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Section 809 Panel Recommendations: Overhaul Audit Practices and Increase Reliance on Private-Sector Accounting Rules

This third installment of Pillsbury's Section 809 alerts focuses on recommendations to modernize and streamline the Department of Defense's (DoD's) appropriations, auditing and accounting practices.

As we reported previously, the Congressionally mandated Section 809 Panel (the Panel) recently issued Volume 3 of its Final Report. This volume builds upon the first two volumes of the Final Report by making additional recommendations for improving DoD's acquisition process. This is the third of four alerts about the substance of Volume 3 of the Final Report. In this client alert, we explore recommendations regarding a broad range of financial issues at DoD.

The Panel's recommendations in appropriations, auditing and accounting practices are designed to move the acquisitions process into the modern era. The recommendations cover both internal Government financial responsibilities, such as budgeting and obligating appropriated funds, and external financial responsibilities that impact contractors directly, such as accounting for the government funds that a contractor receives.

Implementing a New Professional Practice Guide (PPG) (Recommendation 71)

The Panel recommends DoD adopt a PPG to support DoD's contract audit practice and proposes establishing a PPG working group for substantive revisions to the PPG. The Panel provides a draft of the new PPG, which was developed with a Panel working group that included representatives from the Defense Contract Audit Agency (DCAA), the Defense Contract Management Agency (DCMA), the Government Accountability Office (GAO), the American Institute of Certified Public Accountants (AICPA), and industry. The Panel acknowledged the existence of the Defense Contract Audit Manual (DCAM), but noted that "[the DCAM] lacks the collaborative inputs, perspectives, and interpretations of knowledgeable professionals outside DCAA and the government." The PPG focuses on how the auditing concepts and principles can be applied to government contract audits. Among other items, the PPG includes guidance on "numeric materiality" standards for incurred cost audits that the FY 2018 National Defense Authorization Act requested DoD implement. To align with the renewed emphasis on risk, the PPG expands DCAA's current risk-based approach with additional risk factors that reasonably assure DoD that pricing and reimbursement are free of material unallowable costs.

Given the evolutionary nature of accounting guidance, the Panel recommends that DoD also establish another PPG working group (PPGWG) of subject-matter experts that would collaboratively decide upon substantive changes by majority vote. The PPGWG would be composed of five permanent representatives from DCAA, GAO, AICPA, DCMA, and industry. Like the Section 809 Panel, the PPGWG would be exempt from the Federal Advisory Committee Act—enacted to ensure that advice from advisory committees is objective and accessible to the public—but the PPGWG would not take the place of federal regulations or auditing standards, and its decisions and proceedings would be posted on DCAA's website.

The recommendation to institute the PPG is ground-breaking, to say the least. Adoption of this recommendation would set the stage for substantial changes in DCAA audits of all types.

Replacing and Reducing the DFARS Criteria for Determining an Acceptable Accounting System with Objective and Measurable Criteria (Recommendation 72)

The Panel made recommendations designed to revise two specific accounting system-related issues that have been the source of industry frustration (Recommendations 72 & 73). First, Recommendation 72 calls for the replacement of the 18 current DFARS accounting system criteria with an internal control audit utilizing seven professional standards developed to address section 404(b) of the Sarbanes-Oxley Act (SOX 404(b)). The Panel noted that the 18 current criteria have been widely viewed by stakeholders as "not objective and measurable because of the current terminology used in the business system rule." For example, the current DFARS criteria include the following subjective criteria that are difficult to assess: "[a] sound internal control environment," "[a] dequate, reliable data for use in pricing follow-on acquisitions," and "[p]roper segregation of direct costs from indirect costs."

The Panel bases the new criteria on SOX 404(b), which requires a publicly-held company's auditor to attest to, and report on, management's assessment of its internal controls. The new criteria would allow auditors to "evaluate whether key internal controls are in place and operating to provide reasonable assurance" that:

1. Direct costs and indirect costs are classified in accordance with contract terms, FAR, Cost Accounting Standards (CAS) and other regulations;
2. Direct costs are identified and accumulated by contract in accordance with contract terms, FAR, CAS and other regulations, as applicable;
3. Methods are established to accumulate and allocate indirect costs to contracts in accordance with contract terms, FAR, CAS and other regulations;
4. General ledger control accounts accurately reflect all transactions recorded in subsidiary ledgers and/or other information systems that either integrate or interface with the general ledger including, but not limited to, timekeeping, labor cost distribution, fixed assets, accounts payable, project costs, and inventory;
5. Adjustments to the general ledger, subsidiary ledgers, or other information systems bearing on the determination of contract costs (e.g. adjusting journal entries; reclassification journal entries, cost transfers, etc.) are done for reasons that do not violate contract terms, FAR, CAS, and other regulations;
6. Identification and treatment of unallowable costs are accomplished in accordance with contract terms, FAR, CAS, and other regulations; and
7. Billings are prepared in accordance with contract terms, FAR, CAS, and other regulations.

If adopted, Recommendation 72 would substantially change the way DCAA reviews contractor accounting systems and provide much-desired clarity for contractors.

Revising and Adding to the DFARS Definitions Related to Deficiencies to Align Systems Evaluations More Closely with GAAP (Recommendation 73)

In Recommendation 73, the Panel proposes major changes to the DFARS definition of "significant deficiency" to align the terminology with generally accepted accounting principles (GAAP). The DFARS currently defines a "significant deficiency" as a shortcoming in a contractor's accounting system that "materially affects" the ability of DoD to rely upon the information produced. Under GAAP, the same type of deficiency is called a "material weakness." This disconnect between the DFARS and GAAP terminology has caused confusion. To further exacerbate the confusion, GAAP describes a deficiency that is less severe than a "material weakness" as a "significant deficiency." The Panel's recommendation seeks to correct this terminological confusion and to eradicate the problems that have resulted from DoD's use of an all-encompassing single definition of deficiency when a contractor's business system could "have a number of deficiencies that range from trivial to severe." The Panel recommends replacing the term "significant deficiency" in the DFARS with a new definition of material weakness. Additionally, new terms and definitions for "significant deficiency" and "other deficiency" would be added to the DFARS to create a spectrum of terms to describe contractor accounting systems. The new definition for significant deficiency would make it "less severe than a material weakness yet important enough to merit the attention of those charged with governance." "Other deficiency," the least severe, would describe a discrepancy that has "a clearly trivial, or inconsequential, effect on the ability of the business system to prevent or detect and correct, material non-compliances on a timely basis." Contractors have been vocal in urging similar revisions since the DFARS adopted the current definition of "significant deficiency."

Watch This Space

The Panel's recommendations addressing internal government budget and fiscal issues will likely have minimal impact on contractors in the immediate future. But, because these budget and fiscal recommendations will drive change to the "macro" environment of federal acquisition, it is nevertheless important that contractors review and monitor these changes as they may occur.