January 22, 2002

VIA FACSIMILE

Office of the Director
Defense Procurement
Attn: Ms. Teresa Brooks
PDUSD(A&T)/DP(CPA)
3060 Defense Pentagon
Washington, DC 20301-3060


Dear Ms. Brooks:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry, and Government service. The Section’s governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the American Bar Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.
A. **Background**

The Department of Defense is authorized to enter into transactions “other than contracts, cooperative agreements, and grants . . . in carrying out basic, applied, and advanced research projects” pursuant to 10 U.S.C. § 2371. Under Section 845 of the National Defense Authorization Act for Fiscal Year 1994 (Pub. L. 103-160), as amended, this authority for using “other transactions” authority has been expanded until September 2004 to prototype projects that are directly relevant to weapons or weapon systems proposed to be acquired or developed by the Department of Defense.

The Department of Defense (“DOD”) was given authority to enter into “other transaction” (“OT”) agreements so that the military can share in commercially developing research and development efforts without imposing “government-unique procurement requirements [that] inhibited DOD’s ability to take advantage of technological advances made by the private sector.” See General Accounting Office, Rep. No. GAO/NSIAD-00-33, *Acquisition Reform: DOD’s Guidance on Using Section 845 Agreements Could be Improved* (2000), at 1. Thus, OT agreements are awarded without regard to either the Federal Acquisition Regulation (“FAR”) or most of the procurement-related provisions of Titles 10 and 41 of the U.S. Code that are applicable to traditional defense contracts.

The DOD has recognized the beneficial flexibility of OT agreements in its guidance regarding the use of OT authority. For example, in a policy memorandum dated December 14, 1996, the Undersecretary of Defense for Acquisition and Technology, Dr. Paul Kaminski, encouraged the use of OTs and listed nineteen procurement statutes that were considered inapplicable to “other transactions.” Among those inapplicable requirements was 10 U.S.C. § 2313, which mandates that contracts provide for agency and GAO access to contractors’ facilities to audit contractor and subcontractor records.

The absence of audit-access provisions from OT agreements has encouraged participation in defense-related research and prototype projects by firms that have not traditionally been willing to do business with the Government because of the concerns with opening private business to government auditors (whether or not government-specific accounting rules are also imposed).

The first general requirement for audit access by the Comptroller General was added two years ago, but only with regard to OT agreements over $5,000,000. See National Defense Authorization Act for Fiscal Year 2000, Pub. L. 106-65, Section 801. That requirement was then clarified by Section 804 of the Floyd D. Spence

B. The Proposed Rule

The proposed rule, published on November 21, 2001, states that it would implement Section 803 of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001. That portion of the 2001 Authorization Act limited the “appropriate use” of OT authority under Section 845 to those prototype projects in which one of the following conditions is met: (i) “at least one nontraditional defense contractor [is] participating to a significant extent”; (ii) “[a]t least one third of the total cost of the prototype project is to be paid out of funds provided by parties to the transaction other than the Federal Government”; or (iii) a waiver is approved by the senior procurement executive for the agency.

The Act also defined “nontraditional defense contractor” to mean an entity that has not performed or received any contract subject to full CAS coverage or any other contract in excess of $500,000 for prototype projects or basic, applied, or advanced research projects that is subject to the FAR in the 12 months prior to date of the OT agreement. The Section has no comment on the implementation of those conditions and definitions, because the proposed rule appears to track the legislation closely. See Proposed 32 C.F.R. 3.4 and 3.5.

Nevertheless, as described below, the proposed rule also imposes new audit policies on all cost-based OTs, as well as new mandatory clauses for OT agreements (including audit flowdown requirements). See Proposed 32 C.F.R. 3.7. These new audit requirements were neither mandated nor suggested by any of the recent legislation regarding the appropriate use and terms of OT agreements. Moreover, placing new and unnecessarily burdensome requirements on the terms of OT agreements would reduce the flexibility that now encourages nontraditional contractors to participate in Section 845 projects.

Indeed, one of the major goals of the 2001 DOD Authorization Act was to encourage cost sharing and participation in OTs by “nontraditional defense contractors.” That goal would likely be thwarted, however, by the increasing audit burden imposed by the proposed rule – a burden that nontraditional contractors have carefully avoided to date and that recent acquisition-reform efforts have sought to minimize. To see the pendulum swing back so swiftly and sharply from those reform
efforts, without any explanation in the proposed rule, is both unexpected and discouraging.

1. **Expansion of Audit Coverage to All Cost-Based OT Agreements**

Other Transaction agreements typically have not included the audit-access provisions that are common in traditional government contracts. Instead, the Government has relied on either the private entity’s auditors and a certification of accounting procedures and documentation or a tailored audit clause providing limited access for independent auditors. This approach has been consistent with the goal of encouraging participation by nontraditional contractors, which are neither equipped for nor interested in becoming subject to government audit.

The proposed rule expands the audit burden on OT participants in three ways. First, the proposed rule does not simply impose the new audit policies on OT agreements that are based on cost-sharing, but to every OT agreement that “[u]ses amounts generated from the awardee’s financial or cost records as the basis for payment.” See Proposed 32 C.F.R. 3.7(a)(1).

Second, the proposed audit policy would apply regardless of whether the participant is a “traditional” contractor or a “nontraditional” contractor. Thus, although the recent legislation added a definition of “nontraditional defense contractor” and encouraged greater participation by such contractors, the proposed rule does not lift the audit burden for such businesses.

Third, the proposed rule dictates that auditing of OT agreements covered by the new policies will be conducted by the Defense Contract Audit Agency (“DCAA”) for any “[b]usiness units currently performing on procurement contracts subject to the Cost Principles or Cost Accounting Standards.” See Proposed 32 C.F.R. 3.7(d)(2). Hence, the types of OT agreements that in the past may have relied on in-house or independent auditors will now be necessarily subject to government auditors.

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These new audit policies are unsupported by legislative direction and are not tailored to implement the changes under either the 2000 DOD Authorization Act or the 2001 DOD Authorization Act. Although the former Act added GAO audit access for OTs in excess of $5 million, and the latter Act encouraged cost-sharing and participation by nontraditional defense contractors, nothing in either Act suggested that the current audit approach for OTs was inadequate or otherwise needed “fixing.”

The scope and conduct of OT audits should reflect the legislative goals of Section 845. In this case, there has been no relevant change in the legislative policy regarding OT agreements that would support the proposed increase in the audit burden. Accordingly, because no clear need for the proposed rule has been articulated, and because it appears inconsistent with Congressional intent, the Section recommends that the portion of the proposed rule on “Audit Policy” be withdrawn.

2. Audit Flowdown Requirements

The Section is also concerned with the imposition of “flowdown” requirements under the new audit policies. Unlike other provisions of OT agreements, the audit flowdown provisions appear to be nonnegotiable. The proposed rule states: “The Agreements Officer must require awardees to insert an appropriate audit access clause in awards to key participants . . . .” See Proposed 32 C.F.R. 3.7(b). Thus, the rule includes a sample clause that imposes the flowdown requirement on prime recipients. See Proposed 32 C.F.R. 3.7(g)(4). Moreover, the new audit-access requirements apply equally to all “key participants” -- a term defined as meaning any “business unit that makes a significant contribution to the prototype project.” See Proposed 32 C.F.R. 3.7(b), 3.4. Hence, the audit policies apply to any significant sub-recipients of federal funds under the prototype project.

The Section recognizes that the proposed rule’s Audit Policy to some extent parallels the December 21, 2000 guidance issued by Under Secretary of Defense For Acquisition, Technology and Logistics, entitled “Other Transactions (OT) Guide for Prototype Projects, January 2001” (“the OT Guide”). For example, Section C2.14.3.2 of the OT Guide requires the Defense Contract Audit Agency to be involved if the business unit is currently performing a procurement contract subject to the FAR Cost Principles or CAS. In addition, Appendix 5 of the OT Guide, “Sample Audit Access Clauses,” provides audit guidance similar to that in the proposed rule. The Section notes that there is no more authority for the audit guidance in the OT Guide than for the Audit Policy in the proposed rule. Moreover, the existing guidance similarly conflicts with the intent of attracting commercial companies to perform research and development for DOD. Thus, the Section recommends that the audit policy reflected in the OT Guide be withdrawn as well.
The proposed rule would establish a threshold of only $300,000 for imposing the general audit-access obligations on sub-recipients through flowdown requirements. See Proposed 32 CFR 3.7(b)(2). The $300,000 threshold is unusually low and likely will cover a large number of entities participating in OT agreements. By contrast, the threshold for audit access by the Comptroller General established by Congress is $5,000,000, and the threshold for potential coverage as a “nontraditional contractor” established by legislation is $500,000.

Like the other proposed changes in audit policy, the $300,000 threshold does not derive from the recent legislation. Although it is not explained in the proposed rule, the $300,000 threshold may derive from the threshold established under OMB Circular A-133, “Audits of States, Local Governments, and Non-Profit Organizations,” which implements the Single Audit Act. Nevertheless, the scope of the proposed audit policy is much broader than the scope of the Single Audit Act; it potentially applies not simply to governmental and non-profit organizations but to all participants in OTs.

Requiring audit access on smaller OTs – both as prime and sub-recipients – will likely discourage participation by nontraditional contractors, which is contrary to the legislative goals of Section 845. Therefore, if the “Audit Policy” portion of the proposed rule is not withdrawn, the Section recommends that a higher threshold be adopted for all audit access applicable to sub-recipients. Moreover, there should be a threshold for the applicability of audit access to prime recipients as well.

3. Audits Conducted by Independent Public Accountants

The Section is further concerned with certain aspects of the proposed rule’s requirements relating to audits conducted by independent public accountants (“IPAs”). In particular, Sample Clause 3 provides that the agency may request an IPA examination of records of an awardee that refuses direct government audit access and is not subject to either CAS or the Cost Principles. See Proposed 32 C.F.R. 3.7(d)(3), Sample Clause 3, para. (ii).

The provisions for auditing by IPAs appropriately seek to encourage nontraditional contractors to participate in Section 845 projects by protecting the confidentiality of proprietary information from disclosure. Nevertheless, the audit policy mandates that the Government have access to the IPA’s “working papers” for a period of three years after final payment or after the final audit report.
Because audit working papers typically contain proprietary information, this requirement directly undermines the goal of protecting the confidentiality of proprietary information that nontraditional contractors seek to protect from disclosure. Thus, if the “Audit Policy” portion of the proposed rule is not withdrawn, the Section recommends that the access to IPA working papers be removed from the audit policy and Clause 3.

4. Definitions, Sample Clauses, and Other Audit Policy Issues

If the proposed “Audit Policy” is not withdrawn, the Section recommends that the proposed rule be clarified in several other areas as follows:

• Proposed 32 C.F.R. 3.4 -- in the definition of “key participant,” the phrase “A business unit” should be revised to read “A business unit of a sub-recipient.” There appears to be nothing in the proposed rule that clearly states that the flowdown requirements only apply to sub-recipients, as opposed to other business units in the recipient’s organization.

• Proposed 32 C.F.R. 3.7(a) -- the Audit Policy should clearly state that it applies only when the parties agree to include one of the specified clauses in the OT agreement. Thus, in the opening sentence at proposed 32 C.F.R. 3.7(a), the rule should state: “This policy applies only when one of the clauses set forth in paragraph (g) is included in the OT agreement, and only when the agreement . . .”. This would also clarify that the proposed Audit Policy would apply only prospectively, i.e., only to OT agreements awarded after the effective date of the rule.

• Proposed 32 C.F.R. 3.7(c) -- the proposed rule provides that audits “normally will be performed only when the Agreements Officer determines it is necessary to verify the awardee’s compliance with the terms of the agreement.” The Section suggests that this should be the only purpose for which an audit should be conducted. Thus, the term “normally” should be removed.

• Proposed 32 C.F.R. 3.7(d)(3) -- the proposed rule recognizes private auditing only by “qualified IPAs,” but offers no guidance regarding
what is required for an IPA to be considered “qualified.” The Section recommends clarification of this issue.

- Proposed 32 C.F.R. 3.7(d)(3)(ii) -- the proposed rule provides only that the Agreements Officer “should grant approval to use an IPA” in the instance when the participant “[i]s not performing a procurement contract subject to the Cost Principles or Cost Accounting Standards at the time of agreement award, and ... [w]ill not accept the agreement if the Government has access to the business unit's records.” The Section recommends that the operative term be changed from “should” to “shall” unless there are clear criteria under which the approval may be denied in these circumstances. Without this assurance, the scope of the audit-access requirements is not fixed, but is subject to the discretion of the agency. That result offers little protection to nontraditional contractors whose participation is to be encouraged.

- Proposed 32 C.F.R. 3.7(g) Sample Clauses 2 and 3 -- the phrase “awardee” as used to define the party whose records may be audited is too broad. The scope of access should be limited to records of “the business unit of the awardee” in keeping with other parts of the proposed rule. Moreover, the reference to the “awardee’s records” should be limited to the “directly pertinent records” in order to prevent the audit access from being overly broad. Hence, the terms “awardee’s records” in Clauses 2 and 3 should be changed to read “directly pertinent records of those business units of the awardee performing the work under the OT agreement.” The phrase “sufficient records of the awardee to ensure full accountability . . .” in Clause 3(vi) should be changed to read “directly pertinent records of those business units of the awardee performing the work under the OT agreement sufficient to ensure full accountability . . .”.

- Proposed 32 C.F.R. 3.7(g)(2), Sample Clause 3 -- the phrase “The audit will be conducted by an independent public accountant (IPA)” should be changed to “The audit will be conducted by a mutually acceptable independent public accountant (IPA) at Government expense.” See Proposed 32 C.F.R. 3.7(d)(3)(ii).

- Proposed 32 C.F.R. 3.7(g)(3), Sample Clause 3, para. (i) -- the clause requires audits by IPAs to be “performed in accordance with Generally
Accepted Government Auditing Standards (GAGAS).” Although capitalized, the term is not defined. The Section recommends clarification of this issue.

- Proposed 32 C.F.R. 3.7(g)(3), Sample Clause 3, para. (v)(A) -- the clause provides that the Government shall have the right to “[w]ithhold or disallow a percentage of costs” in the event that IPA audits have not been conducted in a timely manner or, alternatively, to “[s]uspend performance until the audit is completed satisfactorily; and/or . . . [t]erminate the agreement.” Given the alternative remedies available to the Government, the Section recommends that the OT agreement itself should specify the percentage of payments that might be withheld or disallowed, in order to avoid disputes in that regard.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

Norman R. Thorpe
Chair, Section of Public Contract Law

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