is sufficient.
SUBCONTRACT AUDIT: DCAA’S RECENT APPROACH

- OVER THE LAST SEVERAL YEARS, DCAA HAS BEEN VERY AGGRESSIVE IN QUESTIONING SUBCONTRACT COSTS WHEN IT DETERMINES:
  - An audit has not been performed of T&M, LH or cost type contracts
  - DCAA has applied a 20% decrement to calculate questioned costs for unaudited subcontracts
  - DoDIG cited DCAA for noncompliance with GAGAS and attestation standards due to the use of the 20% decrement (Hotline Complaint Regarding the DCAA Examination of a Contractor’s Subcontract Costs dated 12/23/2014).
  - Therefore, DCAA appears to have discontinued use of the decrement factor. However, now may question the whole amount of the unaudited subcontracts.

Implications: DCAA has not backed off from its aggressive approaches to questioning unaudited subcontract costs.
SUBCONTRACT AUDIT: OTHER AGENCY APPROACH (NON-DOD)

- IN MARCH 2016, DOE OIG REPORT INDICATED:
  - Alliance for Renewable Energy (Alliance) is required by its contract to conduct or arrange for audits of its subcontractors when costs are a factor in determining the amount payable to the subcontractor.
  - In the past the subcontract audit function for Alliance did not consistently follow Generally Accepted Government Audit Standards (GAGAS) and was found deficient in this area in a 2013 report.
SUBCONTRACT AUDIT - THE CURRENT SITUATION: HOW TO PROCEED?

• Given the somewhat contradictory information (i.e., DCAA approach vs. ASBCA cases vs. FAR requirements vs. agency-specific approaches), it can be unclear to prime contractors how to respond to mitigate risk while also controlling the costs of the subcontract audit

• BEST PRACTICE RECOMMENDATIONS
  o Conduct or cause to be conducted audits of cost type subcontract indirect rates
  o Follow GAGAS in the conducting of the subcontract audits
  o Consider controls in place relative to ongoing evaluation of subcontractor direct costs, hours, and application of agreed-upon (fixed) rates to hours.
  o If a non-DoD contractor, determine your agency’s position with regard to subcontract audit and proceed accordingly
SUBCONTRACT AUDIT: GAGAS REQUIREMENTS

• GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS)

• As mentioned in a previous slide, Government customers are now frequently expecting subcontract audits to be performed in accordance with GAGAS. Therefore, we will cover the implications of performing subcontract audits in accordance with GAGAS.

• Issues to be discussed include:
  • Options for conducting GAGAS audits (types of audits)
  • Who can perform GAGAS audits?
  • Does it make sense to outsource GAGAS audits?
Determining Significance and Obtaining an Understanding of Internal Control

GAGAS 8.39 - 8.40

- Auditors should determine and document whether internal control is significant to the audit objectives and obtain an understanding of such internal control.

- Assessing Internal Control

GAGAS 8.49

- If internal controls determined to be significant to the audit objectives, auditors should assess their design, implementation, and/or operating effectiveness of such internal control to the extent necessary to address the audit objectives.
SUBCONTRACT AUDIT: GAGAS REQUIREMENTS (AUDIT OPTIONS)

• ATTESTATION ENGAGEMENTS

• Examinations: DCAA typically performs incurred cost audits as examination engagements.
• Reviews: Lesser in scope and may not be considered sufficient
• Agreed Upon Procedures (AUP): Because exercise of auditor judgment is a key element to successfully performing incurred cost audits, it is almost impossible to do these as AUP engagements.

• Incurred cost audits can be performed as examination engagements, although we believe the best option is to conduct as a performance audit.
SUBCONTRACT AUDIT: GAGAS REQUIREMENTS (AUDIT OPTIONS)

• PERFORMANCE AUDITS

• Audits that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria
• Enables the exercise of judgment and coordination with the client in developing the specific objective, scope and criteria to be applied
• Greater flexibility in how reports are presented and what content is reported
• Performance audit standards do not (as of yet) incorporate AICPA standards as do financial audits and attestation engagements
For all types of GAGAS audits, compliance with the Conceptual Framework is required. Independence includes:

- Independence of Mind
- Independence of Appearance

An important consideration when deciding whether to perform audits in house or to outsource is the independence consideration. If the Government believes there are unresolved threats to independence, it may not accept the audit results.
SUBCONTRACT AUDIT: OTHER GAGAS REQUIREMENTS

• WHO CAN PERFORM GAGAS AUDITS?

• OTHER REQUIREMENTS
  • Requires audit leadership and team members with adequate professional competence and the appropriate background in performing GAGAS compliant audits (3.69)
  • CPE: All auditors working on GAGAS engagements must meet GAGAS specific CPE requirements (3.76). This must be documented and retained.
  • An acceptable audit Quality Control system (3.93)
  • External peer review (3.96)
  • Policies and safeguards related to custody and retention of audit documentation (3.92)
• WHO CAN PERFORM GAGAS AUDITS?

• WORKPAPER REQUIREMENTS
• Workpaper files must be of high quality and have specific content to meet GAGAS requirements, including:
  – Audit planning documentation
  – Materiality determination
  – Risk Assessment
  – Sampling and Projection of Exceptions
  – Testing of controls
  – Summarization of results
SUBCONTRACT AUDIT: WORKPAPER REQUIREMENTS

• WHO CAN PERFORM GAGAS AUDITS?

• WORKPAPER REQUIREMENTS
  • Workpaper files must be of high quality and have six elements to meet GAGAS requirements, including:
    – Audit planning documentation
    – Materiality determination
    – Risk Assessment
    – Sampling and Projection of Exceptions
    – Testing of controls
    – Summarization of results
WHAT IS A FLOWDOWN CLAUSE?

- A Government prime contract clause incorporated into a subcontract/PO/consulting agreement/etc.
  - A flowdown transfers requirements from a prime contract into a subcontract in support of the prime contract
  - Subcontract clauses “flow down” responsibilities of the prime contractor to subcontractor
  - Can significantly impact obligations and risk of performing a subcontract
WHAT IS A FLOWDOWN CLAUSE?

• Each FAR/DFARS/other agency clause is unique and can tell the prime contractor if the clause is to be *inserted, incorporated, will include the language, shall insert*, etc. (all these terms are used to indicate flowdown) into a subcontract.

• It is the responsibility of the prime contractor to decide which of the flowdown clauses apply by matching the work effort to the description found in the clause.
  – For example, a clause may only require flowdown if the subcontracted work is valued at greater than $100,000 or in all subcontracts that involve access to classified material.
WHAT IS A FLOWDOWN CLAUSE?

A Clause is generally flowed down in one of three ways:

• By reference to a clause without including its full text in the subcontract
• By incorporating the full text of the clause
• By applying the “substantially as follows” or “substantially the same as” basis
THE IMPORTANCE OF FLOWDOWN CLAUSES

Why do flowdown clauses matter?

• PRIME CONTRACTOR
  • Ensure subcontractors/suppliers are required to comply with certain contract requirements
  • Business system maintenance/approval
  • Maximize cost recovery by ensuring cost reasonableness
  • Manage/allocate performance uncertainties and risk

• SUBCONTRACTOR
  • Ability to participate in huge Federal marketplace
  • Ensures subcontractor understands contractual/compliance obligations
FLOWDOWN CLAUSES TO COST TYPE AND T&M SUBCONTRACTS

• FAR 52.216-7 Allowable Cost and Payment
• This is not a mandatory flow down clause
• This clause would be necessary and applicable to cost type subcontracts where indirect rates and direct costs are to be based on actual costs incurred
• What are the expectation and implications with regards to inclusion of the clause in T&M subcontracts?
FLOWDOWN CLAUSES TO T&M SUBCONTRACTS

Expectations of Inclusion of the clause in T&M subcontracts

• The government has indicated in guidance to its contracting officers that the clause must be included in any T&M prime contracts where direct costs are based on actual costs incurred and/or where an actual indirect rate is applied to actual direct costs.
• Any indirect rates applied would have to be based on actual rates to not violate the Cost Plus Percentage of Cost (CPPC) prohibition.
• DCMA Instruction 135, Section 3.2.3.2 indicates the Prime contractor is responsible for auditing subcontract costs - to accomplish this, the subcontract would need to include the FAR 52.216-7 clause.
• To know for sure, companies would need to reach out to their Contracting Officer and obtain agreement on what the expectations will be for T&M subcontract audit.
Implications of Inclusion of FAR 52.216-7 in T&M Subcontracts

- Including this clause in T&M subcontracts does impose additional requirements on the Prime, such as ensuring that indirect rates applied to direct cost and direct costs audited in a timely manner. However, the alternative is to place recovery of subcontract costs at risk if the expectation from the government customer is that these costs are audited.
FLOWDOWN CLAUSES TO T&M SUBCONTRACTS

Implications of Inclusion of FAR 52.216-7 in T&M subcontracts

This clause requires the contractor to submit an annual incurred cost submission (ICS) within six months of the end of the fiscal year

• The clause mandates the ICS to contain specific schedules including:
  – Actual claimed direct cost by contract
  – Indirect rate pools and bases and rate calculations
  – Information on subcontracts
  – A certificate of final indirect rates
  – Various reconciliations

• Requires the execution of a written understanding on final indirect cost rates
FLOWDOWN CLAUSES TO T&M SUBCONTRACTS

Possible Approach to Including/Excluding FAR 52.216-7 in T&M Subcontracts (subject to discussion with Contracting Officer)

1. Consider materiality - including the clause in small T&M subcontracts with little flexibly priced costs may be overly burdensome.

2. Consider whether actual indirect rates are applied. If this is the case, it will be harder to argue that the clause does not apply.

3. For those T&M for which the only flexibly priced cost are direct costs, the requirements related to annual indirect rate submission do not align with the nature of the contract. Discuss with the Contracting Officer and determine if the clause can be excluded.
INTERNAL AUDIT ROLE IN REGULATORY COMPLIANCE FOR SUBCONTRACTING

We have noted a number of issues that Government Contractor Internal Audit Departments have found to be areas requiring their involvement, including:

• Cost Plus Percentage of Cost (CPPC) prohibition compliance
• Assessment of compliance with competition, cost/price analysis in subcontracting requirements
• Counterfeit Electronic Part compliance controls
• Assessment of subcontractor compliance with affirmative action requirements and other mandatory regulatory requirements of government contractors
INTERNAL AUDIT ROLE IN REGULATORY COMPLIANCE FOR SUBCONTRACTING

• Assessment of controls to evaluate ASBCA case results and changes to regulations related to subcontracting

• Evaluation of controls relative to subcontract type decisions

• Consider recent change to DCAA accounting system audit program whereby DCAA now considers that a system deficiency exists when the prime cannot evidence adequate subcontract monitoring controls.
The New CMMC & Other Security Requirement from 3 Perspectives: DoD, Supply Chain, and Legal

Beginning in 2020, the DoD will require that all DoD contractors throughout the supply chain provide written proof of a compliant security program in RFP responses. To establish accreditation, the DoD is establishing a new standard and maturity ranking called the Cybersecurity Maturity Model Certification (CMMC). Under the CMMC, contractors will be assessed on their implementation of required cybersecurity controls and processes, and their cybersecurity against a maturity scale.

Join us for this timely presentation as we discuss the implications of these requirements from the DoD, supply chain, and legal perspectives. Key takeaways will include:

- Definitions of the 5 levels of cybersecurity hygiene
- How to comply with advanced breach-detection mandates
- Actions government contractors and subcontractors should take now to prepare and demonstrate compliance
- Legal perspective to ensure the entire supply chain is secure and adheres to requirements
QUESTIONS & ANSWERS
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THANK YOU FOR ATTENDING!

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