

## **Recommendation 58: Address the issue of over-age contracts through (a) establishing an end-to-end, integrated, streamlined process, (b) codifying DCMA's Quick Close Out class deviation in the DFARS, and (c) extending DCMA's Low Risk Quick Close Out initiative by 2 years.**

### **Problem**

If Recommendation 57 is adopted, and the 5-year cancellation deadline is lengthened to 8 years, it may, in the short term, result in reduced pressure on the contract administration organizations that deal with contract closeouts. DCMA currently has a large backlog of approximately 65,000 over-aged contracts and this issue needs to be resolved to allow agencies to reach a workload steady state of closing out contracts. Resource constraints and processes that limit the ability to close out contracts appear to cause this backlog. The current DCMA backlog represents only a portion of the contracts administered by DoD and the entire scope of over-aged contracts needs to be identified. A cross-organization mitigation strategy with streamlined process improvements would preclude this situation from reoccurring and placing current funds at risk of use for cancelled bills.

### **Background**

The primary focus of the acquisition system is the selection and administration of contracts. Work on a contract can go on long after the delivery of the last product or the performance of the last service with contract closeout the final step in the contract lifecycle.

Contract closeout is a complex set of processes and subprocesses that includes the contractor and government working together to confirm all deliveries or performance services have been properly completed, settling up the final contract indirect costs rates, reconciling the various type and year of funds used on the contract, dispositioning residual inventory or government property, disposing of any classified information, addressing any patents filed by the contractor related to work performed under the contract, addressing any open warranty matters, settling any partial terminations of the work to be performed, resolution of any contract disputes or other legal matters, and more.

Closeout can be a relatively simple process in firm-fixed-price contracts but can be enormously complex for flexibly priced (fixed-price-incentive and cost-reimbursement) contracts. Among the most time-consuming of these closeout tasks is the settling of the contractor's final indirect costs and the settlement of the indirect costs are found to be the root cause of the overaged contract backlog.

A major component of any flexibly priced contract is the cost associated with general and administrative expenses, labor rates, receiving and inspection costs and other essential, but indirect costs. At the time a contract is priced, negotiated estimates of indirect rates are used to establish billing rates. At the end of each contractor fiscal year in which the contract was performed the contractor must prepare a final indirect cost overhead rate proposal, including any final indirect costs applicable to any corporate headquarters. The final indirect-costs-rate proposal for each year is submitted to DCAA for audit and DCMA for final negotiation of all allowable and allocable indirect costs.

The process described above for the prime contractor's direct and indirect costs is repeated for each flexibly priced subcontract the prime may have awarded in support of the prime contract. The prime

contractor cannot submit its final indirect-cost proposal to the government for audit and negotiation until all its flexibly priced subcontracts have been settled and the final costs incorporated into the prime's final cost proposals for submission to the government.

This lengthy contract closeout process starts when the contractor prepares a final indirect-cost proposal including all direct costs (including final subcontract costs) and the negotiated final overhead rates for each year of performance. The final indirect-cost proposal is submitted to DCAA for audit. DCAA provides audit and financial advisory services to DoD and other federal entities responsible for acquisition and contract administration. When DCAA completes the audit, then DCMA conducts final negotiations. Once complete, any excess funds are deobligated or any shortage of funds is addressed by working through DFAS. DCMA works directly with defense suppliers to help ensure DoD, federal, and allied government supplies and services are delivered on time, at projected cost, and with all performance requirements met.

“DCMA professionals serve as ‘information brokers’ and in-plant representatives for military, Federal, and allied government buying agencies — both during the initial stages of the acquisition cycle and throughout the life of the resulting contracts. Before contract award, DCMA provides advice and information to help construct effective solicitations, identify potential risks, select the most capable contractors, and write contracts that meet the needs of customers in DoD, federal, and allied government agencies. After contract award, DCMA monitors contractors’ performance and management systems to ensure that cost, product performance, and delivery schedules are in compliance with the terms and conditions of the contracts.”<sup>1</sup> DCMA serves as the ACO with responsibility for more than 20,000 contractors and more than \$223 billion in unliquidated obligations.

In 2011, Congress expressed concern about the backlog of incurred cost audits at DCAA and directed GAO to review reasons for the backlog, as well as DCAA’s plan to address it.<sup>2</sup> At that time, DCAA had a backlog of more than 21,000 incurred cost audits.<sup>3</sup> Since 2011, DCAA has reduced its inventory of contractors’ incurred cost proposals awaiting audit by about half to 14,208, and DCAA has substantially reduced its backlog of older proposals.<sup>4</sup>

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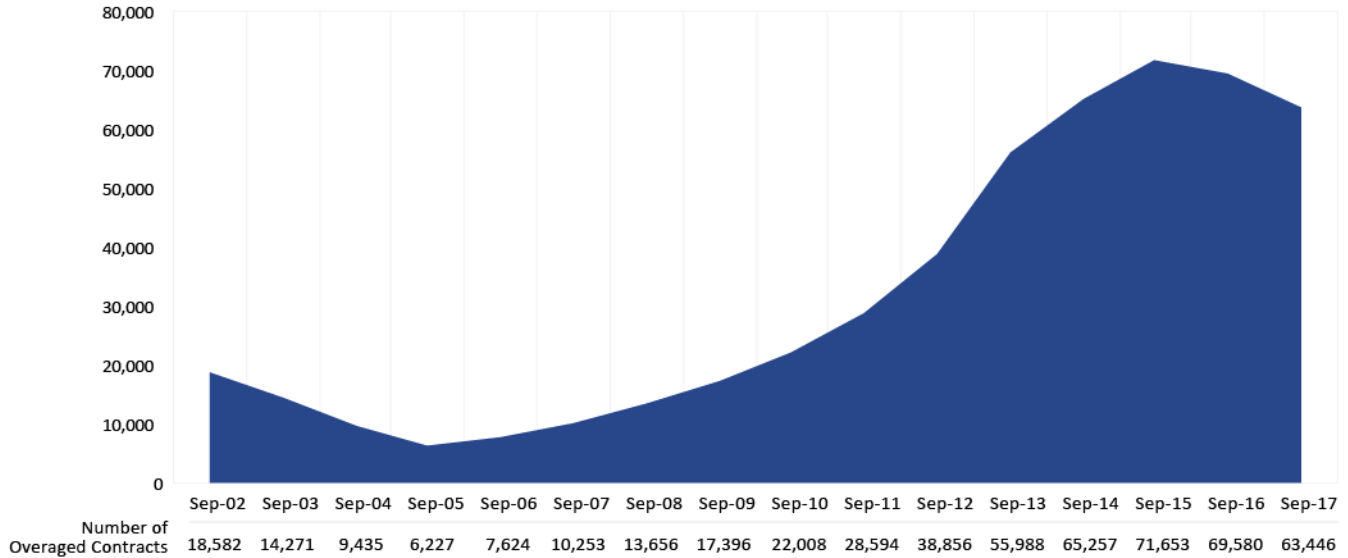
<sup>1</sup> “About the Agency,” Defense Contract Management Agency, accessed November 1, 2018, <http://www.dcmamail.com/About-Us/>.

<sup>2</sup> GAO, *Defense Contracting: DOD Initiative to Address Audit Backlog Shows Promise, but Additional Management Attention Needed to Close Aging Contracts*, GAO-13-131, December 2012, accessed September 15, 2017, <http://www.gao.gov/assets/660/650970.pdf>.

<sup>3</sup> DCAA, *Report to Congress on FY 2016 Activities: Defense Contract Audit Agency*, March 31, 2017, 9, accessed November 1, 2018, [https://www.dcaa.mil/Content/Documents/DCAA\\_FY2016\\_Report\\_to\\_Congress.pdf](https://www.dcaa.mil/Content/Documents/DCAA_FY2016_Report_to_Congress.pdf).

<sup>4</sup> GAO, *Federal Contracting: Additional Management Attention and Action Needed to Close Contracts and Reduce Audit Backlog*, GAO-17-738, September 2017, 1, accessed June 11, 2018, <https://www.gao.gov/assets/690/687497.pdf>.

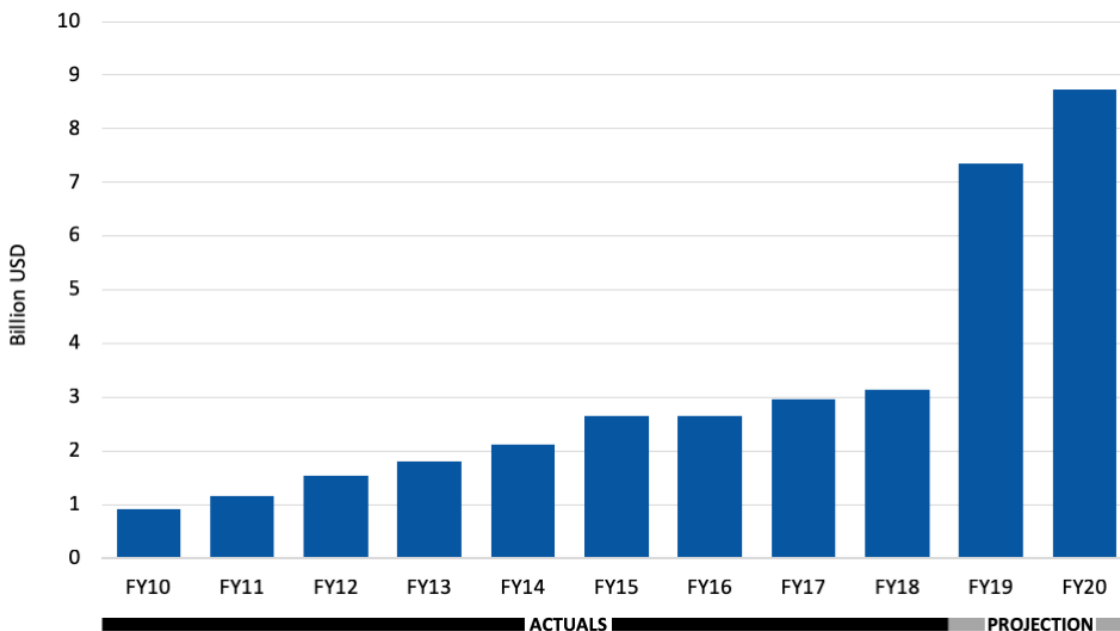
**Figure 4-20. DCMA Historical Over-aged Contract Backlog<sup>5</sup>**



DCAA’s focus on completing incurred-cost audits has caused the DCMA contract-closeout backlog to increase. It is not a one-for-one relationship. Each incurred cost audit may have many contracts associated with it. Currently, DCMA has a backlog of approximately 65,000 over-aged contracts and can complete an average of 18,000 contracts a year. Figure 4-20 above reflects the impact of the DCAA focus to reduce the incurred cost audit backlog starting in 2011. At the same time, DCMA has been prioritizing upcoming cancelling-year invoices versus actually closing out the contract. This is necessary in order to prevent using current appropriations to pay final invoices as shown in the Figure 4-21. DCMA’s objective is to reduce this projection prior to those funds actually being cancelled.

<sup>5</sup> DCMA graph, email to Section 809 Panel, August 9, 2018.

**Figure 4-21. DCMA Projected Cancelling Year Funds at Risk (\$B)<sup>6</sup>**



**Discussion**

In addition to addressing the DCMA over-aged contract backlog, streamlining initiatives need to be implemented to prevent future incurred- cost audits and over-aged contract backlogs. Research shows that initiatives are being developed and implemented as a result of three things: (1) the Section 809 Panel *Volume 1 Report*, (2) GAO reports, and (3) emphasis by DCMA senior leadership.<sup>7</sup>

**Section 809 Panel**

The Section 809 Panel recommendations in *Volume 1, Section 2: Contract Compliance and Audit*, proposed initiatives to prevent backlogs of incurred cost audits such as (a) providing flexibility to contracting officers and auditors to use audit and advisory services when appropriate, (b) reviewing the roles of DCAA and DCMA to ensure appropriate alignment and eliminate redundancies, (c) establishing statutory time limits for defense oversight activities, and (d) clarifying and streamlining the definition of and requirements for an adequate incurred cost proposal to refocus the purpose of DoD’s oversight.

**GAO and Commission on Wartime Contracting**

GAO reports that the Defense Procurement and Acquisition Policy Group was required to establish the Contract Closeout Working Group in September 2014 to improve and streamline the contract closeout process, including policy revisions and technology updates to its systems, with no projected completion date.<sup>8</sup> The Commission on Wartime Contracting noted the rapidly growing incurred-cost backlog at DCAA in its final report in 2011. The commission found that Congress did not provide

<sup>6</sup> Data points gathered from DCMA response to the RMD700A2 from the PBR19-23 cycle, email to Section 809 Panel, July 2, 2018.

<sup>7</sup> DCMA response to the RMD700A2 from the PBR19-23 cycle, email to Section 809 Panel, July 2, 2018.

<sup>8</sup> GAO, *Federal Contracting: Additional Management Attention and Action Needed to Close Contracts and Reduce Audit Backlog*, GAO-17-738, September 2017, 1, accessed June 11, 2018, <https://www.gao.gov/assets/690/687497.pdf>.

DCAA and DCMA adequate resources and staffing to accomplish their respective missions. The commission also recognized the difficulty placed on defense contractors when delays in incurred cost audits leave the contractors facing cash management problems.

### ***DCMA Initiatives***

DCMA recognized the need to institute streamlining initiatives to address the over-aged contract closeouts by issuing a DCMA Quick-Closeout Procedure Class Deviation. This deviation was issued on August 15, 2017, but has a sunset date of September 30, 2020. It streamlines the quick-closeout process only for DCMA's ACOs by removing requirements to obtain an audit report or Low-Risk Adequacy Memorandum from DCAA prior to settling quick-closeout rates. It also authorizes ACOs to settle final overhead rates and close any and all physically complete contracts regardless of dollar value or the percent of unsettled direct and indirect costs allocable to the contracts.<sup>9</sup>

DCMA recently released new guidance for ACOs to perform the Low Risk Quick Closeout Process (LRQCO). This initiative was released April 13, 2018, and has a sunset date of September 30, 2020. It allows ACOs to close out low-risk contracts with less than \$750,000 of remaining funds by accepting the contractor's indirect rates through a bilateral agreement. Following this process means the ACO does not have to wait on final DCAA audits of the contractor's rates or negotiate the rates with the contractor. This new streamlined initiative will help reduce the over-age contracts each year with approximately 40,000 contracts currently in this category.<sup>10</sup>

Another initiative DCMA is pursuing is to no longer accept non-core services contracts, which are not included in DCMA's core mission requirements. This could mean a reduction of approximately 5,000 contracts per year that could potentially become over-aged and have cancelling funds within DCMA. Although this initiative could ultimately move the work load back to the services and increase their over-aged contract backlog.

DCMA has partnered with DCAA to prioritize audits and emphasize audits with cancelling funds. This partnership allows them to actually perform the audit to close out the contract rather than focusing on interim billing for cancelling funds. DCAA now has the audit plan with DCMA priorities (cancelling funds) through FY 2020.

The streamlining initiatives reflect DCMA and external agencies' recognition that the over-aged contract backlog needs to be addressed, but these initiatives will not fully remedy the existing backlog of approximately 65,000 over-aged contracts. The existing backlog can only be mitigated by cross-organization monitoring and discipline. As shown in Figure 4-22, DoD recognized that DCMA needed additional resources. DoD provided funding for 30 additional full-time equivalents (FTEs) starting in FY 2019. DCMA developed the Figure 4-22 burn-down plan based on those 30 additional FTEs and the implementation of initiatives described in the discussion above. The projection below also reflects that DCMA will still not be able to fully address the over-aged contract backlog by FY 2022. The light-blue dashed line depicts the point that even if the workforce were augmented again with an additional 30 FTEs starting in FY 2020, DCMA would still not reach a steady state by FY 2022. To reach a steady state

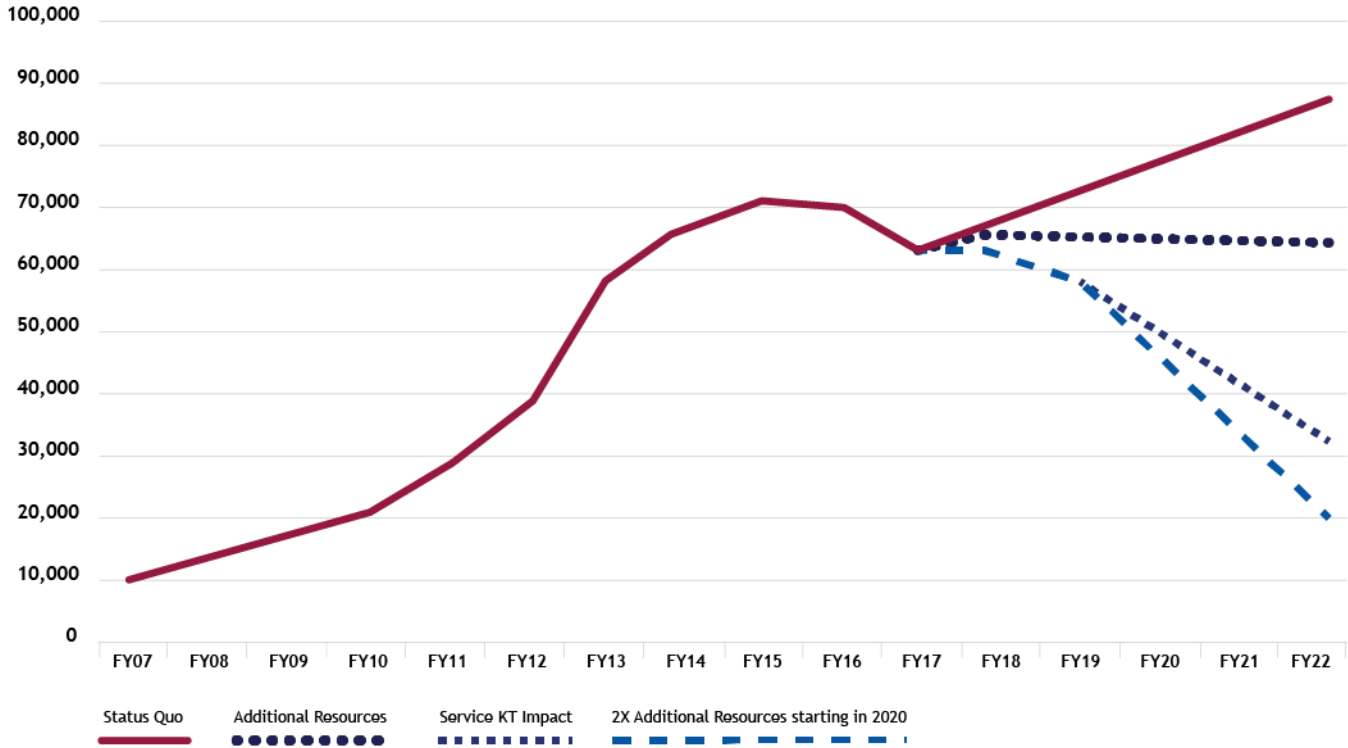
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<sup>9</sup> DCMA Memorandum to DCMA Component Heads, *DCMA Quick-Closeout Procedure Class Deviation (DCMA 17-142)*, August 15, 2017.

<sup>10</sup> DCMA Memorandum to DCMA Component Heads, *DCMA Low Risk Quick Closeout Initiative*, April 13, 2018.

workload, DCMA would need process improvements and possibly additional resources to address approximately 15,000 over-aged contract audits annually for 3 years starting in FY 2020, and the additional resources would require approximately \$3.5 million or more annually. Because DoD could spend up to \$3.5 million of current-year funds to pay cancelled bills, one might suggest applying those dollars to remedy this issue. But these current-year funds were originally appropriated for other requirements and that would contradict the original intent of the appropriation by Congress.

**Figure 4-22. DCMA Over-aged Contract Burn-down Projection**

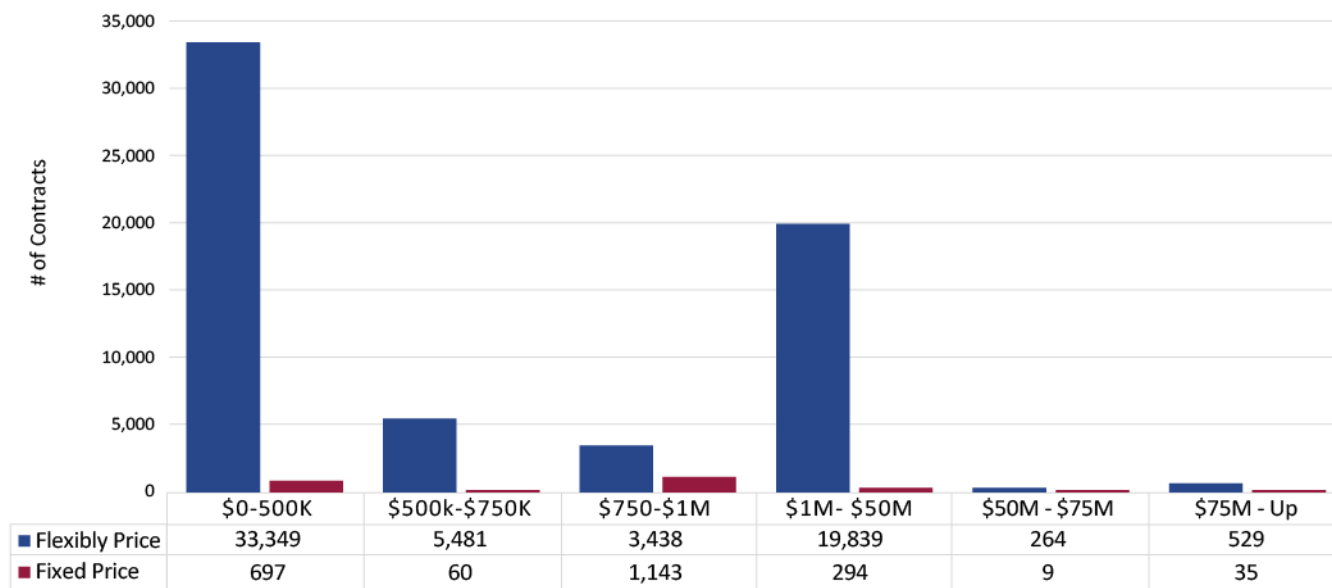


**Conclusions**

To eliminate the backlog, DCMA must reach a workload steady state, and then apply process improvements to prevent reoccurrence. As shown in Figure 4-23 below, the majority of over-aged contracts could potentially be closed with application of the DCMA QCO streamlined initiatives described above. As depicted in Figure 4-22 above, DCMA will not reach a workload steady state by 2020 and the Secretary of Defense should require the DCMA class deviation initiative dated August 15, 2017 be made a permanent change versus a temporary deviation that sunsets in 2020. DCMA, through the class deviation, has been operating in this manner for years without any negative consequences. In addition, the LRQCO sunset date should be extended at least another 2 years.

The application of these recommendations could eliminate the over-aged contract backlog within 2 to 3 years and allow DCMA to reach a workload steady state, but for DCMA to maintain that level, the DCMA Quick-Closeout Procedure Class Deviation should be a permanent change to the DFARS.

**Figure 4-23. DCMA Over-aged Contracts (Total Contract Value)**



To prevent reoccurrence of this backlog, the Secretary of Defense should direct the DoD Chief Management Officer (CMO) to work with USD(C) and USD(Acquisition and Sustainment), to perform further analysis that describes the entire scope of the problem to develop an end-to-end integrated streamlined process. The metrics reflected in Figure 4-23 are only for DCMA-administered contracts and not the entire scope of DoD. CMO should present the results in a report to Congress and propose a mitigation strategy that addresses the entire over-aged contract issue for DoD. The report should contain the following:

- Recommendation assigning responsibility to a single process owner with authority to set priorities and approve closeout policies affecting all involved agencies (recognizing that the current problem started when DCAA made a unilateral policy change on what a *low risk* closeout is, without regard to the downstream effects on other agencies, particularly DCMA).
- Recommendation of process improvements such that closeout happens in a timely manner. *Timely* in this regard should mean that expiring funds are identified, and prioritized for closeout in sufficient time so the Services/Agencies don't have to use current funds to satisfy past obligations.
- Recommendation of appropriate metrics and levels of review to ensure appropriate leadership attention so this cycle of contract backlogs doesn't recur.
  - Reporting tools and emphasis should be put in place to preclude the utilization of current year funds to address cancelled funding bills
  - Automation where appropriate to align and integrate business systems

Congress has already set precedence in Sections 925–927 of the FY 2019 NDAA that the DCMO review the roles and responsibilities of DCAA, DCMA, and DFAS, but does not require an integrated end-to-end look across the three organizations. DCMO should expand the FY 2019 NDAA direction to include

an integrated look to determine much needed process improvements and prevent the over-aged contract backlog from reoccurring in the future. It is imperative that this issue be addressed now and in the future to eliminate the application of current-year funds to pay cancelled bills, which results in harming existing programs and DoD strategic interests, as well as undermining the original intent of the appropriators.

## **Implementation**

### ***Legislative Branch***

- Direct the Secretary of Defense to submit a report that reflects an end-to-end, integrated, streamlined process-improvement strategy for preventing the reoccurrence of over-aged contract backlog by March 1, 2021.

### ***Executive Branch***

*Note: DoD, in implementing these recommendations, should engage with industry in accordance with the recommendations in Section 8.*

- Codify DCMA's Quick Close Out class deviation in the DFARS by:
  - Removing requirements to obtain an audit report or low-risk adequacy memorandum from the DCAA prior to settling quick-closeout rates.
  - Authorizing ACOs to settle final overhead rates when it is in the best interest of the government and close any and all physically complete contracts regardless of dollar value or the percent of unsettled direct and indirect costs allocable to the contracts.
  - Applying the streamlined QCO process to flexibly priced contracts.
- Develop a report to Secretary of Defense providing the entire scope of the DoD over-aged contract backlog with current funds at risk for cancelling and an integrated mitigation strategy to resolve and prevent reoccurrence.
- Develop a QCO burn-down plan addressing the entire DoD over-aged contract backlog with quarterly status reports to the Secretary of Defense.
- Extend the current sunset date of the DCMA LRQCO initiative that was issued April 13, 2018 by 2 years.

### ***Implications for Other Agencies***

- There are no cross-agency implications for this recommendation.



## RECOMMENDED REPORT LANGUAGE

### **SEC. \_\_\_\_. REVIEW OF CONTRACT CLOSEOUT FUNCTIONS PERFORMED BY THE DEFENSE CONTRACT AUDIT AGENCY, THE DEFENSE CONTRACT MANAGEMENT AGENCY, AND THE DEFENSE FINANCE AND ACCOUNTING SYSTEM.**

This section would direct the Secretary of Defense to perform an integrated review of the contract closeout functions performed by the Defense Contract Audit Agency (DCAA), the Defense Contract Management Agency (DCMA) and the Defense Finance and Accounting System (DFAS).

The committee recognizes the need for process improvements in the area of contract closeout. Because of closeout delays that have created a large backlog of overaged contracts in the Department of Defense, vendors must in some cases be paid out of appropriations from different fiscal years, undermining the original purpose of the funding. Because contract closeout responsibilities are performed by different organizations under different leaderships within the Department, the Secretary of Defense, pursuant to this section, would direct the Chief Management Officer (CMO) to perform an analysis that describes the entire scope of the contract closeout problem. The CMO would work with the Office of the Undersecretary of Defense (Comptroller) and the Undersecretary of Defense for Acquisition & Sustainment in order to develop an end-to-end integrated streamlined process to improve contract closeouts in a timely manner. Results of the review, along with a proposed mitigation strategy addressing the entire over-aged contract issue for the Department, would be presented to the congressional defense committees by March 1, 2021.

**RECOMMENDATION 58:**

**SEC. \_\_\_\_ . REVIEW OF CONTRACT CLOSEOUT FUNCTIONS PERFORMED BY THE  
DEFENSE CONTRACT AUDIT AGENCY, THE DEFENSE CONTRACT  
MANAGEMENT AGENCY, AND THE DEFENSE FINANCE AND  
ACCOUNTING SYSTEM.**

(a) REVIEW.—The Secretary of Defense shall, acting through the Chief Management Officer of the Department of Defense, direct the Under Secretary of Defense for Acquisition and Sustainment and the Under Secretary of Defense (Comptroller) to conduct an integrated review of the contract closeout functions of the Defense Contract Audit Agency, the Defense Contract Management Agency, and the Defense Finance and Accounting System. The review shall include the following:

(1) An assessment for providing a recommendation of an integrated end-to-end process for contract closeouts.

(2) An assessment for providing improvements to the end-to-end contract closeout process so that closeout can happen in a timely manner.

(3) An assessment of appropriate metrics and levels of review to ensure appropriate leadership attention so as to prevent overaged contract closeout backlogs, including—

(A) an assessment of recommended reporting tools to preclude the utilization of current year funds to address canceled funding bills; and

(B) an assessment of required automation where appropriate to align and integrate business systems.

1           (4) Determination of a single process owner with authority to set policies and  
2           priorities and approve process changes to ensure contract closeouts continue to happen in  
3           a timely manner.

4           (b) DEFINITION.—In this section, the term “timely” means that expiring funds are  
5           identified and prioritized for closeout in sufficient time so that the responsible component of the  
6           Department of Defense does not have to use current funds to satisfy past obligations.

7           (c) REPORT.—Not later than March 1, 2021, the Secretary of Defense shall submit to the  
8           congressional defense committees a report setting forth the results of the review conducted under  
9           subsection (a).

## RECOMMENDED REGULATORY REVISIONS

### Recommendation 58

#### DCMA 17-142

#### DFARS 201.404

#### *DFARS Subpart \_\_\_\_ -- Quick-Closeout Procedure.*

42.708 -- Quick-Closeout Procedure.

(a) The contracting officer responsible for contract closeout shall negotiate the settlement of direct and indirect costs for a specific contract, task order, or delivery order to be closed, in advance of the determination of final indirect rates set forth in 42.705, if –

(1) The contract, task order, or delivery order is physically complete;

~~(2) The amount of unsettled direct costs and indirect costs to be allocated to the contract, task order, or delivery order is relatively insignificant. Cost amounts will be considered relatively insignificant when the total unsettled direct costs and indirect costs to be allocated to any one contract, task order, or delivery order does not exceed the lesser of –~~

~~(i) \$1,000,000; or~~

~~(ii) 10 percent of the total contract, task order, or delivery order amount;~~

(3) The contracting officer performs a risk assessment and determines that the use of the quick-closeout procedure is appropriate. The risk assessment shall include –

(i) Consideration of the contractor's accounting, estimating, and purchasing systems;

(ii) Other concerns of the cognizant contract auditors; and

(iii) Any other pertinent information, such as, documented history of Federal Government approved indirect cost rate agreements, changes to contractor's rate structure, volatility of rate fluctuations during affected periods, mergers or acquisitions, special contract provisions limiting contractor's recovery of otherwise allowable indirect costs under cost reimbursement or time-and-materials contracts; and

(4) Agreement can be reached on a reasonable estimate of allocable dollars.

(b) Determinations of final indirect costs under the quick-closeout procedure provided for by the Allowable Cost and Payment clause at 52.216-7 shall be final for the contract it covers and no adjustment shall be made to other contracts for over- or under-recoveries of costs allocated or allocable to the contract covered by the agreement.

(c) Indirect cost rates used in the quick closeout of a contract shall not be considered a binding precedent when establishing the final indirect cost rates for other contracts.