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## Government Procurement & Audit Challenges for Government Contractors

### Calendar Year 2011 Newsletter

by

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This annual newsletter delineates our forecast of government contract procurement and oversight trends and issues that we believe will have a significant impact on government contractors in 2011 (references are calendar year unless designated as “FY” which is government fiscal year). In addition to keeping contractors informed of these trends, we trust that the newsletter will assist government contractors in anticipating and preparing for procurement challenges including the ever-expanding and continuously evolving audits. Our newsletter addresses a wide range of topics including DCAA audit trends, cost and pricing red flags, acquisition reform, and DOD policy changes. We have carefully analyzed data and information gleaned from a broad range of sources and filtered that data to identify issues and audit related “hot topics” which will likely test the resolve of both large and small government contractors in meeting the increasingly competitive and increasingly regulated environment of government contracting in 2011. As with any annual newsletter, there is no certainty in terms of guaranteeing that a topic/issue will evolve into, or continue to attract a high level of Government interest or oversight. However, we have been substantially accurate in prior year predictions, especially those related to contract audit (DCAA) oversight; hence, we recommend that all government contractors give consideration to the contractor financial, management, and other functional areas that are affected by the topics/issues discussed herein.

### Acquisition Reform and General Acquisition Topics

Government cost reduction initiatives should be of most interest to any government contractor. Although acquisition cost reduction initiatives are not limited to DOD, the most visible evidence of these initiatives is that contained in a number of DOD statements originating with the Secretary of Defense or the Undersecretary of Defense for AT&L. In June 2010, DOD sought industry comments in achieving DOD’s goal to do more without more. In August 2010, Robert Gates announced cost reduction strategies including one to cut funding for support contracts by 10 percent annually for 2011-2013. In September 2010, Dr. Ashton Carter issued a “Memorandum for Acquisition

Professionals”, which mirrored Gates’ announcement, and Dr. Carter followed with a November Memorandum for “Obtaining Greater Efficiency and Productivity in Defense Spending”. Most recently, on January 6, 2011, Secretary Gates announced that DOD had identified \$100 billion in savings which would be realigned with priority programs; however, at that time the current administration announced its expectations that DOD reduce its expenditures by an additional \$78B over five years.

In further defining or refining its cost reduction strategies, Secretary Gates has clarified that \$6B will result from reducing staff support contractors by 10 percent annually for three years under the assumption that staff support can be performed by government

employees or the staff support is unnecessary. In any case, \$6B less for DOD contractors who have been providing staff support.

In terms of other cost reductions to DOD, Dr. Ashton Carter has included IR&D (Independent Research and Development) as a potential cost reduction based upon reassessing the return on investment, so to speak. Stated differently and perhaps more directly aimed at reducing DOD's cost sharing: "Are IR&D projects and the related costs of benefit, or potential, benefit to DOD?" (By implication a return to the prior regulations which included potential military relevance within the FAR 31.205-18 allowability criterion).

It should be obvious that there are at least three strategies for reducing costs to DOD or other government contracts; the first is for contractors to reduce costs through cost reduction initiatives. Secondly and independent from contractor cost reductions, the government merely changes the ground rules defining allowable or allocable costs, thus reducing the DOD or government share of a contractor's proposed or incurred cost. Thirdly, maximize competition which will drive down the cost or actually the price to the government without regard to the cost to the contractor or supplier.

In light of government and particularly DOD cost reduction initiatives, we expect the following:

- More IDIQ contracts initially awarded to multiple contractors allowing the government contracting agency to compete the individual task orders
- More government constraints upon single source prime contract awards as well as scrutiny of sole or single source subcontract awards
- Greater expectation that "re-competes" of government contracts will result in cost reductions by the incumbent contractor or awards to other than the incumbent contractor
- More frequent use of government "should cost studies" as the basis for a government pre-negotiation objective whose cost estimates are not defined by a contractor's actual or projected costs

- More use of earned value management concepts in attempting to measure program accomplishments or failings which will feed into decisions to truncate or terminate non-performing programs (note Dr. Carter's November 2010 memo includes performance monitoring requirements which have obvious implications in terms of continuing or discontinuing DOD programs)
- Expanded use of "reverse auctions" wherein the auction process allows bidders to reduce (reverse) previous bids to under-bid the competition (this process was recently heralded as a major cost reduction success for a civilian agency)

Indirectly related to government contracting but relevant to government payments in general, the government has launched "recovery audits" as one tool for reducing improper payments which were estimated at \$110 billion in FY2010. Recovery audits are typically outsourced to forensic auditors or analysts whose compensation is a percentage of government recoveries (or at least identification of amounts subject to recovery given that the government doesn't always follow-up with the actual recovery). In form, we now have the equivalent of government auditors who are paid on a commission basis.

Regarding insourcing versus outsourcing, the government continues to look to achieve the proper balance of government employees versus contracting out for services including government actions to redefine inherently governmental (with recent redefinitions designed to favor insourcing). The government has been responsive to allegations of arbitrary insourcing goals by prohibiting such arbitrary goals (prohibited in the FY2011 Defense Authorization Act) and there is some speculation that the 2010 elections will slow the migration to insourcing. However, there is still a prohibition or freeze on A-76 Public-Private competitions; hence, it is unlikely that functions will migrate from insourced to outsourced (other than those narrowly impacted by recovery audits).

In addition to cost reduction initiatives and strategies, the current administration continues to emphasize “transparency” in government. In many cases, transparency equates to significantly greater taxpayer access to government expenditures including those government monies spent by government contractors. In fact, the latest changes to the Transparency Act (first implemented in 2006) invoke requirements for prime contractor reporting of the names and salaries of its five most highly paid executives and the same executive compensation information for subcontractors receiving certain first tier subcontract awards. In terms of the subcontract awards, as of March 2011, the requirement will be in government contracts greater than \$25K to report first tier subcontract awards of \$25K or more. In terms of reporting contractor or first tier subcontractor compensation, there are two exceptions which include, i) a company which already reports executive compensation under SEC or IRS regulations, or ii) a company with less than \$25 million in revenue from federal government sources and less than 80% of its revenue from federal government contracts, subcontracts or grants.

One other topic within procurement and contract audits (at least within DOD) is the role and responsibility of DCAA and DCMA. As discussed throughout this newsletter, DCAA appears to be usurping long-standing contracting officer authority and to some extent DPAP (Defense Procurement and Acquisition Policy) has tacitly endorsed or permitted this activity. Most recently, DPAP issued a memorandum on January 4, 2011 which addressed certain responsibilities to “align DCMA and DCAA processes to ensure that work is complementary”. That memorandum confirmed increases in thresholds for audits of forward pricing bid proposals and forward pricing rate agreements or recommendations (see the article herein “Forward Pricing Bid Proposals”) and DCMA authority for Financial Capability Reviews, Purchasing System Reviews and the respective roles of DCMA and DCAA when the DFARS proposed rule on business systems is implemented (see the article herein “Business Systems”).

However, DPAP has not and cannot address one other trend which has been DCAA auditors who have referred contracting officer decisions to an Office of Inspector General (OIG). Those referrals have resulted in a number of OIG reports which have been severely critical of ACO or PCO decisions including OIG recommendations for an ACO or PCO to re-open an issue and to alter the terms of issue resolution (seeking greater recovery for the government). This “veiled threat” will continue to have a chilling effect on DCAA working relationships with procurement and contract administration agencies.

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## GAO Reports – Continued Impact on Procurement and Audit

The GAO reports issued in July 2008 and September 2009 highlighting DCAA’s failure to comply with Generally Accepted Government Auditing Standards (GAGAS) when performing audits will continue to impact DCAA’s policies, audit strategies, and the manner in which auditors deal with contractors into 2011.

To reiterate findings disclosed in those reports, DCAA was not independent (resulting in opinions more favorable to government contractors), made undocumented changes to initial audit opinions (from “inadequate” to “adequate” opinions), and performed insufficient audit testing resulting in an audit opinion which was not supported with sufficient evidentiary matter (audit work product). DCAA audits reviewed by the GAO included accounting internal controls, forward pricing bid proposals, incurred cost proposals, equitable adjustment proposals, and cost reimbursable contract invoices. GAO cited underlying causes for poor audit performance as inadequate supervision, insufficient employee training, and working from a production output mentality rather than a risk based approach. In short, auditors worked in a “poor management environment” built around an overall DCAA strategy premised upon “quantity” versus “quality”. In continuing strategies from 2010, we anticipate that during 2011 DCAA will embrace audit policies and procedures that are designed to reverse the perception that DCAA is

weak, not independent, and ineffective as an advocate of the general public (taxpayer).

The impact of the GAO reports on DCAA audit policy and DOD procurement policy relative to contract oversight has been huge. DOD audit and procurement policy and practices have been significantly amended (or created) to conceptually ensure DCAA follows GAGAS to the letter, government contractors are held to the highest standards of compliance with relevant regulations (in DCAA's interpretation), and that any identified (or perceived) contractor deficiency is reported, regardless of materiality. Although it continues to evolve, DCAA has also taken the position that once it issues an audit report, the DCAA recommendations should be strictly supported by government administrative and procurement officials. A series of DCAA policy memos have been issued that are aimed at improving quality (i.e. avoiding any future GAGAS noncompliances), applying a more consistent approach in performing audits, and assuming more authority in a quest to be independent of administrative and procurement contracting officers (to some extent endorsed by Defense Procurement and Acquisition Policy (DPAP) policies requiring ACO or PCO coordination with DCAA).

As we reported in our 2010 annual newsletter, audit policies were issued in 2008 and 2009 to ensure timely access to records, reporting of any internal control deficiency as rendering the related system as inadequate, expansion of transaction testing for internal controls and cost presentations, and a limited discussion approach in providing contractors DCAA's basis for audit findings with minimal time for the contractor to respond to those findings.

During 2010, DPAP proposed, revised and re-proposed rules to DFARS that would codify requirements for business systems (see the article herein "Business Systems"), as well as having previously issued a December 2009 memo mandating procuring officials to coordinate with DCAA and escalate for internal review and approval pre-negotiation positions which did not sustain at least 75 percent of DCAA audit exceptions (see the article herein "Forward Pricing Bid Proposals").

These DPAP actions, although not directly an outcome of the GAO reports, have the dual effect of empowering DCAA with more authority in holding contractors to DCAA's interpretations of the regulations while mollifying DCAA in its assertion that procuring authorities (e.g., DCMA and PCOs) have not reasonably considered DCAA findings and recommendations in prior years.

In 2010 we saw no abatement of DCAA's aggressive audit approach and rigid criteria for reporting deficiencies and questioned costs—as evidenced by more strenuous expectations of contractors in support of contractor forward pricing bid proposals. It is important to note that during 2010 DCAA resources were almost entirely focused upon forward pricing/bid proposals while DCAA reassesses its audits of business systems ("ICAPS") and further delays audits of incurred cost proposals (see the article herein "Incurred Cost Proposals"). However, DCAA has modified its audit communication standards applicable to all DCAA audits (see the article herein "DCAA Communications with Contractors and Customers").

Going into 2011, we do not anticipate any real changes in DCAA's audit philosophy or approach in identifying and reporting "significant" findings. Issues that will continue as a direct or indirect result of GAO reports follow:

- Continued pressures on DCAA's audit work force to cover the increased audit hours needed to meet government audit standards—(required due to expanded scope and more extensive testing of evidential data (transactions) to support audit findings).
- Until DCAA re-evaluates its audits of contractor business systems (internal controls) and gauges the impact of the DFARS business system proposed (or ultimately final) rule, audits of those controls will be limited to new accounting system and billing system reviews, and follow-up audits of systems where corrective action was previously identified (see the article herein "Business Systems"). More likely, DCAA audits of contractor business systems will not

ramp-up until late in FY 2011 or until the following government fiscal year (FY 2012).

- For those internal controls audits that are undertaken by DCAA during 2011, any contractor failure to satisfy a DCAA defined “control objective” will be considered a reportable deficiency; however, DCAA will probably not provide an audit opinion that the system is adequate/inadequate, but only report the deficiencies to the contracting officer who i) could approve or disapprove the system or ii) do nothing while waiting for a final DFARS rule.
- Any audit will include an expanded audit scope with a renewed emphasis on statistical sampling techniques resulting in more transactions selected for audit testing and additional contractor administrative support to address auditor demands.
- Although modified in a DCAA September 2010 memo (see the article herein “DCAA Communication with Contractors and Customers”), DCAA will maintain a continued cautious approach in maintaining a dialogue with contractor personnel during and at the conclusion of the audit fieldwork.
- No substantial increase in numbers of audits over CY 2010. Factors affecting this trend include a continued shortage of auditor resources (the agency will probably not continue to expand during FY2011 due to budget constraints within DOD) and that auditors are no longer held to budgets or due dates to assure that audits meet all quality criteria within GAGAS. However, because of expansion of scope and testing and DCAA’s emphasis on protecting the taxpayer, there will be increased audit exceptions or findings per audit and thus an increase in contractor administrative effort required to respond and to resolve those findings.

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## DCAA Communication with Contractors and Customers

DCAA issued guidelines in a September 9, 2010 memo regarding auditor communication with its government customers as well as contractors. These “Rules of Engagement” for auditors were obviously created to

define acceptable auditor communications and avert non-compliance with GAGAS, particularly in maintaining auditor independence while performing audits. The memo establishes lines in the sand for auditors when participating in pre-audit procurement meetings, responding to audit requests, communicating with government customers and contractors prior to and during the audits, attending entrance conferences, and participating in exit meetings. The guidance covers demand audits (specific requests from customers, such as bid proposals) and self-initiated audits (incurred cost proposals, defective pricing, business systems, etc.).

The guidance is of critical importance to government contractors in understanding and anticipating the level of auditor dialogue prior to, during, and upon conclusion of audits; more importantly (to a DCAA field auditor), the memo identifies the boundaries auditors must stay within to avoid advising a contractor and compromising auditor independence. The guidance provides responsibilities and guidelines for disclosing or not disclosing to contractors audit findings during and upon completion of audits. The guidance does moderate the lack of communications and secrecy many contractors have experienced in the past two years whereby auditors have frequently provided little or no interim feedback, preliminary audit findings, or rationale behind audit findings until well after audit conclusions were formulated and cast in stone. The memorandum for example does stipulate that when planning the engagement, auditors should communicate in writing with contractors as necessary; explain the purpose and overall plan for conducting the audit to contractors; discuss preliminary audit findings; ensure conclusions are based on “a complete understanding of the facts”, and; discuss the audit results and obtain the contractor’s response to those findings. In addition, the memo does clarify that, with the exception of forward pricing audits, the auditor will provide a copy of the draft report, or pertinent sections of that report (unfortunately, the last statement gives the auditor the flexibility to provide less than the full draft report).

Understand that the memo first and foremost is to prevent the auditor from actions and communications which could be perceived as compromising auditor independence (GAGAS). Auditors, for example, may not provide recommendations/suggestions to contractors, and the agency reserves the right to provide an exit briefing only after all levels of management have reviewed and approved auditor findings—once findings are reviewed and approved by various levels of management, contractors can expect little movement by the DCAA field office to remove any of these findings. The guidance stops short of explicitly stating that auditors should provide additional audit workpapers/calculation information to support audit report findings, which is often necessary since many audit reports provide little or no connection of the deficiency or questioned cost to the regulations and how reported questioned costs/deficiencies were actually derived.

In summary the guidance is driven toward DCAA achieving and maintaining compliance with GAGAS (independence, audit of sufficient evidential data) and not necessarily to open the door for clearer and more responsible communication with contractors.

What should government contractors expect, or not expect, from this “Rules of Engagement” memo?

- Contractors should expect and/or seek more communication from auditors before audits commence to include explanations of the purpose and overall plan for performing the audit, as well as data required to conduct the audit.
- Contractors may expect more dialogue from auditors and procurement officials during initial “walk-throughs” of bid proposals (applicable to large dollar proposals) providing the contractor an opportunity to clarify assumptions before the audit commences.
- Contractors should expect and/or seek a more open dialogue during the audit for the auditor to “obtain a full understanding of the contractor’s basis for each item in the submission, or each aspect of the area subject to audit”.
- Contractors should not necessarily expect a dialogue from auditors on “preliminary findings” because the guidance ties the necessity of discussing preliminary issues to ensuring conclusions are based on all pertinent facts. Additionally, the auditor may be looking to obtain internal reviews and approvals before discussing anything with the contractor notwithstanding that the auditor would not give the contractor the opportunity to provide all relevant facts. Thus, in support of an audit conclusion, if an auditor is confident he or she has considered all relevant facts contractors may not be provided any findings until the exit meeting.
- The memo makes it clear that results of any forward pricing audit will not be disclosed to the contractor, with the exception of factual matters.
- Should auditor communications disclose errors or preliminary findings to contractors, and contractors take corrective action before the audit concludes (resubmit cost proposal, update incurred cost submission, etc.), understand the audit policy requires that the reported results address the original proposal, submission, accounting system, etc. and not an updated or corrected presentation or system.
- Contractors should recognize the difficulty of convincing DCAA to make changes to a draft audit report (eliminating preliminary findings /exceptions) because the auditor and the internal DCAA review process will have at that point considered their findings justified and supported and making such changes was a major problem reported in GAO Reports.

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## Access to Records

Access to records, which invokes not only FAR 52.215-2 but also FAR 15.408 and 52.232-7, continues to receive congressional scrutiny, in part due to DCAA assertions to the CWC that contractors are not providing DCAA with access to all “necessary” contractor records. Although DCAA has made this assertion with only anecdotal data presented in CWC hearings, DCAA’s deploring has apparently gained traction in the context of the FY 2011 Defense

Authorization Act which includes a provision to “authorize its auditors to compel the production of necessary audit documentation by withholding payments to contractors”.

In terms of translating DCAA’s continuing quest for “necessary” contractor records, there are at least two subsets; subcontractor records which support subcontractor costs which flow into prime contractor invoices on government prime contracts (see the article herein “Subcontract Management”) and internal audits (prime contractor and/or subcontractor). Since losing the Newport News case (which denied DCAA access to contractor internal audits under FAR 52.215-2 under a DCAA subpoena authority) DCAA has been in search of the means to gain such access.

Coincidentally (or perhaps not coincidentally), in early FY 2011, the GAO notified 10 contractors of a GAO review which was initiated with a GAO request for contractor internal audits. Although the GAO has yet to clearly or consistently explain the objectives of this project, it could be to improve acquisition efficiencies through government reliance on contractor internal audits. It could also be a component of DCAA’s and apparently the government’s interest in obtaining contractor internal audits simply to have access to contractor internal audits. As voiced by one contracting officer (supporting DCAA in the debate), “if a contractor has nothing to hide, why won’t the contractor provide internal audits?”

DCAA has all too often stated that access to internal audits is for the sake of obtaining “audit leads” and in no context for purposes of reliance on the work of the contractor’s internal auditors. Such reliance is quite difficult under government auditing standards (GAGAS) and DCAA is not about to risk another GAGAS noncompliance issue; hence, the obvious interest in contractor internal audits is to obtain audit leads which will focus DCAA audits on the underlying deficiencies. Nothing better facilitates an external audit whose objective is to disclose and report unfavorable findings than a contractor’s own candid internal reviews. As suggested in the Newport News Case, DCAA access to contractor internal audits will cause these internal audits

to be anything but candid disclosures of internal problems.

There is one other ubiquitous subtopic related to access to records, and that is DCAA’s continuing assertion that access to records extends to contractor employees. FAR 52.215-2 does not support DCAA’s assertion, nonetheless, DCAA auditors are told to request data and access to contractor employees. In most cases, contractors have acquiesced, particularly as it relates to DCAA’s “floorchecks” wherein contractor employees are randomly or not-so-randomly selected in order for DCAA to evaluate a contractor’s timekeeping system. In some cases, the auditor performing the floorcheck evolves into an employee interrogation including repetitive questions (slightly re-worded) as to create the opportunity for inconsistent employee responses. Considering that DCAA has no contractual authority to interview, much less interrogate contractor employees, a contractor can and should have a contractor representative (e.g. audit liaison) accompany the floorcheck and when necessary, terminate the floorcheck.

Considering DCAA’s audit policies on access to records and the FY2011 Defense Authorization Act which appears to reinforce DCAA demands for access to “necessary” records, we anticipate:

- Auditors will request access to internal audits or similar internal management reviews and contractors will continue to deny such access and/or limit the access to i) lists of internal audits, ii) redacted read-only internal audit reports or iii) in rare cases, total access to selected internal audit reports, but not to internal audit work papers
- Auditors will continue to execute DCAA floorchecks and will potentially expand the number of employees’ floorchecked merely to assure that the number is high enough to be GAGAS compliant. Auditors will in some cases use trick questions or questions never asked before merely relying on the element of surprise to result in reportable findings

- Auditors will somewhat routinely assert that contractor delays (in responding to DCAA audit request for records) are a potential access to records issue which could lead to a denial of access letter, cost suspensions, etc.

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## Subcontract Management

As with many other acquisition topics, subcontract management is evolving, in this case into government expectations that prime contractors will assume a greater role in “managing” subcontractors. In that context, the government expectations for a prime contractor are defined in FAR Part 15.404-3 for proposal pricing and FAR Part 42.202(e)(2) for subcontract execution/administration. Unfortunately, neither regulation provides much specificity as evidenced by the requirement that a prime contractor conduct “appropriate cost or price analysis to establish the reasonableness of proposed subcontract prices” (15.404-3(b)(1)) or “the prime contractor is responsible for managing its subcontracts” (42.202(e)(2)).

In FY2009, DCAA began to challenge prime contractors with respect to prime contractor’s inclusion of subcontractor invoices/costs as a cost component of the prime contractor invoice to the government. Basically and unexpectedly, DCAA was asserting that a prime contractor must access and audit subcontractor incurred cost data as a fundamental requirement of an adequate prime contractor billing system. In terms of translating this into a very concrete application, in CWC hearings, DCAA reported that it had questioned \$6 million for a subcontractor in Kuwait because neither the prime contractor (nor DCAA) had access to the subcontractor’s books and records.

Although DCAA’s audits of subcontract costs (during contract performance) has subsided, that is a function of DCAA’s audit resources being consumed with forward pricing and bid proposal audits and not a function of a change in DCAA audit philosophy. With respect to DCAA audits of prime contractor responsibilities for subcontractor cost or price analysis,

we further discuss that in the article herein “Forward Pricing Bid Proposals”.

In terms of subcontractor management expectations for 2011, we predict the following:

- DCAA will be auditing prime contractor billings (invoices) and DCAA will expect the prime contractor to “manage” its subcontracts beyond the mere review and approval of a subcontractor invoice. DCAA auditors will not have a consistent set of expectations and the most extreme will be expectations that the prime contractor should mimic a DCAA audit inclusive of cost verification from subcontractor job cost summary reports down to the lowest level of detailed supporting documentation
- DCAA will continue to expect prime contractors to notify DCAA of auditable subcontract awards (auditable subcontracts include cost type, T&M, and FPI); however, it remains to be seen if and when DCAA will perform an “assist” audit of the auditable subcontract
- DCAA will continue to expect that subcontracts be audited with final allowable costs determined before the prime contract can be administratively closed.

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## Forward Pricing Bid Proposals

Government procurement officials, including DCAA auditors, will continue to rigorously evaluate cost and forward pricing rate proposals, with a high likelihood of identifying questioned costs or rates along with audit reported opinions that any given contractor proposal is not adequate for purposes of negotiating a fair and reasonable price. In some cases, the audit will spawn a second “flash” report which separately identifies an estimating system deficiency. However, DOD policy (DPAP) significantly increased the threshold before an audit is required; hence, the number of bid proposal audits should decrease significantly in 2011. For those proposals which are audited, 2011 proposal audits will be affected by the continuing impact of the September 2009 GAO audit report, newly defined audit policies for more extensive audit tests when evaluating proposals,

and other changes in procurement policy (DOD) requiring more internal coordination. The GAO report castigated DCAA for insufficient analysis and testing of information supporting cost proposals (among many other issues) in which case audit reported opinions for cost proposals could not be supported.

In 2010, DCAA issued several policy/guidance memorandums that have a bearing on how DCAA will evaluate proposals and the intent to utilize their stature as a “partner” with DPAP to ensure bid proposal audit results are considered by procurement commands. An internal DCAA memo addressing the use of regression analysis (typically used to evaluate proposed indirect rates) added more work to the auditor’s bid proposal effort by stipulating that auditors must first audit the historical baseline information to be used for regression analysis. Two DCAA memos were issued (June & August 2010) addressing audits of indirect costs projections within cost proposals. The June 2010 memo focused on Forward Pricing Rate Agreements (FPRAs), stating that where DCAA was not involved in the evaluation of data that supported the negotiation of FPRAs, auditors should unsupport related proposed indirect costs and issue a “disclaimer”. Both the June and August memos also reinforced and publicized DCAA’s interpretation of FAR 15.408, Table 15-2, regarding contractor’s responsibility to “consistently” support with budgetary data all rate forecasts for all years (mainly indirect) included within cost proposals—principal mandate, for all years included in the solicitation, contractors must prepare budgetary data with the same level of detail (with some qualifications), regardless of how meaningless such data may be (i.e. form over substance). In conjunction with a December 2009 DPAP memo, DCAA issued its own implementing guidance (May 2010) related to elevation of audit disagreements with the DOD, when at least 75% of audit bid proposal recommendations is not included within the PCO’s pre-negotiation position.

DOD changed its policy on cost proposal thresholds requiring field pricing assistance (specifically DCAA audits) by incorporating a DOD PGI (Procedures, Guidance and Information) increasing the FFP and cost reimbursable thresholds to those exceeding \$10 million

and \$100 million, respectively. DCAA followed suit with an October 2010 guidance memo consistent with DOD policy and affirming DCAA’s policy to challenge requests for audits below those thresholds (with the exception of certain subcontract proposals and proposals with unusual circumstances/risk; see our November 2010 newsletter). An acquisition reform memo issued in Sept 2010 by Dr. Ashton Carter, the Undersecretary of Defense for AT&L, reaffirms the Obama’s administration acquisition reform commitment to increasing competition for bids, which would have the impact of reducing proposals requiring cost data. Within this memo, Dr. Carter calls into question the continuation of the FPRA (Forward Pricing Rate Agreement) process, stating that such agreements are few, costly to execute, and suggesting that procurement offices move toward Forward Pricing Rate Recommendations—this memo explicitly states the use of DCAA information, when available, should be used as FPRR baseline, implying that DCAA will have a larger role in auditing and recommending forward pricing rates for government contractors.

In January 2011, DPAP issued a memorandum which clarified roles and responsibilities such that DCMA is responsible for FPRAs/FPRRs for large contractors (contracting officer determined rates) and DCAA is responsible for FPRRs for the vast majority of contracts which have audit determined rates. Discussed within this same memo, DPAP has directed that DCMA and not DCAA assume the responsibility for financial capability reviews as part of the Pre-Award Survey Process under FAR Part 9.106 (these reviews are routinely performed concurrent with a proposal review). Further implied within the DPAP January 2011 memo is that DCMA will undertake the responsibility of performing cost or price analysis of bid proposals which are below the revised proposal dollar thresholds—the memo noted that DCMA is in process of hiring additional cost/price analysts.

During 2010, we have seen DCAA’s continued emphasis on prime contractors to undertake the primary role of cost analysis of subcontractor bid proposals, when FAR Part 15 regulations apply. Although not always practical for prime contractors to access and

analyze subcontractor cost data, auditors persist in demanding documented cost analysis. Given the DOD policy change in thresholds for field pricing assistance discussed above, prime or higher tier subcontractors, will face more pressure in undertaking more aggressive subcontract management methods in 2011; however, DPAP's January 4, 2011 memorandum suggests that when requested, DCAA will timely audit subcontractor cost data (where prime contractors do not have access to subcontractor cost data). Auditors also continue to insist on absolute "checklist" compliance in terms of cost proposals consistent with FAR 15.408, Table 15-2 presentation and content, having summarily deemed a number of 2010 cost proposals prepared by our clients as "inadequate for audit" based upon the most minuscule of reasons.

Given the procurement policy amendments and DCAA 2010 audit trends, we believe the audit focus on forward pricing cost proposals for 2011 will include:

- Auditors will demand budgetary cost information to support forecasted indirect rates for each of the prospective award periods stipulated in the solicitation (regardless of any practical value and this could be applied to subcontract audits below DPAP thresholds).
- Smaller government contractors or any contractor submitting lower value cost proposals, will see less of DCAA in 2011 in auditing those cost proposals, given the new audit thresholds (however, this may ultimately result in an increase in "Postaward Audits and Defective Pricing" as discussed in that section in this newsletter).
- Depending on procurement organization interpretations of the Carter September 14, 2010 memo in combination with the DPAP January 4, 2011 memo more authority may be placed on DCAA to recommend forward pricing rates as a basis for FPRRs; whether this audit process may be formal or informal remains to be seen, but expect to see more DCAA interface with contractors in establishing FPRR information for PCO office use in evaluating contractor bids.
- DCAA will expect prime contractors to demonstrate and document cost analysis of subcontractor cost proposals, where the criteria of FAR 15.404-3 (b) & (c) are applicable; we believe more cost proposals will be rejected as "inadequate" without this demonstration.
- DCAA will insist that cost or pricing data supporting a bid proposal strictly adhere to the presentation and documentation requirements within FAR 15.408, Table 15-2, even if such prospective pricing action awards are not likely to be TINA covered (i.e. not necessarily certified cost or pricing data). Auditors are likely to summarily reject submitted proposals if all details of FAR Part 15.408 and Table 15-2 are not met.
- Auditors will consider any perceived estimating deficiencies during proposal reviews (large or small contractors) as significant, and will likely convert those individual deficiencies into "flash reports" focused upon the separate (and in many cases redundant) reporting of the systemic deficiency. DCAA often recommends re-opener clauses to protect the government's interest and in any case, contractors are at a higher risk of PCO credibility issues during the proposal negotiation process if this trend continues.
- Expect auditors to spend much more time in analyzing cost proposals to include statistical sampling techniques and in-depth evaluation of any historical information used as a pricing basis—should auditors use analytical techniques such as regression analysis, projections of which are based on historical data, auditors will require contractor support at the lowest level (e.g. timesheets for direct labor) for historical data before using it for analytical projections.

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## Truth-in-Negotiations Act (TINA): Post-Award Audits for Defective Pricing

We believe that in late 2011 and thereafter, government procurement agencies and DCAA will have a renewed interest in TINA compliance and post-award defective pricing audits for TINA covered pricing actions. As DOD increases the threshold for proposal audits, the “unaudited” proposals increase the risk that cost or pricing data may not have been current, accurate or complete (see our September 2010 newsletter). Additionally, the volume of post-award audits can only increase because resource constraints caused DCAA to perform almost no post-award audits in 2009-2010. However, should acquisition reform objectives, such as lowering the government’s administrative burden via use of more competitive bids, actually kick-in, one would expect that fewer solicitations would demand submission of “certified cost or pricing data” which is a requirement for the pricing action to be subject to TINA and defective pricing audits. Although maximizing competition is an initiative of the current administration, it remains to be seen if and when additional competition causes a significant shift from certified cost or pricing data; hence, in the near future we do not expect a reduction in the universe of contracting actions subject to TINA.

Expect DCAA to ramp up its expectations that contractors identify contract awards subject to TINA to facilitate DCAA’s data gathering and audit planning phase just prior to the new government fiscal year (begins October 1), with some emphasis on FFP pricing actions between \$700,000 and \$10 million. Contractors should be especially diligent in cost estimating practices for proposals likely to generate a TINA award, and fully understand the TINA expectations during the pre-award bid process. The most critical process in supporting and negotiating a pricing action with the U.S. Government is adequately disclosing or submitting “cost or pricing data” prior to the price-agreement date and TINA certification.

Of passing interest, the proposed rule on business systems (see the article herein “Business Systems”) includes estimating systems inclusive of a government expectation that contractors should compare cost estimates to actual costs and to analyze the variance. That philosophy and expectation could summarily and routinely require contractors to disclose that variance analysis to the government and in the case of cost under-runs, trigger postaward reviews or audits.

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## Business Systems

In 2010, DCAA essentially furloughed its business systems (internal controls or “ICAPS”) audits in large part because DCAA’s resources were being dedicated to audits of forward pricing bid proposals and secondarily, because DCAA was performing a comprehensive reassessment of its audit process for evaluating and reporting on contractor internal controls. While DCAA has been reassessing internal control audits, the DAR Council (which is responsible for the DFARS or DOD FAR Supplement) has been issuing proposed rules which would define and require six business systems for those contractors who are awarded a contract which includes the yet to be finalized provision concerning business systems. The DAR Council issued a proposed rule in January 2010, followed by significant numbers of highly critical public comments, followed by a revised proposed rule in December 2010.

The impetus for the proposed rule is the findings of the CWC (Commission on Wartime Contracting) and its mantra that contractor business systems are the “first line of defense against the war against fraud, waste and abuse”. Not that it changes anything, but FAR 52.203-13, Contractor Code of Business Ethics and Conduct, when introduced in late 2008, was similarly heralded as a primary defense against “fraud, waste and abuse” and the False Claims Act and the Qui Tam process receive similar accolades. Suffice to say that the government has many rules which are designed to deter or prevent fraud, waste and abuse and as the Business Systems rule is finalized, its primary deterrence or motivating factor will be the withhold provisions (5% for large

contractors and 2% for small businesses) which can apply to more than one business system yielding total withholdings of 20% for other than a small business. In contrast to the January 2010 proposed rule, the revised proposed rule would only apply to contracts meeting a \$50 million threshold and not to lower value contracts or existing contracts.

In terms of the “business systems” which are defined within the proposed rule, these include:

- Estimating
- Accounting
- Material Management and Accounting (MMAS)
- EVMS (Earned Value Management)
- Purchasing (CPSR or Contractor Purchasing System)
- Government Property

In terms of the evaluation criteria which would apply to the government review and approval or disapproval of any of the six systems, the revised proposed rule declares that it has eliminated ambiguities (i.e. “including but not limited to” and “as applicable”) which should result in objective criteria. In actuality, the evaluation criteria remains highly subjective but for the limited objective criteria such as the inventory accuracy percentage applicable to MMAS. For example, a contractor’s purchasing system is expected to maximize competitive subcontracts and other purchases to the extent practicable. In fact, the only absolutely clear criterion is that a system will be disapproved based upon “a failure to maintain one or more system criteria” (thus a precise definition of system failure as the result of “a” deficiency).

In no case does the proposed rule nor existing DCAA guidance require that the government demonstrate any actual harm to the government before asserting that a business systems is deficient. It is all based upon risk including those deficiencies “which may lead to harm that may not be calculated readily”.

In addition to the evolving regulation on business systems, DCAA is concurrently pilot testing its audit of contractor accounting and billing systems. That

ongoing pilot test is expected to yield a new or revised audit program which will be deployed at other contractors later in FY 2011 (based upon DCAA statements at “selected” contractors during the annual audit planning discussions). It remains to be seen if and when i) DCAA will complete its pilot test, ii) DCAA will expand business systems audits to other contractors, and iii) the DFARS rule will be finalized requiring DCAA to further refine its business system audits.

In the meantime, DCAA still has its audit policy concerning limited scope audits (10-PAS-005) which addresses DCAA audits of contractor corrective actions (plans and implementation). That audit policy implicates follow-up audits limited to the corrections of previously reported deficiencies with the only favorable result to the contractor that a previously issued report (with reported deficiencies and an opinion that the system is not adequate) will be displaced by a report indicating that the deficiencies have been corrected, but with no DCAA opinion of the business system. In fact, this process along with the concept of “flash” (or spontaneous) DCAA audit reports of system deficiencies is in direct contradiction of the proposed rule which states that it is “not appropriate for DCAA to perform a narrowly focused follow-up review”.

Considering all ongoing government activities which will ultimately impact the manner in which contractor business systems are evaluated (subject to explicit contractual requirements for those ultimately subject to a final DFARS rule), we suggest the following:

- DCAA may not be issuing an opinion on a contractor business systems but will be reporting the deficiencies (or in rare cases, lack thereof)
- Contracting officers (at least DOD after the DFARS rule is implemented) will be approving or disapproving a contractor’s business system and will be relying on DCAA advisory reports

- DCAA audits, including those in response to an ACO request to review a portion of a contractor business system (e.g. purchasing), will include audit tests independently designed and determined by DCAA which will include a significant amount of substantive (or transaction) tests
- Existing DCAA audit opinions of contractor business systems will fade into the sunset as time passes including those which are simply dated (more than three years old) and those replaced by a process which assigns system approval or disapproval to an ACO
- A GAGAS compliant audit must consider the internal controls of the contractor; hence, DCAA will be forced to address how to selectively extract and apply components of a final DFARS rule to other audits of contractor business systems (contractor internal controls) including audits of contracts with civilian agencies and DOD contracts under the DFARS threshold.

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## Incurring Cost Proposals

Incurring cost proposals continue to attract contract auditor attention albeit somewhat muted by DCAA's lack of resources in FY2010 to timely audit all but a few incurred cost proposals. Regardless of DCAA's inability to timely initiate, perform, and complete these audits, the allowable cost and payment clause (FAR 52.216-7 which invokes FAR 42.705) has the requirement that a contractor submit its final indirect cost rate proposal within six months after the end of a contractor fiscal year. Thus contractors have a contractual obligation with due date whereas DCAA has nothing which binds it to a time-line. In fact DCAA does perform an initial adequacy review of contractor incurred cost proposals (ICPs) and does notify contractors of inadequate ICPs notwithstanding the fact that DCAA will not be able to audit an adequate ICP until some future, to-be-determined date. Although it may seem to be a goal with no meaningful purpose, DCAA tracks its receipt of contractor ICPs against DCAA's initial adequacy review of the ICP; (while placing no emphasis on completing the actual audits of ICPs).

As discussed in this newsletter, the September 2009 GAO report identified significant DCAA audit shortcomings in DCAA's audits of ICPs, specifically citing that inadequate audit testing of incurred cost transactions was performed upon which to sufficiently conclude that claimed costs were largely free of unallowable, non-allocable and unreasonable incurred costs. Moreover, cost reimbursable (a.k.a flexibly-priced) contracts represent, in the minds of Congress and the Executive Branch, an incubator for the incurrence of unnecessary and wasteful expenditures which foster perpetual contractor cost overruns and recurring requests for more money. Suffice to say that audits of incurred costs remain a very sensitive matter in spite of the apparent hiatus in DCAA audit activity.

Expect DCAA auditors to be less lenient in accepting past-due and inadequate incurred cost proposals—DCAA expectations are that proposals include all schedules (as listed in DCAA's pamphlet, "Information for Contractors", chapter six) and that contracting officers will defer to DCAA's judgment on the matter of adequate ICPs. Auditors continue to expect any and all schedules even if some schedules are not applicable or useless. Not that it keeps DCAA from asking for all schedules today, but in August 2009, a proposed FAR Rule addressing contract close-outs could result in a contractual requirement for contractors to submit all schedules and data shown in the DCAA pamphlet as part of an acceptable incurred cost proposal. Should this rule be finalized as proposed, contractors will have less latitude in debating with auditors rational options for omitting unnecessary DCAA Pamphlet 7641.90 data from those proposals.

Failure to submit adequate and/or timely ICPs can be considered a billing system deficiency with a "flash" report with the consequences of suspending direct billing privilege (If it still exists for any given contractor).

In summary, at least for now, the audit emphasis is on the requirement for an adequate ICP within six months after the end of a contractor fiscal year. If an ICP is deemed inadequate by a contract auditor, the auditor will have the tacit support of contracting officers. Beyond that, it remains to be seen if and when DCAA

will recharge itself with expectations for timely completion of incurred cost audits or at the very least, actually initiating these audits recognizing that the duration and scope of these audits is likely to be more expansive than in years past thanks to the fallout from the GAO reports.

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## Cost Allowability

Government procurement officials and auditors continue to focus on the same types of costs that we have spoken to in prior newsletters although we must acknowledge that these issues have been less frequent in 2010 simply because DCAA has been performing a relatively limited number of audits of incurred cost proposals. Nonetheless, our discussion below highlights those costs highest at risk for auditor challenge particularly when those costs are ultimately billed to flexibly-priced contracts.

### a. Professional and Consulting Fees

Challenges of incurred or proposed professional costs most often occur due to lack of sufficient documentation as stipulated within FAR 31.205-33(f) or due to reasonableness which is typically tied to a more subjective auditor assertion that the contractor had insufficient documentation and/or the lack of competitive bids to establish that fees were reasonable (see the article herein “Reasonableness”). 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.

Based on our 2010 client experiences, professional fees most often deemed unallowable (largely due to issues with documentation) included those incurred or which might have been incurred for business development, litigation support, lobbying and organization activities (mergers and acquisitions).

Consulting agreements involving business development activities, especially those involving liaison with government procurement or legislative officials, will precipitate more audit attention, and an expectation that the contractor obtain and maintain adequate detail (as opposed to vague and confusing verbiage) in engagement agreements, invoices and reports to distinguish allowable from unallowable activities. In today’s procurement environment it is especially critical that contractors or any entity using public funds maintain the appearance of integrity in government contracting to avoid any perceptions or misperceptions of fraud, waste or abuse. In particular, government contractors are encouraged to remove any professional or consulting costs from its billings or cost estimates where such costs could be viewed as expressly unallowable.

We also caution government contractors to understand the ramifications and pitfalls of issuing consulting agreements with retainer provisions for which the regulations incorporate the same three part allowability criteria (documentation) as for other consulting agreements. In some cases, these retainer agreements contain ill-defined services to be rendered and/or lack specificity or any detail in the consultant invoices. Recognize that an invoice submitted under a retainer agreement must provide a description of services provided and time expended (the requirement for “time expended” is counter-intuitive)—because FAR 31.205-33 requires it; hence, all costs will be questioned in the absence of the required documentation. 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 per FAR 31.205-1, auditors continue to be skeptical of major

expenditures for any costs incurred for any advertising or promotional activity, even though some of those costs (recruitment, open house, etc.) are allowable.

During 2010, the following audit challenges of advertising and public relations were experienced by some of our clients:

- Trade shows even though some of those events were used for technical training presentations (CPE given) or where government customers expected participation by contractors.
- Open houses—food was served creating in the auditor's distorted view that where there's food, it must be a recreational activity.
- Recruiting and employment advertising in newspapers and magazines; because of extensive and elegant graphics calling attention to the contractors, auditors questioned costs for these ads as being less driven by employee recruitment, more company image enhancement.

#### c. Business Meetings and Conferences

Auditors continue to evaluate many business events, even where costs for those events are immaterial, to determine if there are features of recreation or evidence that some expenses incurred for meetings and conferences were simply unnecessary (unreasonable). As stated in our 2010 annual newsletter, 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, allowable purpose of the business event.

Some typical meeting and conference events or situations precipitating audit interest to determine the allowability of related costs include:

- Lunch or refreshments provided as part of in-house business or staff meetings,
- Company offsite events, such as annual planning conferences for senior managers, where the facilities rented were in close proximity to recreational activities (golfing, boating, picnic grounds, bingo parlor, etc.).
- Evening business dinners/meetings, especially those where senior executives or managers attended.
- Any business activity, especially if offsite where food is served and where documentation demonstrating the purpose of the event is generic or not evident.

Be aware that costs for activities where food is served or recreational activities are nearby are not necessarily unallowable. Although auditors sometimes stop short of evaluating the underlying purpose of the event that gave rise to the cost, contractors should be prepared to support the purpose of the event with adequate documentation prepared in advance of or during the activity to include attendees, an agenda, minutes of meeting, hand-outs, sign-in sheet and so on.

#### d. Employee Business Travel

Business travel expenses, whether direct or indirect, continue to attract much audit scrutiny for allowability under FAR 31.205-46. Employee travel costs include per diem, transportation, and miscellaneous costs, and unfortunately auditors sometimes misapply the travel cost principle and incorrectly assert certain costs as unallowable.

Contractors should be prepared to address the following issues, and/or understand certain risks in dealing with auditors in 2011:

- In early 2010, a FAR rule became effective that 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”. DCAA followed up with a March 2010 audit policy which imposes extensive documentation requirements on contractors to demonstrate “lowest price available”. Based upon this internal DCAA memo, auditors will expect contractors to have a procedure for advance travel planning and to document and retain airfare quotes from multiple sources. Also noted in this guidance is the expectation that non-refundable air fares be obtained or otherwise demonstrated why refundable tickets were necessary. Using this open-ended guidance that leaves much to the auditor’s judgment as to whether the contractor exercised reasonable care in ensuring lowest fares were obtained, we expect auditors will ultimately question more air fare travel costs including refundable air fare (if and when DCAA begins to audit incurred cost proposals; See our April 2010 newsletter).

- DCAA will continue to question any air fare costs that are for “business class” or “first class”, even though provisions of FAR 31.205-46(b) provide a few conditions where air fare costs above the lowest available may be allowable. DCAA has, based on our experience, disregarded any contractor assertions that fares above the “lowest available” (presumably coach class) would meet one of the exceptions in the FAR cost principle.
- Government procurement officials and auditors 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. Additionally, challenges may be based upon the misapplication of other FTR or JTR provisions which have not been incorporated into the FAR cost principle for travel. Examples include rental autos (insisting compact auto be rented), stipulating a 75% first & last travel day maximum per diem (there is no

defined percentage applicable to contractors), and holding companies to a long-term travel, reduced hotel allowance (when such provisions only apply to government civilian employees).

- Auditors continue to determine that 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 are maintained to support allowable employee travel expenses.

#### e. Executive and Other Compensation

Expect auditors to continue to analyze the reasonableness of executive compensation (FAR 31.205-6(b)) when reviewing annual incurred cost proposals (Schedule T) and challenging or questioning costs based on reasonableness. Although DCAA may not make any further inquiries of a contractor, these reasonableness tests occur through DCAA’s use of salary surveys and benchmarking performed behind the scenes by DCAA’s compensation specialists. Reasonableness as defined by DCAA is measured using DCAA’s choice of salary surveys, specific application techniques, and judgmental discarding of some surveys used by government contractors as inaccurate or unreliable. A contractor using its own choice of third-party compensation surveys to justify reasonableness should be prepared for DCAA’s challenge should the contractor’s choice of surveys result in higher compensation than DCAA’s choice of surveys.

Auditors are also likely to review specific components of compensation for allowability, such as incentive/bonus compensation subject to specific requirements as stipulated in FAR 31.205-6(f). Two allowability components exist in the cited FAR provisions: (1) awards or payments must be supported by an agreement between contractor and employee, or an established practice or plan must be consistently followed by the contractor, and; (2) the basis for the award is supported.

Reasons for challenging bonus or incentive compensation ranges from the valid (no written or established plan) to the invalid and highly subjective (plan has too much subjectivity, plan is limited to certain classifications of employees, or actual payment was not soon enough after the end of the plan year).

#### f. Legal Fees

In our 2010 predictions, we opined that auditors would focus on legal costs incurred related to civil actions, or other litigation events the costs of which are not specifically stipulated as “unallowable” in FAR 31.205-47. Our prediction of civil litigation was based on a 2009 court decision (*Geren v. Tecom*) which established a legal precedent whereby contractors would be expected to demonstrate that there was “very little likelihood of success” for legal and settlement costs to be allowable when an out-of-court compromise is reached (See our November 2009 newsletter). This court decision, coupled with other court decisions that have clouded the application of this cost principle to civil and other third party actions not addressed in the cost principle, raises the specter of increased audit risk in evaluation of any legal costs incurred by a government contractor, especially those where consent or compromise is the outcome, or where embedded within the core of the litigation is an underlying contract clause that, in the view of the government, has been violated and therefore parallels the legal circumstances within this cost principle where legal costs do explicitly carry parameters for litigation costs to be allowable.

Contractors should be prepared to address the following issues; and/or understand certain risks in dealing with auditors in 2011:

- Contractors that incur significant legal costs (as well as settlement costs) incidental to employee actions in particular should be aware of the court decisions, and carefully document the due

diligence undertaken in demonstrating the “reasonableness” of those costs.

- Changes in financial structure (ownership) of company (unallowable organization costs) such as creating new entities, mergers, acquisitions, or change in stock rights or ownership
- Fees that do not meet documentation standards in FAR 31.205-33(f).
- Costs incurred in connection with a “bid protest” especially companies who were the successful offerors, but because of a bid protest, made a business decision to engage attorneys for self-protection or in the belief that they were supporting the awarding procurement agency during the protest evaluation process. Legal costs of the successful company for defending against a bid protest are unallowable unless such costs are incurred “pursuant to a written request from the cognizant contracting officer”. The government (not the successful contractor) defends itself against a bid protest
- Costs incurred for defense against any government “proceeding” within the FAR 31.205-47 definition where the outcome was adverse in some manner.

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## Reasonableness

Our 2010 experience with our clients has closely mirrored our prediction that auditors would continue to challenge, more frequently, costs using the “reasonableness” criteria in FAR 31.201-3. The FAR criteria generally summarize a contractor meeting reasonableness expectations if its business practices mirror those employed by a prudent person in conducting a purely competitive, commercial business. Although this cost principle outlines very broad business criteria in establishing reasonableness (ordinary and necessary, accepted business practices, etc.), the FAR Part 31 Cost Principles reasonableness regulation is open-ended, and does not include defined and final parameters for determining when a cost is reasonable or unreasonable. In summary,

determining when a cost is unreasonable, and defining the benchmarks for asserting such, is a function of judgment and often times the individual's personal expectations of reasonable practices and costs. However, the 31.201-3 principle does contain one very ominous requirement, that if based upon a review of the facts, the reasonableness of a cost is initially challenged, the burden of proof is on the contractor, which puts the contractor on the defense should auditors challenge costs based on reasonableness, even if no audit rationale or meaningful review of the facts support the audit position.

Auditors will continue to use the "reasonableness" as a subjective wildcard in challenging costs during 2011, and in many cases, question the entire recorded cost, when only a portion of the transaction value is excessive. Audit trends have been to question the entire value, rather than going to the trouble of establishing a benchmark for calculating only the value deemed as unreasonable. In some cases, costs cited by auditors as unallowable under a specific FAR cost principle are in fact not unallowable by virtue of the specific cost identified as expressly unallowable, but rather fall under the "reasonableness" criteria (which are not subject to FAR 42.709 penalties provisions). The vast majority of reasonableness challenges are due to lack of adequate supporting documentation that demonstrates the reason the cost was incurred, or the purpose of the expense; fewer costs questioned instances based on "reasonableness" are actually those where the auditor had sufficient information and challenged costs based on auditor determined reasonableness criteria (e.g. questioning the amount for a relocation expense which exceeded the maximum allowed within the contractor policy). Given the GAO criticism of DCAA not having supported its basis for findings, one would have expected DCAA to better document its rationale for challenging costs as unreasonable; however, that has not happened because FAR 31.201-3 shifts the burden of proof to the contractor and the GAO has not made an issue of DCAA's questioning too much costs.

## Provisional Indirect Billing Rates

Going into 2011, auditors will continue to consider audits of contractors' billing systems as a high priority where interim contract financing and invoiced amounts are based on incurred costs. Because provisional indirect billing rates are a principal component of a billing system where actual costs become the basis for invoiced amounts, auditors will have certain expectations that provisional indirect billing rates are based on FAR 42.704 guidelines. GAO reports issued during 2008 and 2009 identifying significant DCAA audit deficiencies in government contractor internal controls audits continue to affect the DCAA posture of applying more stringent audit procedures to ensure government contractors are not overcharging the government via overstated invoices.

Given our client history this past year, we believe that auditors will expect contractors to submit forecasted budgetary data for the billing period as a basis for approved provisional billing rates, in lieu of historical indirect cost data even though historical data is identified in FAR 42.704 as an option depending on "dollar value of contracts". Additionally, some clients have submitted their proposed provisional billing rates (for a subsequent fiscal year) and received no acknowledgment or response from DCAA or the administrative contracting officer in which case we recommend that the contractor bill those fiscal year costs with the proposed rates. In spite of the government's inaction in some cases, contractors should initiate the process of obtaining approval of annual billing rates and recognize that the absence of sufficient information supporting those rates may result in audit reported billing system deficiencies.

Expect the following audit risks in 2011:

- Contractors should pro-actively develop and submit annual proposed billing rates with either historical or forecast budgetary data, rather than waiting for a government procurement or administrative activity to request such data. If the government fails to respond, at least follow-up requesting an acknowledgement that the rates were received.

- Understand that auditors have occasionally challenged long-standing and acceptable cost accounting practices during billing rate evaluations, sometimes merely on the basis of personal perception as to certain practices being better than others, and if this situation arises, be prepared to demonstrate a history of government acceptance of those practices.
- Maintain 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 too high or too low.
- Evaluate year-end actual rates promptly, and determine if adjustments in provisional rates are warranted. Notify your auditor or ACO if you believe the provisional rates need to be adjusted up or down. Failure to monitor and track actual rates to provisional rates can be considered a billing system deficiency, a “flash” report and unfavorable consequences including artificially low provisional rates (“to protect the government’s interests”) or removal from direct billing (if the authority still applies to any given contractor).
- If a contractor has not updated and submitted provisional billing rates for 2011, that contractor is already delinquent with respect to DCAA expectations.

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