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CAS Board Eliminates Overseas Exemption

By Michael E. Steen, CPA Technical Director at Beason & Nalley, Inc.

In an action which was essentially a foregone conclusion, the CAS Board issued its final rule which eliminated the exemption from CAS (Cost Accounting Standards) for contracts and subcontracts executed and performed entirely outside the United States. The final rule published on August 10, 2011 will be effective on October 11, 2011 at which point there will no longer be an exemption for contracts or subcontracts executed and performed outside the United States.

There is a pre-existing limitation which will apply (9903.201-2(e)); specifically that contracts with foreign concerns subject to CAS shall only be subject to Standard 9904.401, consistency in estimating and Standard 9904.402, consistency in allocating costs incurred for the same purpose (references are to 48 CFR). Unfortunately, CAS applicability will potentially involve a CAS Disclosure Statement from a foreign concern (if the foreign contractor or subcontractor annual CAS awards exceed \$50 million in preceding fiscal years) and more ominously, the administrative provisions of FAR Part 30, CAS Administration. Additionally, it can be assured that CAS applicability to foreign subcontractors will invoke government expectations (i.e., DCAA) for prime contractors to add verification of CAS compliance to the ever expanding list of prime contractor responsibilities for managing subcontracts.

The final rule was a foregone conclusion considering the history of the foreign exemption, in particular when the CAS Board reviewed the exemption in 2008 and concluded that it was appropriate to maintain the exemption (by discontinuing the review). Congress almost immediately reacted with Section 823(a) of the NDAA FY2009 which required the CAS Board to revisit the overseas exemption. Obviously, discontinuing the 2008 review and retaining the overseas exemption was the wrong answer in the eyes of Congress (or certain representatives), hence, the notice of proposed rule (NPR in October 2010) was merely a formality given the expectations of Congress. In that context, the NPR leading to the pre-determined final rule was merely a superficial action to adhere to the rule making process. In fairness to the elimination of the exemption, it was a quirky regulation given the fact that a contract or subcontract performed entirely outside the United States could lose the exemption and be subject to CAS merely by virtue of having executed (signed) the contract in the United States.

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Similarly the exemption (dating back to 1973) was never based upon any accounting considerations, but was based upon the fact that CAS was authorized by an act which was limited to the United States and its Territories.

Unfortunately the fact that the exemption was not based upon any accounting considerations played into the pre-determination to eliminate the exemption. Historically (1973) there *was not* an accounting basis for the overseas exemption; hence, the CAS Board stated that there *is not* (in 2011) an accounting basis for the exemption. In fact, the CAS Board conveniently took this out of its proper time context and conveniently overlooked the fact that no one really knows if there is an accounting basis for continuing the exemption. Once it was determined in 1973 that the law limited the applicability of CAS, there was no need to assess whether there could have been an accounting basis for an overseas exemption. With no further explanation or support for its statement, the CAS Board merely asserts that the place of contract execution and performance is not germane to the issue at hand. Further, in addressing (or actually avoiding) one public comment which expressed concerns with the fact that CAS was developed in consideration of US GAAP (Generally Accepted Accounting Principles) while foreign concerns use IFRS (International Financial Reporting Standards), the CAS Board summarily and flippantly dismissed this fact as “not relevant”.

Unlike the FAR Council, which typically presents in detail the public comments, the CAS Board presents a highly-summarized version of the public comments and the CAS Board response. For example, the final rule never mentions one public comment that the cost for a foreign concern to implement CAS will be specific to a CAS covered subcontract; hence, a direct cost with no predictable or discernible benefits. Any foreign contractor or subcontractor required to produce a CAS Disclosure Statement and/or modify any estimating or accounting practices solely because of a contract requirement could/should treat those costs as a direct cost to that contract. Certainly a CAS Disclosure Statement has no benefit to any foreign contractor other than to satisfy a US government contract regulation which will become applicable through a specific contract or subcontract.

Public comments also factually noted that both the Special Inspector General for Iraq and the Commission on Wartime Contracting have cited numerous overseas subcontracting issues while neither cited the CAS overseas exemption as the

cause; the CAS Board's very terse response: “The CAS Board does not accept this reasoning for retaining the overseas exemption”.

Finally, the CAS Board did acknowledge that there will be an impact on foreign contractors or more likely foreign subcontractors; however, the CAS Board “believes” that there will be mitigating factors that lessen the impact on foreign concern subcontractors. Unfortunately the CAS Board never actually defines or describes these mitigating factors, but the CAS Board does provide the assurance that if this “belief” (in mitigating factors) proves to be unfounded, the CAS Board can reconsider the overseas exemption. Apparently the CAS Board has never read the definition of “unfounded” which is “without factual or rational basis”. By any measure, the CAS Board's belief in mitigating factors is in fact “unfounded” but we doubt that the CAS Board will actually reconsider the overseas exemption (now or ever).

As with any regulation, it is what it is and it will be incumbent upon prime contractors to be aware of the implications vis-à-vis subcontract awards to foreign concerns. It is a certainty that DCAA will add this to its long list of accounting/billing system criteria expected of prime contractors which will involve DCAA's request for evidence that a prime is accomplishing CAS oversight of foreign subcontractors. There are CAS exemptions which will remain including firm-fixed price subcontracts awarded on the basis of adequate price competition without submission of cost or pricing data as well as certain contract types awarded as commercial items. Perhaps unintentionally the elimination of the CAS overseas exemption will encourage prime contractors to seek to award more subcontracts which meet the FAR 15.403-1(c)(1) definition of adequate price competition.

Latest DCAA Field Guidance: Independence, EVMS, and Independent Reference Reviews

By Darryl L. Walker, CPA, CFE, CGFM Technical Director at Beason & Nalley, Inc.

The Defense Contract Audit Agency (DCAA) issued guidance to its auditors in three separate July 2011 memorandums, two of which are bolted to compliance with GAGAS (Government Auditing Standards) and improving quality of the audit product, and the other stipulating a limited role in EVMS evaluations.

Following is a briefing of each July guidance memorandum.

Independence Impairments, 011-PAS-010

Auditors are reminded to promptly notify managers on situations where auditor independence may be impaired, and supervisors are cautioned to be aware of auditor “circumstances or behavior” that could be indicative of independence or objectivity issues. DCAA iterates that loss of independence circumvents GAGAS professional auditing standards on independence, and given 2008 GAO reported DCAA lapses in auditor independence, the agency is highly sensitive to demonstrating to government procurement, legislative representatives, and the general public an aggressive commitment to avert these problems.

All issues are to be investigated and resolved promptly with a documented outcome of any review. The memo also states that managers and supervisors are to coordinate with regional offices as necessary which is a foregone conclusion because field managers and supervisors have very little authority to manage audits let alone decide potential personnel issues. Of passing interest, the auditor independence issues highlighted in the GAO reports actually pertained to supervisors, managers and ultimately a Deputy Regional Director who were allegedly influenced by contractors and/or contracting officers to remove “findings” from audit reports. It was actually poor judgment and/or valid but poorly documented decisions but hardly an auditor independence issue.

EVMS Audit Role, 11-PPS-011(R)

DCAA will no longer self-initiate Earned Value Management System (EVMS) audits, but rather will act in a subordinate role to DCMA in accomplishing the audits. The level of EVMS assistance required will be determined by DCMA, and DCAA will initiate reviews only upon a written request from the DCMA.

The guidance memo acknowledges that DCMA is designated as the DOD Executive Agent for EVMS audits, and that specific authority for compliance and validation of that system is vested with DCMA Headquarters, EVM Center. A DCMA Contract Management Office (CMO) monitor is delegated the “overall responsibility for coordinating and accomplishing the EVMS surveillance”, meaning that final determination of the adequacy of the EVMS business system (for DOD contracts) is clearly that of DCMA.

A DCMA/DCAA Memorandum of Understanding (MOU) was executed in the May-June 2011 timeframe defining the division of responsibilities each agency will have in evaluating EVM business systems for compliance. DCAA’s level of support will encompass services only for eight of the ANSI/EIA-748 EVM standards which are those pertaining to monitoring cost performance, and the type of service will be at the discretion of DCMA; services may include initial or updated compliance reviews or periodic surveillance functions.

The MOU notes that both compliance and surveillance engagements will be of an examination attestation engagement; additionally DCAA audit reports must identify deficiencies with sufficient information that will allow DCMA to determine the specific nature of those deficiencies as well as the “potential adverse impact” of reported deficiencies. And the MOU includes verbiage on establishing DCAA audit report due dates, to include resolution of DCMA/DCAA spats regarding requested DCAA report due dates. Although not specifically stated, DCAA will likely not issue an opinion in its reports given the limited role in ascertaining overall EVMS compliance.

Notwithstanding the clear establishment of DCMA taking the lead in all EVMS audits, the MOU allows DCAA to act independently in determining the scope and procedures required to accomplish the DCMA request; auditors must, however, take a risk based approach in defining the scope and executing the audit procedures. DCAA recently deactivated two of its EVMS audit programs (self-initiated), and replaced those with a single audit program focused on the role in which they will now function, that is focused on compliance or surveillance procedures for the eight cost-related EVM standards.

The MOU did not mute DCAA’s prerogative to elevate disagreements with an ACO’s decision to discard or ignore DCAA EVMS reported findings. The MOU allows, and almost encourages, DCAA to appeal such decisions pursuant to procedures to a December 2009 Defense Procurement and Acquisition Policy memorandum on resolving contract recommendation issues.

The elimination of DCAA’s option to self-initiate an EVMS audit is no doubt due to two issues; the new DFARS business system (interim) rule (May 18, 2011) which squarely places the responsibility with DCMA of determining which identified issues are considered significant and therefore renders the system inadequate, and; lack of DCAA personnel resources to

continue undertaking discretionary audits of the entire EVMS functions which are causing continuous delays in issuing reports for many other DCAA audits. Whether relieving DCAA of self-initiated or discretionary control of EVMS audits improves timeliness in completing those audits remains to be seen.

Independent Reference Review, 11-PPS-012(R)

The DCAA auditors now have another layer of internal quality review to undergo before releasing a report which may otherwise have already been through a lengthy iterative internal quality review process. Guidance from DCAA Headquarters requires an Independent Reference Review (IRR) of reports and workpapers for certain types of audits, before reports are issued to procurement.

Instructions from Headquarters require another DCAA employee, of supervisory auditor ranking (GS-13), to verify all significant facts, calculations, and evidential data to the conclusions identified in the workpapers and carried forward to the audit report. Essentially, the independent reviewer will trace draft conclusions and supporting facts and figures contained in the draft audit report to the supporting audit workpapers referenced in the draft report. The process is another internal verification for quality, e.g., reported facts, numbers, and conclusions are supported by work paper verification and evidential data. Regardless of whether the subject audit is already put under the microscope with other reviews (supervisor, FAO manager, Technical Specialist (depending on audit type), and Regional Audit Manager (if applicable)), selected audits will receive one more turn in the barrel before released to procurement customers, and hopefully escape higher level internal or external reviews and criticism (Headquarters, DODIG, GAO, etc.).

The lucky reviewer will be someone not directly associated with the completed audit workpapers and draft report, not under direct management of the supervisory auditor having responsibility for that audit, and qualified in relevant technical skills pertinent to the audit type. Although not specifically stipulated, some field and regional offices are interpreting the process as requiring the report and supporting workpaper file for an IRR by a reviewer in another field office. The list of audits subjected to an IRR is lengthy and includes incurred cost audits \$100 mil or over in examined dollars; certain high dollar value forward pricing assignments, and; all internal controls, EVMS, Cost Accounting Standards compliance &

CAS cost impact statement, restructuring rate proposals, and post award (defective pricing) audits.

The IRR process, judging by the instructions contained within the DCAA memo, appears to be an onerous, endless task including elaborate appeal procedures that can be taken as high as the Deputy Regional Director (DRD)--if the supervisory auditor cognizant of the audit does not agree with the reviewer (if there are identified problems), and the reviewer afterwards doesn't agree with the supervisor's negative assessment of the reviewer's observations, a hierarchy of elevated reviews is permitted until everyone agrees, or the DRD makes the final decision. If the reviewer does find issues, and everyone agrees, the reviewer certifies his/her work, corrective action must be taken and then verified by the reviewer before the audit report is issued.

The process, we are told, is not a creation of the DCAA, but rather a work product quality evaluation mandate stuck under DCAA's nose by another government oversight agency (it mirrors the process used by the GAO). Given DCAA's propensity to rigidly plow the field, as directed by other agencies, to avoid more bloodshed like that borne of the GAO 2008 and 2009 reports which blasted DCAA's work quality, contractors may beware that another level of review, which nonetheless may be performed quickly, will have the effect of slowing the audit conclusion process.

2011 Executive Compensation Cap – Missing In Action

By Michael E. Steen, CPA Technical Director at Beason & Nalley, Inc.

We routinely receive client inquiries concerning the 2011 Federal Register (date/volume) posting the 2011 executive compensation cap which is implemented in FAR 31.205-6(p). Although we are essentially eight months into calendar year 2011, OMB has yet to publish the executive compensation cap for 2011. In contrast, the 2010 Cap was published on April 15, 2010.

As with virtually everything else in government contracting, the government is not subject to mandatory due dates and even if these are imposed, there is rarely any penalty for failing to accomplish the objective by the specified date (for examples of this, one only needs to read one or more GAO reports where a law required government agencies to accomplish actions by

prescribed dates and one or more agencies failed while invariably promising to “get right on it”).

In terms of why OMB has failed to publish the 2011 cap, we can surmise that it may pertain to DCAA's involvement with the analysis of the financial data which forms the basis for the compensation cap (DCAA compiles and computes the median executive compensation for publicly traded companies with sales over \$50 million). It is all too obvious that DCAA has neither budgets nor due dates and will accomplish its audits or other financial advisory services at its own pace independent of customer expectations or unfavorable impacts to contractors. In the case of the 2011 cap and DCAA's analysis of financial data, we suspect that DCAA may have initially completed the fieldwork earlier this year, but the results have been going through the endless levels of internal review necessary to assure the perfect analysis, with all references perfectly cross-referenced to the multitude of financial statements which serve the basis for the compensation cap. As with DCAA audits, no audit (or analysis) can make it through this process without multiple iterations involving analysis, review, corrective actions, review, etc.

Contractors are left with no choice but to continue to use the 2010 executive compensation cap which includes future cost estimates regardless of the future years involved (i.e., by regulation, a contractor cannot apply escalation to the 2010 cap in pricing out years). Similarly, contractors who have fiscal years which are not calendar year end fiscal years, have no way of pro-rating the 2010 cap with the 2011 cap. For example, a contractor with a March 31, 2011 fiscal year end would typically prorate the cap using 75 percent of the 2010 cap and 25 percent of the 2011; however, there can be no proration in the absence of the 2011 cap (note: the regulations are subject to interpretation regarding the concept of pro-rating the cap for fiscal years which include portions of two calendar years; however, our example is premised upon DCAA's interpretation).

To no one's surprise, the government's inability to timely produce and publish a 2011 cap works to the advantage of the government and the disadvantage of the contractors. Related to the executive compensation cap, it is worth noting that the FY2012 Defense Authorization bills include a provision which will expand the current cap to include anyone working on a contract (not clear how that would apply to indirect employees who are most likely those covered by the current cap which only applies to the top five most highly compensated

executives/managers leaving number six and below not currently subject to the cap). More ominously, the same FY2012 DOD bills include provisions for DOD to negotiate freezes on contractor labor and overhead rates to 2010 levels (obviously someone doesn't understand overhead rates which don't necessarily increase over time). Being a government contractor just gets better and better.

IRS Final Rule & Commentary on 3% Withhold of Payments to Government Contractors

By Darryl L. Walker, CPA, CFE, CGFM Technical Director at Beason & Nalley, Inc.

The IRS issued its final regulations in May 2011 implementing a three percent withhold of all payments of \$10,000 or more made by any federal, state, or local government with annual expenditure of \$100 million or more. Many organizations and individuals will be exempt from this requirement as set forth in the final rule; examples include people receiving retirement benefits or where individual wages are subject to withholding, payments for interest & real property, those made to foreign governments or Indian tribal governments, and payments under confidential or classified contracts, just to name a few. But government prime contractors will not be exempt from withholdings, unless individual payments made to those companies are less than \$10,000.

The final rule did indeed delay the effective date until January 1, 2013 much to the relief of certain legislators who have opposed this rule.

The impact on government contractors is adverse no matter how you slice the cheese. The withhold calculation is on total contract value, not on net revenue (e.g., earned revenue, income, etc.), which means that direct and indirect costs incurred by contractors are hit by a three percent reduction in addition to any earned revenue in a payment; hence, government contractors under a cost type contract, for example, will have three percent of legitimate and allowable costs incurred withheld under this rule, as well as any other withholds applicable under payment provisions. For certain cost-plus fixed fee contracts, contracting offices sometimes invoke a fifteen percent withhold on the fixed fee, and other terms may require caps or ceilings on indirect costs; regardless of these other withholds, a broad three percent tax

withhold on total payment value may still apply. Application of tax liabilities on total payment value unfairly attaches a tax penalty on legitimate costs incurred in performing a government contract apparently over-ruling explicit cost type contract payment provisions, for example, that such costs be reimbursed without deduction unless regulatory reasons exist to protect the government's interest (e.g., deductions for unallowable costs, uncorrected business system internal controls deficiencies, etc.).

Certain government contractors which make a small profit margin or fee, or otherwise have limited cash flow (e.g., small start-up businesses) will be troubled the most. Contractors with cost plus no fee contracts, depending on how the IRS applies the rule to payments for these arrangements, that are subject to a three percent withhold will be held hostage to a perpetual loss position until withholds are restored. In fact, contractors who negotiate a low profit or fee amount (e.g., five percent or lower) with the government could also be thrown into a net loss position given the fact that withholds will increase contractor borrowing for increased working capital. These increased borrowings will increase the incurrence of more interest expenses which cannot be recovered by the contractor since it is an unallowable expense. As one commentator put it, the withhold provision is nothing more than an interest free loan made by a contractor to the government, an organization that cannot manage its own finances or dig its way out of debt due to incompetent and ill-informed legislators and White House officials.

Be aware that the three percent withhold rule on \$10,000 or more payments means just that—payments made to the recipient, not the contractor's individual invoice amount. When one reads the rule carefully, some companies may invoice frequently for amounts lesser than \$10K, but if a federal agency payment to the contractor encompasses several contractor invoices, the total of which is \$10K or more, then a withhold will apply.

The genesis of this rule comes from a widely held presumption that government contractors, among others, receiving federal monies, were and are frequently delinquent in paying federal taxes—and no corrective action was in place to restore owed taxes to the government. Hence the initiation of three percent punitive measure applied to all prime government contractors regardless of any actual avoidance of payments of tax liabilities. The Act did not seek to target only companies with a history of tax payment delinquency based upon the

government's broad perception that all government contractors are innately tax cheats who also make too much money off the backs of the general public.

There are, however, legislators who understand the ramifications of this law, and at this time, are still fighting to repeal the withhold provision, or at least more precisely target the applicability of the withhold provision to companies with a history of tax delinquency. Optimistically the renewed bipartisan interest in jobs creation may also come into play given that the arbitrary three percent withhold will reduce, not create any jobs except for those IRS jobs for enforcing the arbitrary withhold.

Government Achieves Mixed Results Migrating from Cost-type and Time and Materials Contracts

By Michael E. Steen, CPA Technical Director at Beason & Nalley, Inc.

In 2009 and thereafter, the government has announced a number of strategies for reducing "high-risk" contracts. Typically, these are defined as cost reimbursable contracts and/or time and material (T&M) or labor hour (LH) contracts. Although these contract types have never been shown to actually cost more than alternative contract types (which the government finally acknowledged), these are viewed with skepticism by both the Legislative and Executive Branch. To reinforce and to track the government's collective success in reducing high risk contracting, the 2009 National Defense Authorization Act required the Office of Management and Budget (OMB) to report on the use of cost-reimbursement contracting by executive agencies.

In a letter dated July 8, 2011, OMB issued its first report and expanded that report to include T&M/LH contracts. T&M/LH contracts were obviously added because the 2009 to 2010 trend showed an overall reduction from \$29 billion in 2009 to \$28 billion in 2010. Although some sources reported this as a 19 percent reduction, it is in fact 3.4 percent, but nonetheless a reduction. In developing this data, OMB relied upon unadjusted data from the FPDS (Federal Procurement Data System).

In contrast to the successful reduction in the dollar value of T&M/LH contracts, OMB reported that unadjusted FPDS data showed cost-type awards of \$151 billion in 2009 and \$162

billion in 2010. This 7.3 percent increase is unfortunately going the wrong direction but this data is notably based upon the same source (FPDS) as was the basis for declaring success with respect to T&M/LH contracts. Immediately OMB declared this to be in error because the 2009 data “may have” underreported cost type awards by as much as \$9 billion. OMB believes this to be true because of a GAO (Government Accountability Office) report on similar data in 2008. In reading OMB’s rationale to explain a speculative anomaly in 2009 (oddly enough relying upon 2008 data) it becomes all too apparent that if the 2009 cost-type contract awards were likely underreported by \$9 billion it is highly likely that the 2009 T&M/LH contracts were over-reported. The “may have been” underreported \$9 billion simply shifts to another contract category most likely T&M/LH; it does not simply disappear from the 2009 baseline data. All things considered, it is plausible that actual contract awards in 2010 went the wrong direction vis-à-vis the goals to reduce both cost-type and T&M/LH contracts.

As with other government contracting initiatives, it apparently doesn’t matter what the data actually shows and/or how absurdly the data must be manipulated as long as the reported outcome can be twisted into the preferred outcome. Unfortunately, this incident also belies the fact that the recipients of this report aren’t overly concerned with the manipulation of data as long as the conclusions are consistent with preferred outcomes and expectations.

However, there is a very positive aspect of this report which is confirmation of the fact that contracting officers are apparently awarding contracts based upon the contract type which best accommodates the facts and circumstances of the individual solicitation and contract award. Apparently individual contracting officers are not being sucked into an arbitrary and potentially illogical goal of reducing awards of certain contract types when in fact the contract type should be consistent with FAR Part 16 which is essentially unchanged. Certainly there remains the risk to contractors that a contracting officer, particularly an inexperienced one, will insist upon a contract type which shifts an imbalanced risk to the contractor. Faced with this, a contractor may have to employ the anti-drug slogan and “just say no”.

On a side note, but also related to agency results in terms of reducing “high-risk” contract types, the Center for Strategic and International Studies reported that from 2007 to 2010, the department of Homeland Security had significantly increased

its fixed-price awards while conversely reducing its reliance on cost-type and T&M (“high risk”) contracts. However, the report identified a cause and effect, in particular that earlier years had involved T&M and cost-type contracts in the wake of natural disasters. In other words, a rational, logical shift away from certain contract types as a function of the contracting environment while having nothing to do with an arbitrary government-wide goal.

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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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