



Government Procurement & Audit Challenges for Government Contractors Calendar Year 2010

This special annual newsletter outlines government contracts procurement issues and trends that we believe will have the most significant impact on government contractors in CY 2010, and includes our predictions as to how those issues will affect the contractor community. Another way of saying this, the following dialogue, for better or worse, we hope will enable companies doing business with the government on how to endure the fall-out created by historical acquisition events of a political nature; significant reform initiatives in acquisition processes; changing trends in audit oversight resulting from Congressional oversight and internal DCAA audit policy, and; the continued Congressional spotlight placed on lessons learned from wartime contracting history. We have carefully analyzed a huge amount of information and filtered that data to identify issues and auditor “hot topics” likely to test the resolve of both large and small government contractors in meeting the ever-changing and rigorous demands of contracting processes and activities into CY 2010. Although we make no guarantee that such issues will either evolve into, or continue to attract the high level of Government oversight as with prior years, we recommend that all government contractors be prepared to endure government procurement scrutiny of contractor financial, management, and other functional areas that are affected by the topics/issues we have included in this document.

American Recovery and Reinvestment Act (ARRA) of 2009

The ARRA or the “Recovery Act” was passed in early 2009 with the initial implementing Guidance published by OMB on February 18, 2009. The OMB guidance provided very broad accountability objectives, including transparency, mitigating fraud, waste and abuse, that projects avoid delays and overruns and program goals are achieved (with the exception of transparency, all of these objectives certainly apply to government contracting in general). In addition to the broad accountability objectives, ARRA ultimately introduced some more specific requirements:

- GAO (Government Accountability Office) audit authority which includes access to interview contractor and subcontractor personnel including

those for FAR Part 12 Commercial Items. Additionally, this access applies retroactively to the extent the contracting parties agree to a bilateral modification of existing contracts coupled with the provision that a contractor which refuses retroactive contract modification will not be eligible for recovery act funds (so much for fairness and equity). Of passing note, the FAR incorporated a final rule which gives the GAO the right to interview contractor employees; thus extending part of the ARRA GAO access (to personnel) to FAR contracts in general.

- IG (Inspector General) access to interview contractor personnel, but not subcontractor personnel with the same provisions for retroactive applicability as with the GAO access.
- ARRA reporting requirements wherein recipients of recovery act funds register and report on the use of

funds at federalreporting.gov (FAR case 2009-009, published August 25, 2009)

- Recovery Board's "tip line" wherein anyone can report a complaint with respect to the expenditure of recovery act funds.

Based upon initial feedback, the most resource intensive component of ARRA provisions is the reporting requirement which is quarterly and due on the 10th of the month following the end of the quarter. It is impossible to measure the labor hours spent by 130,000 recipients; however, the complexity and/or lack of clarity within the reporting criteria initially created the need for 60 help desk employees handling more than 31,000 requests for assistance. This serves as a reminder that with each new government contracting requirement comes the hidden administrative costs.

Regarding the tip line, as of October 2009, the Recovery Board had received 340 complaints with many forwarded to agency IGs which has resulted in approximately 80 investigations. Additionally the GAO had received 106 referrals pertaining to recovery act funds with an unspecified number leading to active audits or investigations. In any case a reminder that both the IG and/or the GAO have the rights to interview contractor employees without ever disclosing the reason for the interview. Based upon Congressional and Executive Branch assurances that stimulus monies will be well spent, it is safe to say that those who misuse the funds will be pursued if for no other reason than to serve as examples of effective government oversight.

It should be readily apparent that ARRA funding is available, but it is by no means "money for the taking". Recipients can expect additional scrutiny ranging from potentially intrusive oversight, such as an IG wanting to interview your employees to the more mundane such as contracting officer inquiries to validate ARRA quarterly reporting. In fact, none of this is mundane because contracting officers are being reminded that quarterly reporting is as much a contract requirement as is the service or product covered by the contract. Like any government contract, a contractor needs to know what they are signing up for and also recognize that a single

contract may have ARRA funding as well as other funding. Government contracting is never simple.

GAO Reports on DCAA Audit Standards

DCAA has been the target of two GAO reports issued between July 2008 and October 2009, which highlighted and discussed DCAA's failure to adhere to government auditing standards (GAGAS) thereby jeopardizing DCAA's fiduciary responsibilities to the general public in mitigating risks of overpayments to government contractors. The GAO 2008 audit included a review of fourteen DCAA audits and concluded that DCAA had not followed GAGAS; the report chastised the agency for lack of independence (resulting in opinions more favorable to government contractors), undocumented management changes to initial audit opinions (from inadequate to adequate opinions), insufficient work product to support audit opinions, insufficient audit testing, and DCAA management intimidation of its auditors.

GAO issued its second audit report in September 2009 (an expansion of work initiated and summarized in the July 2008 report), and the results added to criticisms of DCAA in complying with GAGAS and audit quality control guidelines. Specifically, the report cited examples of insufficient testing of contractor internal controls, lack of independence, inadequate supervisory guidance and insufficient employee training. The report found that, among other things, DCAA audit opinions for 33 of 37 internal controls audits ("clean" DCAA opinions issued) were not supported by sufficient testing of internal controls, thus rendering those opinions unreliable for making contract award and administration decisions. GAO pointed out that DCAA's rescission of more than 80 DCAA internal controls audits is demonstrative of audit quality problems. Lack of sufficient audit testing of forward pricing and incurred cost proposals to support DCAA opinions were also highlighted in this report.

The September 2009 GAO report also outlined corrective action taken by DCAA resulting from the July

2008 findings, and added recommendations for improving the mission statement and execution strategy, including the elimination of DCAA metrics that continued to focus on production output more than on quality audits—in theory, allowing auditors more time to do their job. And most importantly, GAO undertook the Congressional challenge of recommending DCAA organizational changes such as elevating the agency to one with similar responsibilities as Executive Department Inspector General (IG) entities and enabling auditor access to records. The findings enumerated in the GAO report take square aim at the “poor management environment”, lack of risk based auditing approach, and a long-standing DCAA culture that has resulted in loss of quality control.

Another GAO report was issued on October 15, 2009 (GAO-10-163T) that largely summarized findings set forth with the two previous reports and reflected testimony that was presented to the House Armed Services Committee.

Following the July 2008 report, DCAA issued several guidance memorandums defining new policies on improving independence via restricting agency auditors in collaborative processes with procurement officials (example, IPT participation). The Agency now places more rigid requirements upon auditors in identifying and reporting internal controls deficiencies; holds contractors to rigorous access to records requirements; encourages auditors to distance themselves from contractors via limited dialogue and exchange of informal information during audits; makes contractors adhere to the strictest of rules in submitting incurred cost proposals in a prescribed, but not always necessary, detailed schedule format, and; raises the bar for any government contractor to pass any audit related to management and financial internal controls (these issues are further discussed in other sections within this newsletter).

The September 2009 report will likely lead to more audit quality guidance and changes in the manner in which auditors plan and execute audits. We expect that quality initiatives will be undertaken to include better documented audits, higher levels of management

review of findings, and more emphasis in training the DCAA work force. More disturbing, however, is that GAO has reinforced the Congressional notion (via testimony to the Senate on September 23, 2009) that DCAA should be more empowered to function as an independent agency with a higher level of authority (over contracting officers) and an expanded audit charter.

So what is the likely fall-out of the GAO audits on the DCAA audit mission, and the flow-down effect on government contractors? Here are a few scenarios we believe will occur, or actually re-occur to the extent they’ve already begun:

- Increase in DCAA's audit work force to cover the audit hours needed to meet government audit standards, notably adequate testing of evidential data to support audit findings
- Continued limited dialogue with contractor personnel, both during the audit and upon conclusion, in a demonstration of audit independence, thereby avoiding any appearance of bias favoring contractors; hence contractors will continue to receive minimal information describing the basis for findings. Auditors may also avoid any dialogue with contractors that involve critical and detailed discussions where contractors request further explanation as to the basis for findings, and auditors perceive such discussions as “negotiations”. Limitation on discussions will delay the audit process, extend the duration and cost for attempted resolution of audit issues, and yield more unresolved issues moving to the contract disputes mode (when contractors have no other choice for an equitable resolution).
- Increase in numbers of audits of accounting and management internal controls, and extended testing of controls, which will result in more findings and higher percentages of contractor financial systems being summarily deemed inadequate; larger contractors whose internal controls systems were audited by DCAA prior to 2008 may have their previously reported “clean” opinions re-evaluated, with the potential for DCAA to rescind the clean

opinion and re-audit many of those systems. Consequently, a higher likelihood of “inadequate” systems upon conclusion of these new audits subject to higher audit standards, even though previous audits deemed these systems to be adequate and neither the actual contractor internal controls nor the FAR have changed.

- As a contractor, you should anticipate that any gap between DCAA’s expectations (their internal control objectives listed on their webpage) and your policies and procedures will be reported as a significant deficiency along with a DCAA opinion that the particular system is inadequate. In 2009, we learned of several instances where ACOs disagreed with DCAA internal control findings (reason that audit exceptions were not significant); however, with the September 2009 GAO report all but metaphorically executing DCAA for its lack of adequately supporting “clean opinions” for internal controls audits, we may see an increasing trend of insignificant audit exceptions being reported to avoid the appearance of GAGAS compliance issues.
- Expansion in scope and time in performing all audits, particularly those types noted in the September 2009 GAO report (proposals and internal controls); auditors will be challenged to undertake whatever effort is required to perform extensive substantive testing during all audits, and adequately documenting all findings. We believe detailed procedures employed will more likely be statistical sampling, rather than judgmental selection of transactions for evaluation. And, following this expanded effort, there is obviously a higher likelihood of more audit findings and thus a heavier administrative burden placed on contractors to address and respond to those findings. We do not believe that the GAO reports will necessarily result in more audits in CY 2010 simply because each audit will now take considerably more time to perform to assure GAGAS compliance.
- Opening discussions for realigning DCAA organization, with perhaps a first round of added authority to the DCAA audit charter, given the political thinking that auditors require more power

and flexibility to do an adequate job. Whether this re-organization process starts in 2010, we do believe auditors will continue their crusade in requesting access to any and all records during an audit however remotely related to the specific audit performed. Historically DCAA requests for access have included data not relevant to the specific audit mission and have included access to contractor employees; all with unreasonably short turn-around times for response (See further discussion on Access to Records in this newsletter).

- Although not in itself a consequence of the GAO reports, we believe government contractors will find themselves in a “no-win” position with auditors and contract administrative offices (the latter unwilling to challenge audits) resulting from adverse findings on various types of audits leading to contract disputes and legal action against federal government agencies. Over the past year, we’ve learned many contractors are over-burdened with insignificant and/or unsupported audit findings, where DCAA has been unwilling to meaningfully discuss these audit findings. Further, some of those contractors are facing a costly administrative process in responding to and resolving audit challenges, cash flow issues are arising due to rescission of direct billing privileges or government withholdings from billed amounts, and potential loss of future business (especially small contractors) is an expanding threat because procurement offices are compelled to take seriously any DCAA reported deficiency (regardless of the existence of a real problem) before the award of a new contract or task order.

Acquisition Reform

In March 2009 the Obama administration laid the foundation for reforming contracting processes with the objective of eliminating waste in spending with government contractors through improvement of contracting processes and we believe that the “improvements” will have a long-term impact on government contracting.

The White House issued a March 4, 2009 memo to executive agency and department heads outlining broadly defined objectives toward acquisition reform, and made it painfully clear that agencies must work to limit cost reimbursable and increase FFP contracts and to discontinue, where possible, award of sole-source contracts and improve processes to use the competition vehicle more frequently. Also included were objectives for evaluating the OMB A-76 competitive awards process, where private industry is allowed to compete for services contracts with government agencies. One objective of this evaluation is to determine if outsourced jobs could be brought back in-house (referred to as in-sourcing), where federal employees could more efficiently accomplish those jobs currently out-sourced to contractors.

Follow-up memorandums of guidance were issued on July 29, 2009 and October 27, 2009, containing more specific steps for executive agencies to begin working toward acquisition reform. The July 29 memo proposed steps to reduce spending 7% by FY 2011 through terminating “ineffective, wasteful” programs, improving skills of federal workforce, and enhancing better oversight of contracts in controlling use of funds. A second mandate is to reduce by at least 10% obligated dollars for new contracts that are not awarded competitively and/or those that are flexibly-priced.

The October 27 directive, including two specific memos to government agency heads, simply added more rhetoric to the previously issued directives, and highlighted “improving the civilian agency acquisition workforce” and hiring at least 5% more acquisition personnel while improving proficiency of existing procurement personnel. That memo also expanded on initiatives for increasing competitive awards, limiting cost reimbursement contracts (considered “high risk”), and collaborating with the contracting community in enhancing interest in bidding on competitive solicitations.

Discussion continued throughout 2009 among our Congressional representatives and executive agency heads in evaluating or searching for evidence to support, a continued “in-sourcing” trend. **(Examples:**

introduction of the “Correction of Longstanding Errors in Agencies’ Unsustainable Procurements Act” whose implicit purpose appears to be to justify bringing more jobs now held by government contractors back into the “more skillful, and efficient federal work force”; DOD Secretary Gates initiative to convert 30,000 defense service contractor jobs to government employee positions). Most recently, on Dec. 16, the House approved a DOD spending bill for FY 2010, which, among other provisions, would effectively reduce spending on private contractor outsourcing by realigning appropriated funds to bring “critical department functions” back to the federal civilian workforce. In many respects all other justifications become window-dressing once the funding is shifted from out-sourced to in-sourced functions,

Other political events and activities, such as the ongoing Commission on Wartime Contracting investigations and the impact of GAO reports criticizing DCAA’s quality standards, will increase the sense of urgency in undertaking acquisition reform initiatives outlined by the White House.

It is obvious that the 2009 pile-on of criticism of prior acquisition processes, which lays the blame not only on government contractors for perceived “wasteful spending”, but also on the federal procurement professionals charged with effectively awarding and administering contracts, translates into a daunting challenge for all government contractors. A summary of significant challenges to government contractors in 2010:

- More solicitations issued that are intended to be awarded competitively, although procurement commands at the field level may not be able to generate competition for many programs; nevertheless, fewer sole-source awards, and when such non-competitive awards are required, a huge increase in the internal government administrative process to justify such awards.
- Fewer cost reimbursable solicitations/ contract awards; contractors who continue to receive cost reimbursable contracts, beware—there will likely be more stringent procurement oversight requirements

necessitating more sophisticated contractor systems, such as EVMS or similar program/project management systems.

- If the government is serious about reviewing programs/contracts that are considered wasteful, we will likely see contract terminations for convenience, or conversions of existing cost reimbursable programs to fixed price vehicles. Such conversions or terminations will force contractors, depending on the reasons and mechanisms that enforce these changes, to arbitrate or legally challenge those decisions in another manner.
- More stringent evaluation process of historically OMB A-76 public-private competitive solicitations (between government and contractors) which will favor in-sourcing to government employees.

Commission on Wartime Contracting or CWC

The Commission on Wartime Contracting has since 2008 been conducting its reviews of contracting in Iraq and Afghanistan, a review which was originally going to culminate in a final report in August 2010. In October 2009, Section 822 of the Defense Appropriations Act extended the CWC for an additional year (seems to imply that the CWC cannot timely find the more significant contracting errors).

In June 2009, the Commission issued its first interim report complete with anecdotal evidence of massive amounts of monies misspent (fraud, waste and abuse although the main theme is arguably waste). In addition to the interim report, the commission held hearings in August and September 2009 to further probe whether billions of dollars are at risk from inadequate contractor business systems (internal controls). Within those hearings, the CWC referred to dysfunctional relationships between DCAA and DCMA, but primarily attributed fault to DCMA. Quoting a co-chairperson of the commission (Christopher Shays), in reference to DCMA Contracting Officer's who have not agreed with DCAA "opinions"; "I am struck with the fact

that there's a little bit of gray area so you're going to make sure that you are totally on the contractor's side".

Thus far, the CWC activities have resulted in the predictable demands for better contract oversight while more specifically attacking the process of resolving internal disagreements between the auditors and the contracting officers. In attacking this process, audit recommendations are being taken at face value (by the CWC) leading to the conclusion that contracting officers are unquestionably remiss by not following those audit recommendations (in spite of the fact that those audits were issued by an agency which has failed to comply with auditing standards).

In attempting to address the dysfunctional relationship between DCAA and DCMA, DPAP very recently issued a policy memo which addresses auditor-contracting officer disagreements. Specifically, where a contracting officer's pre-negotiation position sustains less than 75% of the audit recommended costs questioned there is now a coordination, review and approval process which could ultimately elevate a disagreement up to DPAP. DPAP's policy only applies to bid proposals; hence, it remains to be seen if and how this DPAP policy will address DCMA and DCAA disagreements over contractor business systems.

Beyond the immediate and somewhat narrow scope of the DPAP memorandum, there is a greater concern for the direction DPAP seems to be going. Specifically, the DPAP memorandum is inconsistent with respect to Federal Acquisition Regulations, which with rare exception, clearly assign the decision making authority to DCMA (Contracting Officers). To even suggest that DCMA is accountable to DCAA is a complete reversal of government procurement roles and responsibilities and it is contrary to basic auditing concepts. Auditors provide an opinion which may not consider all relevant facts.

Although there is a new director for DCAA, it remains to be seen if the new DCAA will retreat back to its advisory role, but certainly the recent DPAP memorandum is no impetus for DCAA to retreat with respect to DCAA audits of bid proposals.

The ongoing CWC activities coupled with the DPAP memorandum suggest that 2010 will continue to bring audit challenges which cannot be easily dismissed by a contracting officer even when the audit exceptions are poorly stated and/or not supported by regulations. Given this environment, a contractor must take full advantage of any opportunity to rebut a DCAA draft report. It is incumbent upon the contractor to assist the contracting officer in making a decision which considers all relevant facts including those necessarily provided by the contractor because DCAA failed to report them.

FAR Subpart 1.602 still assigns the decision making authority to contracting officers and more specifically states that “In order to execute these responsibilities, contracting officers should be allowed wide latitude to exercise business judgment”. In that context a contractor’s role is now more than ever assisting the contracting officer in making a reasonable and supportable business decision.

DCAA Audits of Contractor Internal Controls or “Business Systems”

Although it largely went undetected in March of 2008, DCAA fundamentally and dramatically redefined its audit criteria in terms of its audits of contractor systems of internal controls (DCAA Memorandum 08-PAS-011). In DCAA vernacular, these are generally the “ICAPS” audits and as discussed in the article on the Commission on Wartime Contracting, these have also been identified as “business systems”.

In terms of what has dramatically changed beginning March 2008, it was the definition of a reportable deficiency which is now any deficiency which “results in at least a reasonable possibility that unallowable costs will be charged to the government and the potential unallowable cost is not clearly immaterial”. In December 2008 (08-PAS-043), DCAA also changed its audit policies to eliminate a middle audit opinion with respect to DCAA’s opinion of a contractor’s internal controls. The middle opinion, “inadequate in part” is no longer an option resulting in a simple “adequate” or “inadequate” audit opinion.

The basic regulatory premise for contractor internal controls has been FAR Subpart 9.104-1 and DFARS 242.75. Only DFARS actually mentions “internal controls” but without any reference to any codification of such controls. In some respects, these long-standing, but very general requirements were supplemented by FAR Subpart 3.10 and contract clause 52.203-13(c) with additional, but fundamentally very basic internal control requirements. In fact when 52.203-13 was issued, the FAR Councils very clearly deferred the details to the individual contractors noting that the regulation only required certain minimum standards and that each contractor would determine its appropriate controls over and above the regulatory minimum.

The fact that the FAR Councils deferred to individual contractors has not altered DCAA’s approach to internal controls which is to define a list of internal control objectives (or a matrix) for each of the applicable subsystems of internal controls. Thus for each of the potentially applicable subsystems, there are a list of control objectives which are the auditors criteria for evaluating contract compliance notwithstanding the fact that DCAA, not the FAR Councils nor any other regulatory body, created these specific internal control requirements.

In terms of the aggregate impact of the DCAA changes to internal control audits, a contractor should anticipate that any gap between DCAA’s expectations (their internal control objectives listed on their webpage) and your policies and procedures will be reported as a significant deficiency along with a DCAA opinion that the particular system is inadequate. Additionally, these DCAA memorandums continue to encourage auditors to recommend that contracting officers **suspend a portion of billed costs** (for DoD contracts) under DFARS provisions although DCMA has publicly stated that suspending costs is not the “slam dunk” as represented by DCAA.

Although DCAA rationalized that any deficiency would automatically be significant because ICAPS audits are only performed at “major” (relatively large) contractors, the reality is that regardless of contractor size, virtually any DCAA audit could result in a declaration that a

contractor's accounting system was lacking internal controls and the accounting system inadequate. Virtually all government contractors are exposed to this risk in the context of DCAA's Postaward Accounting System Audit internally designated as audit code 17740. That audit could be performed at any contractor submitting cost reimbursement or T&M invoices wherein a DCAA auditor is expected to review a sufficient number of those invoices to determine the validity of those invoices and the reliability of contractor processes supporting the billing process.

DCAA also issued an audit policy introducing "limited scope" audits of internal controls (08-PAS-041) which requires that internal control issues coincidentally identified during the course of a non-internal control related audit (e.g. a code 17740 audit) be considered as the basis for deeming the contractor system inadequate. In other words, it does not matter what audit identifies the issue, a single deficiency based upon DCAA's definitions could result in a DCAA declaration that a contractor does not have an adequate accounting or billing system; thus the contractor does not meet one of the basic contractor qualifications in FAR subpart 9.104.

In our estimation, a contractor's greatest exposure is with respect to its billing system which is inextricably interrelated to its accounting system (thus both are covered by DCAA's Code 17740 audit). Contractor's who have been authorized to direct bill are automatically in the "line of fire" because of GAO criticisms that DCAA has failed to appropriately rescind direct billing. This has led to a renewed DCAA emphasis upon auditing interim invoices/vouchers coupled with a reminder that a billing system deficiency is reason to rescind direct billing. In light of GAO criticisms, it is ultimately more risky for DCAA to authorize direct billing as opposed to rescinding direct billing.

Direct billing, long preferred by everyone involved (except the GAO which never actually experiences the time, effort and cost to comply with its dictates), is now anything but preferred by DCAA. Direct billing equates to risk to DCAA and DCAA is risk averse.

Another DCAA ICAPS audit, typically reserved for major contractors but moving to non-major contractors because of 52.203-13, is the control environment and overall accounting system. Loosely tied to FAR 52.203-13 which becomes applicable with the award of a \$5 million contract, DCAA created a four page contractor survey which requests information ranging from that taken directly from the FAR to that which is in direct contradiction of the FAR. For instance, DCAA requests a list of all ethics violations within the past 12 months which is wholly inconsistent with the FAR which requires disclosure of certain violations, but none to DCAA.

A contractor can voluntarily comply with DCAA's demands for access to records to which DCAA has no contractual rights; however, this achieves no discernible benefit to a contractor given that DCAA is primarily looking for audit leads.

As we proceed into 2010, contractors of all sizes should recognize that DCAA has internal control expectations which may or may not be the obvious focus of a particular DCAA audit. Contractors should take note of the various DCAA audit programs (e.g. 17740) and DCAA's expectations for internal controls. These may not be in the FAR, but they are on the DCAA webpage. Using DCAA criteria, a contractor can and should self-assess and take timely corrective actions even if deficiencies are seemingly minor. If DCAA declares an accounting and/or billing system to be inadequate, there is no predicting if or when DCAA will execute a follow-up audit. It may not seem fair, but a contractor can end up living with an unfavorable DCAA audit opinion for an unpredictably long, long time.

Documentation and Access to Records

Adequate documentation remains a key factor in supporting contract costs (direct or indirect) and it can be both a general requirement (i.e. FAR 31.201-2(d)) as well as a specific requirement such as FAR 31.205-33 applicable to professional and consulting costs. In the context of an audit to verify the documentation which

otherwise supports costs incurred or proposed, FAR 52.215-2 opens the door to government access to books and records (in whatever form) as well as access to a contractor plant or facility at reasonable times.

As noted in the article on the ARRA, there is a newly introduced component of access to records which is GAO or IG access to interview contractor and/or subcontractor personnel. Further, the FAR (in general, not limited to ARRA) was changed in late 2009 to provide the GAO with essentially the same access, but with respect to contractor personnel only. Of course there is another more ubiquitous player in terms of audit access and that is DCAA. In December 2008, DCAA issued an audit policy memo (08-PAS-042) which addressed the timing for DCAA access to records and DCAA access to contractor employees.

Since December 2008, it has been DCAA's interpretation that data should be provided to DCAA "upon request" unless the "request requires analysis or extenuating circumstances exist". DCAA is also asserting that it has access to employees and that auditors should generally obtain information directly from the person responsible for the data.

In stark contrast to DCAA's insistence that it has contractual rights to interview contractor employees, there is nothing which supports DCAA's insistence other than evolution (notably contractors have voluntarily allowed DCAA to perform labor floor checks which always involved employee interviews). In fact, the regulations suggest that DCAA does not have a contractual right to interview contractor employees because neither the ARRA nor the FAR mention DCAA in the context of regulations which explicitly address audit access to contractor personnel. The FAR does provide DCAA with very limited access to employees to verify employee qualifications for T&M contracts and within the definition of contractor cooperation under mandatory disclosure requirements of FAR 52.203-13.

In spite of DCAA's initial roll-out of its new interpretation of access to records (complete with overt threats) and the numerous "access to records" threats contractors have experienced since that roll-out, we have seen little

or no DCAA follow-through with respect to their request for unfettered access to employees. Nonetheless auditors will continue to ask because they've been told to ask.

Over and above DCAA requests for access to contractor employee, contractors should also anticipate that DCAA auditors will be asking new and different questions during time charging floor checks. Employees are typically ill-prepared to respond to the unexpected questions and this DCAA strategy is designed as a potential source of audit leads. This further reinforces the need for all contractors to have a contractor representative accompany DCAA (or any other auditor) and when necessary intervene in the discussion.

Although DCAA has no clearly defined contractual rights to interview contractor employees, we are by no means suggesting that a contractor eliminate existing agreements (written or otherwise) allowing DCAA audit access to employees for the purpose of verifying labor charging. However, we are suggesting that a contractor has every contractual right to resist any expansive demands for DCAA audit access to contractor employees.

Cost Allowability

Government procurement officials and auditors continue to focus on the same types of costs that have been considered higher risk in previous years. A discussion of some of these costs for which we have seen increased oversight follows:

a. Professional and Consulting Fees

These costs are continuously under the audit microscope, most often to determine if the documentation requirements stipulated within FAR 31.205-33(f) have been met, so as to determine the nature and purpose of these costs. Specific documentation requirements are: (1) details of all consulting/agreement arrangements, (2) invoices with sufficient detail as to time expended and nature of services provide, and (3) consultants'

work products. Most typical of professional fees suspect as unallowable are those categorized as business development or selling activities involving contacts with any federal, state, or local officials. Activities of this nature are often considered unallowable “lobbying” costs, especially if any consultant is a registered lobbyist or the engagement includes liaison with government officials on behalf of the contractor.

When any consulting service potentially involves selling or marketing liaison with government procurement or legislative officials, government contractors are cautioned to instruct its consultants to describe in adequate detail in reports or invoices, the nature of the services (as opposed to vague and confusing verbiage) so that the contractor and auditors can clearly discern those allowable activities—if services are clearly lobbying or political action endeavors, they should be identified and removed from billings to the government.

Government contractors should also be cautious when issuing consulting agreements with retainer provisions because FAR requires and auditors will request information that support the consumption/use of those standard fees in terms of services provided and time expended. Avoid consultant retainer agreement for services of a vague and general nature that contain or could be construed to contain broadly targeted business development, lobbying, or services with related parties who are not qualified to perform the services engaged.

b. Public Relations and Advertising

Because most companies incur public relations and advertising costs that are unallowable (because allowable public relations and advertising costs are few) per FAR 31.205-1, auditors will continue to evaluate significant expenditures for any costs that are generated by corporate image enhancement or broadly targeted advertising activities, or indicative in any way of entertainment (client or employee).

Auditors will continue to hone in on costs generated by any of the following activities:

- Any trade show, or other function where a company sets up a company information booth within a general stop-and-chat forum, even if specifically invited by a government customer
- Activities where food or refreshments are provided—examples, open houses and new product celebrations
- Direct selling activities (which are allowable) where evening events/business meetings are conducted
- Selling and marketing activities of a direct selling nature conducted for commercial (non-government) business only (although such costs are allowable, “allocability” to government contracts could be an issue).

c. Business Meetings and Conferences

Government contractors should be on-guard regarding potential audit challenges of any business meetings, conferences, management planning seminars, and in-house or external company or departmental activities where there are any features of recreation and/or entertainment, which in the minds of many auditors, overshadow the underlying and allowable purpose of the business event.

During this past year, we have noticed a continued audit focus on such activities where food was provided, the meeting location was off-site and/or contained nearby recreational activities, or events were conducted in the evening or other non-business hours. In previous newsletters, we have discussed examples where, in our opinion, the government disallowed costs using subjective personal judgment, rather than relying on the relevant cost principles (FAR 31.205-43—Trade, technical and professional activity, or 31.205-12, Economic planning costs) and an objective examination of the supporting evidential documentation. Examples:

- Determining that costs for renting offsite business meeting facilities was unacceptable because the company could have avoided rental costs by accomplishing the meeting in-house
- Questioning \$200 in business lunches (employees working through lunch, in-house, to complete B&P project), on the basis lunch should have been provided by employees, and not company
- Deeming unallowable an in-house salad bar/lunch during a day-long FAR Part 31 Cost Principles training event
- Questioning the entire trip costs for six executives of a small company for a two day annual company planning meeting (which was documented as to attendance, meeting agenda, and outcome) as unallowable under FAR 31.205-43 (note that this cost principle says nothing about such costs as being unallowable) on basis spouses attended (travel, lodging, meals for spouses had been removed by contractor).

In all cases above, the basis for challenges was really “reasonableness”, and the benchmarks for reasonableness established by the auditors apparently had little to do with empirical evidential data that clearly demonstrated the nature and purpose of the expenditures or materiality, but more of judgmental notion that any feature of relaxation, levity or employees having been fed a sandwich and Kool-Aid equaled unallowable entertainment.

d. Employee Business Travel

Employee travel costs include per diem, transportation, and miscellaneous costs, and these costs continue to be on the audit “high risk” list to the extent significant travel costs are claimed directly or indirectly on reimbursable contracts. Because auditors and contractors are not always sure how the rules under FAR 31.205-46 should be applied to determine cost allowability, contractors must be familiar with these provisions to ensure that the government does not unfairly interpret or apply allowability parameters that simply do not

exist within this cost principle, such as individual cost components for per diem ceilings, (See our December 2009 newsletter).

In preparing for evaluation of travel costs in 2010, contractors should be prepared to address the following issues, and/or understand certain risks in dealing with auditors:

- FAR rules changed allowability parameters of air fares to “lowest price airfare available to the contractor during normal business hours”, which eliminated certain muddled and outdated verbiage for “standard” or “coach airfare”; however, auditors and contractors are still left with a dilemma as to how to determine and document the lowest available fare. Auditors will likely utilize their own interpretations as to the timing and circumstances under which an airline ticket should have been purchased to determine the lowest available airfare. The audit interpretation will most likely yield a price that is far different (less) than the actual fare paid by the contractor (Imagine that!).
- Auditors will continue to determine allowability of per diem (lodging plus meals & incidentals (M&I)) to the FTR, JTR or State Department travel regulations’ ceiling amounts by applying individual ceilings for lodging and for M&I; the application of this provision from FAR 31.205-46 requires per diem (lodging and M&I) to be calculated in total, not individually.
- Government auditors will continue to determine if air fares passed on to the government represent “business” or “first class” through examination of ticket receipts and boarding passes, and will likely challenge such costs without regard to FAR 31.205-46(b) which provides a few vaguely described scenarios when costs above the lowest airfare available (e.g. business or first class) may be allowable. DCAA has dismissed most of these exceptions on the grounds of insufficient documentation and very specifically rejected the “excessively prolong travel” exception, to include any contractor policies that

use a standard trip duration (e.g. 12 hours for overseas travel) to define a contractor's business or first class justification.

- Auditors and contractors sometimes incorrectly invoke provisions of the FTR or JTR in determining allowability of travel costs such as long-term lodging, partial day travel (75% of otherwise allowable per diem), and mandatory use of a compact auto, when these limitations are not included with this cost principle and are therefore not an explicit requirement for government contractors.
- Auditors continue to evaluate travel costs for compliance with documentation requirements stipulated in 31.205-46(a)(7) which require the date, place of the expenses, trip purpose and traveler name and association with the contractor. A very generic trip purpose may be challenged as inadequate, particularly if the trip was to an "exotic" location, and all travel costs may be questioned, notwithstanding that all of the trip's travel cost elements are otherwise within the cost principle parameters.

e. Executive Compensation

We see no end to DCAA's continued evaluation and challenge to company executive compensation, using DCAA's criteria in judging reasonableness of those compensation levels under FAR 31.205-6(b). In our 2009 annual compliance forecast newsletter, we reminded contractors that DCAA performs an automatic audit test during each incurred cost audit (annual incurred cost proposal – (Schedule T – total compensation of the top five most highly compensated employees) for measuring allowability. DCAA takes the data identified within Schedule T, sends it to DCAA's compensation specialists (Mid-Atlantic) and with a very short turnaround determines the amounts of unreasonable employee compensation. The reasonableness criteria that DCAA utilizes is its own choice of salary surveys and note that DCAA also encourages its auditors to challenge contractor surveys unless the contractor can

convince DCAA of the reliability of those surveys. When using your own compensation surveys to justify reasonableness, be prepared to face stiff opposition in satisfying DCAA as to the reliability of survey data you use to prove reasonableness (other than if you happen to use the same one as does DCAA) because the provider of the survey will tightly control the details.

f. Employee Welfare and Morale

Similar to our discussion regarding business meetings (see discussion in Business Meetings and Conferences of this newsletter), be aware that the government has expended more audit effort in gauging allowability of certain employee morale and welfare costs that are not directly and completely associated with work or a very basic employee wellness program. In addition, our experience has shown more questioned costs of low dollar amounts suggesting no "floor" for materiality considerations.

Examples of costs that have been challenged this past calendar year:

- Employee monthly birthday cakes, and lunch-time recognition meetings (food provided)
- Flowers for employees (bereavement, promotions, etc.)
- Coffee or beverage service

g. Legal Fees

Legal costs continue to be a high risk cost category wherein DCAA will predictably request all supporting information for any significant legal cost. FAR 31.205-47, costs related to legal and other proceedings, does not cover all litigation situations precipitating legal fees, but those historically viewed with careful analysis have related to government proceedings brought by a government agency, initiated under the False Claims Act by a third party, and more recently, included employee civil complaints settled without a judicial decision but rather based on compromise or consent.

Private employment or employee civil complaints are not specifically addressed in this cost principle, and an out-of-court settlement of these is often done as a prudent business action to mitigate legal costs. However, a recent decision (*Geren v. Tecom*) has established a legal precedent whereby contractors will now be expected to demonstrate that there was “very little likelihood of success” for legal and settlement costs to be allowable where an out-of-court compromise is reached (See our November 2009 newsletter). Because of this decision, government procurement officials and auditors are more likely to evaluate and to challenge legal fees and settlement costs under these circumstances.

Other legal situations that will almost always be closely examined by auditors in CY 2010 include:

- Changes in financial structure (ownership) of company (unallowable organization costs) to include spinning off new segments, including those to gain a competitive edge in the bidding and cost accumulation of a new product line or government contract.
- Fees that do not meet documentation standards in FAR 31.205-33(f).
- Any fees incurred in connection with a “bid protest”—particular attention is directed to contractors who are the successful offeror, but because of a bid protest, engage legal counsel as a matter of supporting the awarding command during the protest evaluation process. Legal costs of the winning company for defending against a protest are unallowable unless such costs are incurred “pursuant to a written request from the cognizant contracting officer”.
- Any legal fees incurred where there is a government “proceeding” within the FAR 31.205-47 definition with an adverse outcome for the contractor.

Incurred Cost Proposals

The trends in strict enforcement of ACO and auditor expectations for submission of adequate and timely incurred cost proposals will continue into 2010. Auditors will continue to apply their strict interpretation of the regulations for (1) timely submission of adequate incurred cost proposals (within six months after the end of their fiscal years), and (2) the presentation format and content of those submissions (literally interpreting FAR 42.705-1 & 2 subparts (b1) to require all schedules identified in DCAA’s Pamphlet 7641.90, Ch. 6, even if some schedules are unnecessary or useless. Although current FAR verbiage identifies these schedules as an example of “what generally constitutes an adequate final indirect cost rate proposal...”, DCAA and its auditors incorrectly interpret this verbiage as mandatory.

Be particularly aware that DCAA guidance issued in December 19, 2008 required auditors to remind ACOs that proposal due date extensions (granted solely by ACOs) should be limited for “only exceptional circumstances”, and that contract billing withholds should be utilized under DFARS 242.7502(a)(4) due to inadequate systems. Translated, if inadequate or late incurred cost proposals are submitted, such situations may be indicative of underlying accounting or billing system deficiencies and withholds should be used to “encourage” contractor corrective actions.

In August 2009, a proposed FAR Rule (case 2008-020) was introduced for comment, which if converted to a change in the FAR will provide the government a true regulatory hammer for rejecting incurred cost proposals that do not have all bells and whistles that DCAA already considers a regulatory requirement. That rule would require inclusion with every incurred cost proposal, via specific FAR 52.216-7 verbiage, all schedules and other documentation specifically listed in the DCAA pamphlet 7641.90 (chapter 6).

An interesting development arose in 2009, which could be indicative of an audit trend in 2010 in evaluating incurred cost proposals. This event entailed certain DCAA audit offices “requesting” contractors to permit

DCAA auditors to perform additional transaction testing of incurred cost proposals, but well after those proposals had been audited and final indirect cost rates were determined in a final letter rate agreement. We believe that the catalyst for this initiative was the GAO reported finding that audit testing, including that for incurred cost proposals, had been insufficient to support final indirect rates. Hence, DCAA's actions to re-open and otherwise supplement audit testing to resolve GAO findings resulting in a trial balloon floated with contractors for DCAA to perform additional work even where an audit had been performed and a rate agreement letter signed.

A summary of high risk issues and problems that contractors could face in CY 2010 regarding incurred cost proposals:

- Submission of proposals within regulatory time frames, to include the documentation and schedules demanded by DCAA, with consequences being rejection of billing systems and withhold of billed amounts;
- Fewer instances of ACO discretionary approval of contractor requests for extensions to submitting incurred cost proposals;
- Continued high risk of DCAA rejecting incurred cost proposals based on very strict adequacy review guidelines;
- More extensive testing of cost transactions within accounts of a sensitive nature (see Cost Allowability of this newsletter for discussion of certain high risk costs);
- Challenging indirect cost allocation methods, even though all previous audits (incurred cost, billing rates, bid proposals) had audited and accepted the cost allocation methods;
- More extensive reviews of proposals to include expansion of transaction testing in general; continued limited discussions with contractors as to findings and basis thereof during and after the audit is concluded, and demands for contractor responses to audit findings with inadequate time allowed to review those findings;

- Extensive use of FAR 42.709 provisions in calculating recommended penalties applicable to contracts with the penalties clause; contractors should understand how those calculations and the application thereof are meant to work, given that ACOs and auditors sometimes fail to properly adhere to the regulatory framework, and;
- Potential DCAA requests to re-open previously closed audits to perform additional audit testing, and, upon approval by those targeted government contractors, undo final indirect rate agreements and negotiate new rates.

Forward Pricing Bid Proposals

Partially as a consequence of the September 2009 GAO audit report, which identified lack of sufficient audit work to support audit opinions for proposals (and other audits), auditors will expend more effort in evaluating components of cost proposals, and consequently challenge the adequacy of proposals, question or render unsupported more proposed costs, and issue “flash reports” on specific internal controls deficiencies noted during those audits. Proposals highest at risk for audit challenges are those (1) where certified cost or pricing data is required (subject to the Truth-in-Negotiations Act (TINA)), (2) that reflect multi-year performance periods, and (3) contain significant amounts of subcontracted or purchased services and supplies where auditors have inconsistent opinions as to the level of supporting data required (including competitive quotes) to justify the cost or price.

Government contractors submitting prime contract bids with subcontract proposals should be aware of a June 30, 2009 DCAA audit guidance memo (09-PSP-011) which outlines responsibilities of prime contractors in obtaining, evaluating and supporting the price reasonableness of its subcontractors. Those audit expectations include determining that prime contractors obtained an adequately supported subcontractor proposal that can be evaluated, perform cost or price analysis (or otherwise request the PCO office for support for cost analysis), and facilitate the government analysis when appropriate.

We believe the audit focus on forward pricing cost proposals for CY 2010 will include:

- Evaluating proposed subcontract costs to determine if the prime has obtained and submitted adequate cost proposals from its subcontractors and primes have performed at least a price reasonableness evaluation (as discussed above) — more emphasis if subcontract is major part of work for a sole-source prime contractor;
- Determining that proposal information, when covered by TINA, corresponds to the presentation and documentation requirements within FAR 15.408, Table 15-2; auditors are likely to summarily reject submitted proposals if all details of this FAR Part 15 provision/table are not met;
- Demanding detailed forward pricing budgets supporting all indirect rates, for each fiscal year in which work is proposed;
- Expecting competitive quotations for all or most direct materials/subcontract cost items, or reasons why competitive quotes were not obtained (even though other information has traditionally been accepted as sufficient pricing support), and;
- Deeming any and all estimating deficiencies during proposal reviews (large or small contractors) as significant, and converting those individual deficiencies into “flash reports” leading to a more detailed internal controls analysis of estimating functions.

Provisional Indirect Billing Rates

A critical requirement imposed upon government contractors for billing purposes, when invoiced amounts are based on incurred costs, are government approved provisional (estimated) contractor fiscal year indirect billing rates based on previous year rate audits, prior year history, or new year budgets. Based on the increasing government oversight trends, GAO recommendations for improvement in quality standards, and specific adverse audit findings with respect to client developed/recommended billing rates, we believe more

stringent oversight measures will be applied in assessing contractor internal controls to ensure government contractors are not bilking the taxpayer via overstated invoices. Thus, more emphasis on ensuring indirect billing rates are reliable, and the invoicing system is guarded against potential overpayments by the government. FAR 42.704 sets forth the guiding principles and processes that government auditors and contractors should follow to establish and maintain accurate and reliable rates that reflect the complete fiscal year to which those rates will be applied for interim billings.

Auditors will therefore be focused on:

- Expectations that contractors pro-actively initiate the process for approved indirect billing rates, and that documentation for those rates are provided before or early in the fiscal year to which the indirect rates will be applied. Although not expressly required by regulations, if prior history cannot be used, we recommend that contractors prepare, and submit, forecasted rates, supported by budgetary data, for each new fiscal year. Further, because ACOs and auditors do not always respond with a prompt evaluation of contractors submitted fiscal year rates, contractors should request that ACOs acknowledge receipt of a contractor's proposed provisional rates and advise of a prospective approval date
- Continuous monitoring of provisional rates to actual year-to-date rates with a documented tracking and review process showing that a contractor can continuously ascertain when existing provisional rates appear to be inaccurate; thus requiring revision
- Adjustments of provisional to actual year-end rates promptly, especially if significant over or under billings have occurred
- Maintenance of an adequate cost accounting system which supports accurate charges to contracts/projects.

Our experience with clients has shown that a contractor's failure to initiate actions to establish new fiscal year rates, as well as not having a cost accounting system that will accurately calculate actual

rates throughout the year, can result in disapproval of the direct billing privileges, withholdings of billed costs, and an “inadequate” opinion as to the adequacy of the underlying accounting system.

Allocability

Cost allocability is a concept largely unique to government contracting with applicable regulations ranging from very general FAR provisions to more specific Cost Accounting Standards (CAS). With respect to FAR 31.201-4, the somewhat esoteric definition only requires that an allocation meet the test of “relative benefits received or other equitable relationship”. Other regulations, including CAS, add “causal” in addition to beneficial relationships; hence we operate under the aggregate allocability definition of “causal or beneficial or other equitable relationship”.

One other consideration is that FAR does incorporate certain provisions of CAS, but not with respect to CAS 403 (Home Office Costs), CAS 410 (G&A) and CAS 418 (Direct and Indirect). In fact, the FAR Councils have expressly stated that FAR selectively and specifically incorporate certain provisions of CAS; thus, other provisions of CAS simply do not apply to non-CAS covered contracts. That fact has not kept DCAA auditors from using the inapplicable requirements of CAS (e.g. CAS 403) which makes for an “automatic” contractor rebuttal because DCAA has no authority to supplement or otherwise pre-empt the explicit statements of the FAR Councils.

Contractors have experienced the somewhat routine challenges involving minor disagreements over cost allocations and some of those have gone the limit in terms of contract disputes. Of particular note, the Teknowledge case wherein the government prevailed on a question of the allocability of amortized IR&D costs. Teknowledge incurred all of these costs at a commercial business unit (G&A segment), but allocated 31% of these costs to government contracts being performed at other business units (which seemed to be at odds with FAR 31.205-18 and CAS 420 because the

IR&D costs were initially incurred by a commercial segment).

In the end, Teknowledge lost and unfortunately so did all contractors because the decision made note of the fact that the government never purchased any of the commercially developed IR&D/software. Although nothing in the FAR states or even suggests that IR&D must lead to government contracts, the Teknowledge decision introduced “tangible government benefit” as a measure of allocability. The outcome of this case suggests that the government may now challenge IR&D or other indirect costs as not allocable if the contractor cannot demonstrate a benefit to government contracts as a class of customer so to speak.

It would appear that the Teknowledge case and the Tecom case (discussed under legal costs in the article above) have opened the door to renewed government challenges to cost allocability if the government asserts that a cost does not benefit the government as a class of customer. It will not matter that neither FAR nor CAS supports “class of customer” allocations; we believe there will be similar allocation challenges as the government seeks to extrapolate the Teknowledge decision into other applications. Contractors should anticipate challenges based upon the “end result”; if an auditor can devise an alternative allocation method yielding less costs to government contracts, it is more likely than ever to be a cost allocability issue.

Reasonableness

Similar to cost allocability, cost reasonableness is a concept which has a unique application to government contracting through application of FAR 31.201-3. Although reasonableness nominally applies to cost or pricing data (FAR Part 15), it is more likely to be an incurred cost issue, thus risk for those contracts incorporating FAR 52.216-7, Allowable Cost and Payment.

Basically, a cost is reasonable if it mimics a cost that a contractor would incur in a purely competitive commercial business environment; that is not

influenced by the contractor's ability to recover on a government contract. With the exception of compensation (31.205-6), the FAR does not provide any additional reasonableness criteria; however, the 31.201-3 does contain one very ominous requirement, that if the reasonableness of a cost is initially challenged, the burden of proof is on the contractor.

In application (i.e. DCAA incurred cost audits), there are seemingly more frequent "initial challenges" to reasonableness premised upon nothing more than an auditor assertion that a cost is unreasonable. In some cases, these challenges can involve a cost which has been audited and accepted in years past, but the "new auditor" newly asserts that a cost is unreasonable by simply quoting FAR 31.201-3. Once the burden to support cost reasonableness explicitly shifts to the contractor, the fun (or misery) begins. In most cases, these challenges involve costs for products or services from unrelated third parties; however, the "new auditor" frequently adds his or her expectation for competitive procurements as the deciding component supporting cost reasonableness.

Should the contractor come up short on documentation supporting cost reasonableness, the typical audit report will question the entire amount simply because the auditor will not take the time to determine a reasonable amount. It may seem absurd that reasonableness becomes all or nothing, but in spite of the absurdity, these challenges are likely to continue as it is all too easy for an auditor to challenge the reasonableness of a cost and challenging costs is now more important than ever to DCAA (in light of GAO criticisms).

Contractors can mitigate risk by maximizing competitive procurements (direct and indirect costs) and retaining documentation which supports competitive procurements which is not always a function of best price, but could be best value. It is all about documentation which supports cost reasonableness which is a higher standard than merely supporting that a cost was incurred.

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