

newsletter

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Reporting Subcontract Awards Greater than \$25,000

In an interim rule (75 Fed Reg 39.414, July 8, 2010), prime contractors will be required to report (to a publicly accessible website) new subcontract awards greater than \$25K as well as subcontractor executive compensation for the five most highly compensated executives (in addition to prime contractor executive compensation).

The rule traces back to the Federal Funding Transparency Act (2006) as amended by the Government Funding Transparency Act of 2008 (of note, this new reporting requirement does not originate with the ARRA or "Stimulus Act"). The rationale for the publicly accessible transparency reports is an assumption that wasteful spending will be minimized because "government officials are less likely to earmark funds for special projects if they know the public could identify how much was awarded to whom and for what purpose". Obviously, the government could directly eliminate wasteful spending (i.e. earmarks) by merely eliminating earmarks; however, the government has opted for an indirect solution which assumes that the public will access the website and will be able to identify and distinguish the "wasteful" spending from that which is not wasteful. (Perhaps additional reporting could facilitate this determination by requiring that spending be coded using categories such as i) beneficial, ii) partially beneficial, iii) partially wasteful and iv) wasteful).

In order to "minimize the burden" of this new reporting requirement, the interim rule includes a three-step phase-in schedule:

- Until September 30, 2010, new subcontracts will be reported if the prime contract is \$20 million or more;
- From October 1, 2010 to February 28, 2011, new subcontracts will be reported if the prime contract is \$550K or more;

- From March 1, 2011 forward, new subcontracts will be reported if the prime contract is \$25 thousand or more.

The assumption that the reporting burden will be minimized is certainly debatable because a contractor could find itself with multiple active prime contracts with differing subcontract reporting requirements depending upon the award date of the prime contract. Any assumption or assertion that the “burden will be minimized” is ultimately obliterated by the FAR Councils estimate that this reporting will apply to an estimated 617,001 small businesses (a number which is typically understated and does not include large businesses). On a positive but disingenuous note, the FAR Councils also state that “many contractors received contract funds under the ARRA of 2009, and therefore are familiar with the basic idea of reporting this kind of information into a database”. We should all feel so much better knowing that the ARRA reporting fiasco will somehow help with the newly expanded non-ARRA reporting (see the article in this newsletter on “Stimulus Act” ARRA reporting).

Of further note, the prime contract thresholds change dramatically, dropping from \$20 million through September 30, 2010 to \$25 thousand from March 1, 2011 forward. Obviously, the subcontract reporting will ensnare virtually every government prime contract from March 1, 2011 forward. This becomes even more obvious when one considers that the subcontract reporting will apply to commercial items (including “COTS” or commercial of the shelf) and contracts below the simplified acquisition threshold (currently \$100 thousand). All because the FAR Councils believe that these databases will deter “wasteful and unnecessary spending since government officials will be less likely to earmark funds if they know the public could identify how much was awarded to which organizations and for what purposes”.

In addition to prime contractor reporting of first tier subcontract awards, the interim rule contains a somewhat confusing requirement for the prime contractor to report the executive compensation of the its five most highly compensated executives as well as for its first tier subcontractor(s). The confusion is associated with the summary discussion which only identifies exclusions for classified contracts and contracts with individuals; yet the body of the rule includes a number of additional exemptions. Those exemptions include:

- \$300,000 gross income exception (entity income from all sources is less than \$300,000)
- The contractor or subcontractor received less than 80 percent of its annual gross revenues from federal contracts and subcontracts and

- The contractor or subcontractor received less than \$25,000,000 in annual gross revenue from federal contracts, subcontracts, grants, loans and cooperative agreements and
- The public does not have access to information about the compensation of the senior executives through the periodic reports filed under the SEC Act of 1934 or section 6104 of the IRS Code of 1986.

In understanding the exemptions, it is critical to note that the last three are conjunctive, that is all three must apply for the exception to apply which means that large publicly traded corporations are not exempt; hence, they will be reporting compensation for SEC, IRS, and now FAR. Similarly companies with gross income greater than \$300,000, but which do not “publicly” report for SEC or IRS purposes will be required to report for FAR purposes (regardless of the 80 percent or the \$25,000,000 test).

For those contractors subject to the subcontract reporting, which is contract specific, there is also a less than obvious cost allocation issue; specifically, the cost for subcontract reporting requirement is irrefutably a direct cost having an obvious causal relationship to a particular final cost objective. As such, the cost of reporting subcontract awards could be directly charged to that final cost objective whose contractual clause caused the activity, thus the expense to be incurred (note “could be” versus “should be” depending upon a contractor’s cost accounting practices and/or disclosure statement).

This scenario applied to commercial items introduces the need to factor into the commercial price, the incremental cost of subcontract reporting a cost which is not otherwise included in the commercial price. It should be obvious that the government should pay the cost for the government’s specific contractual requirement, whether subcontract reporting, ARRA quarterly reporting or any other new requirement originating with the ever expanding government requirements. If the government explicitly and contractually requires an activity, thus a contractor or subcontractor incurs a cost solely for that activity; therefore, the government should directly pay for the cost.

Stimulus Act (ARRA) Reporting

In an interim rule (75 Fed Reg 38,684, July 6, 2010), FAR 52.204-11 (American Recovery and Reinvestment Act – Reporting Requirements), first tier subcontractors will be required to report jobs created with ARRA funding. The reporting requirement will apply to those subcontracts with an award value of \$25 thousand or more, but the reporting is prospective, hence, existing contracts will not require

renegotiation (equitable adjustment). Fortunately, the subcontractor reporting only applies to the first tier subcontractors (at least for now), which will yield somewhat illogical ARRA reporting in the context of reporting very small first tier subcontracts (and the jobs associated with those subcontracts), but no such reporting for potentially very large lower-tier subcontracts.

In imposing additional ARRA reporting, the government seems to be discounting or ignoring the fact that the accuracy and utility of ARRA reporting has been suspect since the inception of the reporting requirements. The GAO (Government Accountability Office) has issued two reports on ARRA reporting, beginning with GAO-10-223, November 19, 2009, which provided the “glass is half-full” assessment that ARRA *Recipient Reported Jobs Data Provide Some Insight into Use of Recovery Act Funding, but Data Quality and Reporting Issues Need Attention*. The GAO noted that recipients of ARRA funds “appear to have made good faith efforts to ensure complete and accurate reporting” notwithstanding that the GAO fieldwork, review and analysis indicate that “there are a range of significant reporting and quality issues”.

In the wake of GAO recommendations stemming from the first GAO report, OMB agreed to a number of recommendations including those to better define “jobs created” as well as to examine quality assurance processes, procedures and requirements. In the context of improving the accuracy of ARRA reporting, DPAP (Defense Procurement Acquisition Policy) issued guidance (December 16, 2009) which required contracting officers to include the FAR clause 52.204-11 and required contracting officers to review contractor ARRA reports.

In a second report, *Increasing the Public Understanding of What Funds are Being Spent On and What Outcomes are Expected* (GAO-10-581, July 2010), ARRA reporting was determined to be meeting the “transparency criteria” 25 percent of the time and partially meeting that requirement 68 percent of the time. This massive report (424 pages) is solely based upon a GAO assessment of ARRA reporting and makes note of the fact that federal and state agencies have received limited public feedback which could be read as public understanding is lacking or that the public is simply disinterested. The GAO noted that agencies which provided program specific materials (reporting instructions) that supplemented OMB general instructions were “somewhat more positive” with respect to having more “transparent” descriptions (by implication providing more transparent descriptions should

facilitate the public’s understanding of ARRA expenditures, assuming the public reads the endless reporting).

In its second report, the GAO also asked federal and state agencies about those agencies efforts to make ARRA information available to the public as well as the public feedback. The GAO noted that “these sites contain varying amounts of information such as program objectives, lists of projects and interactive maps. Federal officials told GAO that there has been limited feedback from the public on awards and the award information made available to the public”.

As one would expect, in its July 2010 report the GAO (again) made a number of recommendations to improve the transparency of recovery act reporting and once again, OMB agreed with GAO’s recommendations. A never ending cycle of GAO recommendations followed by government agency agreement only to be followed by another GAO follow-up review in which the pattern repeats and repeats and repeats.

DCAA Audit Guidance on Resolving Contract Audit Recommendations

In audit guidance memorandum 10-PAS-015(R), dated May 27, 2010, DCAA implemented its audit policy in conjunction with DPAP’s DOD Policy Memorandum dated December 4, 2009. These policies establish a process for resolving disagreements between the auditor and contracting officer prior to contract negotiations. The DOD policy places the burden on the contracting officer of discussing significant disagreements with DCAA and documenting that discussion in the pre-negotiation objectives and written communications with the auditor. In other words an intrusive and time consuming documentation process should the contracting officer not agree with DCAA.

Although the DOD policy was clearly focused upon forward pricing proposals wherein the coordination and issue elevation is triggered if the contracting officer’s pre-negotiation objective would sustain less than 75 percent of the DCAA questioned costs, DCAA’s audit policy highlights the fact that the DCAA Director may elevate **any** disagreement that he believes requires the DPAP Director’s attention. In the absence of any DOD policy which addresses these “other issues”, the only way the DCAA Director will know of these other issues is to encourage DCAA auditors, field offices and regional offices to elevate these to the DCAA Director.

It is all too obvious that DCAA auditors are now more than ever in the role of second-guessing contracting officers which is a

radical departure from DCAA's traditional "advisory role". In a cooperative, but superficial gesture, DCAA makes note of the DCMA Board of Review and DCAA's support for those "procedures". It remains to be seen if DCAA will be equally supportive of the actions of the DCMA Board of Review which we believe will routinely disagree with DCAA's often unsupported audit conclusions.

As an aside, but truly indicative of DCAA's inability to timely perform audits or in this case issue audit guidance, it took DCAA approximately six months to issue its audit policy as a corollary to the DPAP policy. Noting that DPAP normally coordinates such policies which directly impact DCAA with DCAA before implementing the policy, the lag-time is actually more than six months. Apparently neither audits (performed by auditors) nor audit policies (issued by executives) are held to any due dates or timely execution.

DCAA Audit Guidance on Forward Pricing Bid Rates – Disclaimers and Unsupported Costs

In a DCAA guidance memorandum to its auditors (10-PSP-018R, June 4, 2010), the agency affirms its practice of disclaiming opinions of bid proposal rates, or unsupported proposal costs, when DCAA either has either not had the opportunity to review, has not completed its review, or cannot review due to insufficient data, the rates included in those price proposals.

The guidance was issued because some auditors issued opinions on audits of the entire bid proposals without having completed sufficient audit evaluations of proposed rates. When rates have not been reviewed by DCAA for whatever reason, auditors are to only opine on proposal cost elements for which auditors could analyze, and thus not express an opinion on the "complete" proposal.

The guidance specifically instructs auditors to avoid expressing an opinion on the adequacy of proposal rates (which may include direct and/or indirect cost rates) if the auditor has not had the opportunity to review those rates, or the review of the rates has not been completed before report issuance date, and to so identify this situation in the audit report. Such a disclaimer would be issued only if the rates "represent a material portion of a pricing proposal"; hence, the outcome of an audit report with a disclaimer would translate into a recommendation that price negotiations not be concluded until the audit results of the rates were available to the contracting officer.

Of particular importance to government contractors, the guidance asserts that auditors should deem direct or indirect rates based on Forward Pricing Rate Agreements (FPRAs) as essentially unacceptable (disclaimer opinion) if the auditors were not previously involved in the audit of information formulating the negotiated rate agreement (FAR 42.1701). Consistent with the FAR, negotiated FPRA rates are employed in pricing proposals to facilitate more efficient and timely government evaluations of individual bid proposals, and FPRA's have long been encouraged by buying commands working in a high volume proposal environment. FPRA's tend to minimize continuous contractor revisions for nominal changes to bid proposed rates; however, FPRA's never relieve the contractor of the TINA requirement for current cost or pricing data. Hence, the FPRA provision for cancellation at the option of either party, most often when the data supporting those negotiated FPRA rates becomes outdated and the revised rates are materially different from the FPRA.

The memo also reinforces the long-standing audit practice of "unsupporting" proposed rates/costs for proposal fiscal years if detailed budgetary data supporting those out-year indirect rates has not been prepared by contractor. This DCAA practice exists regardless of whether an FPRA is in place and it ignores the realities of projecting out-year rates in a government contracting environment wherein the government itself can and does dramatically change its acquisitions based upon changes in the administration, changes in public policy, reactions to the economy, etc.

The provisions of FAR 42.1701 discuss procedures and responsibilities for negotiating FPRAs, and in paragraph (b) states that the ACO "shall invite the cognizant contract auditor and contracting offices...in developing a Government objective and in the negotiations". Under this provision, the ACO must involve DCAA (or other auditors) in establishing a government position for negotiating an FPRA with the contractor. When DCAA is omitted from the FPRA negotiation process (e.g., audit of underlying contractor rate proposal data), perhaps at the discretion of the ACO, the guidance memo concludes that DCAA cannot express an opinion on a cost proposal component which it did not audit because doing so "is not compliant with GAGAS". DCAA's position on this issue, however, ignores the fact that the ACO's internal pricing specialists may have satisfactorily evaluated contractor data supporting the FPRA rates, utilizing effective cost analysis techniques, enabling the ACO to negotiated fair and reasonable direct and indirect rates, notwithstanding DCAA's exclusion from the agreement process.

The guidance memo, via Example 4 in the Enclosure to the memo, reaffirms the auditor's position that indirect budgetary rate data must be presented by the contractor for each fiscal year in which the pricing action is performed to avert a DCAA qualified or adverse report opinion. Although the example speaks to an FPRA scenario, the message is clear that any proposed rates, for all fiscal years of the proposal performance duration, that are not supported by budgetary information will not be considered acceptable for negotiation purposes. As discussed in a previous article in our September 2009 newsletter ("Estimating Indirect Rates—How Much Support is Enough"), we noted that the DCAA position requiring detailed budgets for all out-years of a contractor's proposal is, in part, a misinterpretation of FAR 15.408, Table 15-2 provisions. Nevertheless, DCAA obviously plans to continue asserting that the absence of such detailed annual budgetary data for all proposal fiscal years constitutes a scenario whereby DCAA cannot audit those forward year rates and thus comply with GAGAS.

In its quest for GAGAS compliance above all else, DCAA is ignoring the fact that detailed out-year budgetary data is meaningless, such data adds nothing to the accuracy of the out-year rates, and the detailed forecasted base year budgetary data may be sufficient for drawing conclusions as to the acceptability of out-year bid rates and ultimately determining that the proposed price is fair and reasonable. Lastly, instead of an audit "disclaimer" (audit opinion), should the value of out-year indirect costs (without supporting budgetary data) be significant, the guidance stipulates that the auditor will render the indirect costs unsupported and issue either a qualified or adverse opinion. We anticipate significantly more adverse or qualified opinions versus disclaimers because forward pricing rates (direct and/or indirect) are rarely an immaterial amount of the total cost estimate or price.

Perhaps the most aggressive position taken in this memorandum, inconsistent with DCAA's authority, but nevertheless implicitly signed-on to by the Defense Procurement Acquisition Policy (DPAP), is the statement that auditors may deem FPRA rates used to price a proposal as unacceptable if those rates are significantly different from the rates recommended by DCAA during its evaluation of the contractor data used as a baseline for negotiating those FPRA rates. This notion is a product of a previous DPAP memo issued in December 4, 2009, the policy substance of which is included within a recent DCAA memo (MRD 10-PAS 105, May 27, 2010); that policy allows DCAA to challenge negotiated forward pricing proposal negotiated positions under certain conditions via elevating the disagreement to the appropriate

DoD procurement Component (see our article in this edition entitled, "Guidance on Resolving Contract Audit Recommendations"). Moreover, until the disagreement is settled, the DCAA audit opinion is to reflect the previous DCAA recommended rates, regardless of the rates set forth in a contractually binding FPRA.

Government contractors should also note that within the DCAA guidance rhetoric, specifically related to audited FPRA rates, is a sleeping body-snatcher. The guidance states, via Example 2 within the Enclosure, that auditors must ensure that the "subject proposal is included in the contractor's business base" (making up the FPRA baseline) or would not materially impact the FPRA rates if it is not". Interpretation: if auditors, in their judgment, cannot determine that the impact of the specific proposal being audited is in some manner considered within the data that was used to formulate FPRA rates, auditors could effectively render those rates outdated, and thus ineffective for ensuring current and reliable proposed costs, unless the impact is determined to be immaterial. Given the current DCAA audit mentality of disregarding materiality, one has to wonder if auditors will continuously challenge the reliability of FPRAs, regardless of the impetus of such agreements that were designed to avoid continued administrative burden in negotiating forward pricing actions.

Unfortunately, this audit policy is one more glaring example of DCAA's "declaration of independence", not only with respect to contracting officers, but inexcusably with respect to the FAR.

Interview with New DCAA Head: Agency's Future Direction

Patrick Fitzgerald, newly appointed Director of the Defense Contract Audit Agency, recently provided an interview with Government Executive Magazine (GovExec), the outcome of which sheds some light on DCAA's path to overcome organizational and audit performance problems cited by the General Accountability Office (GAO). Since the release of the GAO reports, the agency has grappled with the arduous tasks of improving compliance with professional auditing standards while enhancing the quality and efficiency of DCAA services.

In the GovExec article authored by Robert Brodsky, Mr. Fitzgerald admits that the GAO reports issued in July 2008 and September 2009 "were an indictment of the agency's policy, guidance and metrics"; however, subsequent endeavors have been implemented to overcome GAO criticisms via additional employee training, evaluation of the agency's promotion policy, consideration toward a risk based audit approach (rather than

an production output policy), and restoration of “trust between DCAA management and the workforce”.

The GAO reports castigated DCAA for compromise of auditor independence, inadequate substantive testing to support auditor conclusions, and insufficient audit supervision. The 2009 GAO report specifically focused on DCAA audits of internal controls and cost presentations, the results of which precipitated recommendations that DCAA revise its mission statement, evaluate its quality assurance program, and elevate DCAA’s audit authority to one of an Inspector General role.

In the interview, Mr. Fitzgerald made it clear that the quality of the DCAA workforce is not in question, but rather the underlying policy in utilizing and supporting the workforce (such as the enforcement of a production oriented environment). The new Director noted that the agency has hired over 500 new auditors, and plans to add another 1,000 auditors to the DCAA ranks by fiscal year 2015.

Added audit resources would reduce the pressure on auditors in dealing with DCAA’s “crushing workload” by providing more time to complete audits, consistent with expectations for more extensive substantive testing to support audit conclusions. Mr. Fitzgerald admits that some audits are requiring more time to complete because “we are doing a more comprehensive job”; the article notes that in FY 2008, a bid proposal review required an average of 28 days to complete, compared to 72 days required for these same type of audits in FY 2010.

Mr. Fitzgerald also called attention to the agency’s efforts toward restoring employee confidence in DCAA’s leadership while dealing with morale issues. To accomplish this objective, the agency has held over 17 “town hall meetings” over the past two months, and has created an internal review group to evaluate and react to employee complaints.

Finally, the new Director intends to eliminate “low-priority” audit services, which may include those that add little value to the audit process while not contravening the agency’s charter. Judging from the interview, Mr. Fitzgerald does intend to revamp agency policy to focus on higher risk government contracts; however, it remains to be seen what categories of audits can be eliminated because Mr. Fitzgerald apparently did not elaborate as to what constitutes a low-priority audit.

Training Opportunities

2010 Beason & Nalley Sponsored Seminar Schedule:

September 16, 2010 – FAR Part 31 Cost Principles

Location: Huntsville, AL
Time: 8:15 AM – 4:45 PM
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October 21, 2010 – Understanding Government Audits and How to Resolve Audit Issues

Location: Reston, VA
Time: 8:15 AM – 4:45 PM
Cost: \$450 per person

November 9, 2010 – Understanding Government Audits and How to Resolve Audit Issues

Location: Huntsville, AL
Time: 8:15 AM – 4:45 PM
Cost: \$325 per person

November 17, 2010 – Cost and Price Analysis in Government Contracting

Location: Reston, VA
Time: 8:15 AM – 4:45 PM
Cost: \$450 per person

If you need additional information, please contact Lori Beth Miller at lmiller@beasonnalley.com or 256-533-1720.

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August 2-3, 2010 – A Contractor’s Guide to the Incurred Cost Submission (ICS)

Arlington, VA

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Arlington, VA

August 4-5, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks

Arlington, VA

August 4-6, 2010 – The Masters Institute in Government Contract Costs

Washington, DC

September 21-22, 2010 – Government Contract Accounting Systems Compliance

Seattle, WA

October 13-14, 2010 – A Contractor’s Guide to the Incurred Cost Submission (ICS)

Las Vegas, NV

October 19-20, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks

Herndon, VA

October 25-26, 2010 – Government Contract Accounting Systems Compliance

Washington, DC

November 30-December 1, 2010 – A Manager’s Guide to EVMS

Las Vegas, NV

December 6-7, 2010 – Government Contract Accounting Systems Compliance

Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Chad Braley
- Courtney Edmonson
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Reader Inputs for Future Newsletters

Beason & Nalley, Inc. develops its topics based upon recent regulations, information, publicly accessible Government policies and our experience in assisting clients with regulatory compliance. However, we are also interested in the ongoing compliance experiences of our readers; hence, we invite your input in terms of suggestions for topics based upon your compliance experiences. Suggested topics along with any background information (i.e., your experience) should be sent to lmiller@beasonnalley.com.

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