

newsletter

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DCAA Audit Policies on Statistical Sampling

In January 2011, two DCAA audit policies related to statistical sampling were posted on DCAA's website (www.dcaa.mil under the "open audit guidance" section). Those policies address "Attribute Sampling" (10-OTS-069(R); October 20, 2010) and "Variable Sampling" (11-OTS-001(R); January 3, 2011). Of passing interest, the January 2011 memorandum notes that it is identical to an earlier memorandum, 10-OTS-051(NR) other than just now being "releasable" to the public (hence the (R) vs. (NR) designation).

Attribute sampling is typically used for evaluations where the audit observation is "yes" or "no" with respect to criteria (e.g. the sampled timesheet was signed by the employee). The two page "attribute sampling" policy significantly changed i) establishing sample size and ii) reporting sample results in audit reports (based upon our previous experience with clients, DCAA had previously reported almost nothing in terms of its sampling plan and results leaving both the contractor and the contracting officer in the mode of "just trust me that I (DCAA auditor) knew what I was doing"). In establishing the sample size, DCAA policy states the sample plan will be premised upon a 90 percent confidence level which also means that the critical error rate will be 1 minus the confidence level (i.e. 10 percent). In reporting the results, DCAA policy indicates that the report will state whether the sample was statistical or non-statistical (a non-statistical sample cannot be projected to the sampling universe which will presumably force most sampling plans to be designed as statistical samples). In fact, it would seem that with respect to DCAA audits and audit policy, a non-statistical sample may only be used (or usable) when the information is going to be used to establish risk parameters for a statistical sample.

DCAA's audit policy provides an extract of an audit report with hypothetical results of a 22 percent error rate (10 errors in a sample of 45 from a universe of 2,798). Of note, we are aware of one client where the nominal error rate was 5.5 percent; however, in its report, DCAA's opinion was based upon the "high end" of the statistical results. In this case, approximately 11 percent albeit a very low probability that the error rate could be that high; nonetheless the auditor concluded that the error rate could be as high as 11 percent which exceeded the critical error rate of 10 percent; thus the contractor's accounting system failed.

Unfortunately one more example of DCAA reporting in its self-created "risk averse" environment; in this case when there was reasonable assurance that the error rate was 5.5 percent the auditor's conclusion was based upon the remote possibility that the error rate "could be" as high as 11 percent. Apparently the audit opinions are not based upon what was actually observed, but "what could be".

In its January 2011 audit policy on variable sampling, DCAA provides a far more detailed window into its revisions impacting sampling plans, evaluation of results and reporting results. Variable sampling is used to quantify dollar differences (identified with each sampling unit/transaction) with the sampling dollar difference extrapolated to the universe. Hence, the relative value of one dollar questioned is significantly more when extrapolated to the universe of transactions. In one case, a client's direct material transactions were sampled and each sample dollar questioned was effectively twelve dollars questioned when extrapolated to the universe.

DCAA provides a table to its auditors for determining a minimal sample size when applied to a universe of more than 250 items. The absolute minimum sample size is 47 which assumes a low expected error rate or variability in questioned cost ratios and a high tolerance for misstatement ("high tolerance for misstatement" appears to us to be an oxymoron of sorts when applied to DCAA's risk averse mindset). In contrast, the minimum could be as high as 145 (high expected error rate or questioned cost ratios and low tolerance for misstatement). In other words, the statistical sampling size could range from 47 to 145 transactions based upon non-statistical "risk" estimates (attributes) by the auditor.

In fact, the guidance states that "tolerance for misstatement" is typically low for engagements performed in compliance with GAGAS (Government Auditing Standards) and because DCAA has apparently made a decision that its engagements will all

be GAGAS compliant, one can assume there will be low tolerance for misstatement.

These policies suggest that DCAA's version of risk based auditing is premised upon risk aversion which is further influenced by the assumption that "public accountability" dictates little tolerance for misstatement (e.g. costs which are unallowable). Translated, DCAA auditors will have no choice but to utilize relatively large sample sizes which provide an umbrella of protection from any potential challenge to GAGAS compliance. Further, this will translate into DCAA requests for "data dumps" solely to facilitate a DCAA statistical sample. Although nothing in the access to records clause FAR 52.215-2 has such a requirement, that will not stop DCAA auditors from "asking" contractors to filter and/or reformat data to facilitate the wild and wonderful new world of statistical sampling.

On a positive note, in and of itself, a larger sample size will increase the statistical reliability of the results, thus providing more assurance that a projected cost disallowance actually represents the sampling universe. Of course, all of this assumes that the criterion applied to each sample transaction is reasonably objective; hence, the audit exception at the transaction level is "black" or "white". The bad news, there are and will be a significant number of audit exceptions which are subject to interpretation (aka: "grey") with DCAA's low tolerance for misstatement resulting in an audit bias for questioning costs which fall into the category of "subject to interpretation".

The life of a government contractor subject to DCAA contract audits continues to increase in complexity and it should be apparent that DCAA's statistical sampling will increase the financial risks of non-recovery of contractor incurred and/or proposed costs (and "yes", DCAA's auditors will be making every attempt to apply statistical sampling to contractor bid proposals).

Incurred Cost Proposals: Planning Now to Mitigate Audit Problems

Government contractors whose fiscal years just ended December 31, 2010: now is the time to begin crafting a plan to defeat any and all DCAA audit challenges/problems that arise when and after you submit your annual incurred cost proposal (ICP)—which will be due on June 30, 2010, i.e. six months after the end of your fiscal year.

Assuming you have been reading our newsletters over the past years, you have been provided with the history and the continuously evolving developments of what to expect of auditors when the actual ICPs audits commence, and have therefore insulated yourselves from the forthcoming firestorm of compliance ridicule (also known as a DCAA audit report citing your accounting system as inadequate premised upon your faulty ICPs festooned with un-reconcilable schedules, unallowable costs, etc.). In any case, getting started now in preparing an audit-proof ICP and understanding audit trends and risks will save you misery later on. A few things you should know and consider in preparing your ICPs:

- It is unlikely that your ACO will grant deadline extensions for submitting your ICP, thus you should be assembling your “team” sooner than later for compiling annual cost and other peripheral information that must be funneled into that presentation; hence, notwithstanding the need to get your financial statements completed, work on the ICP concurrently with year-end closing tasks as well.
- Your proposal will be rejected by DCAA (“inadequate”) if that certified submission does not include all the schedules and data identified in DCAA’s “Information for Contractors” guidebook (chapter 6); although much of this data is not applicable, non-essential, or simply non-value added, omission of any pieces of the puzzle will likely result in a returned ICP which could be extrapolated into a presumption that your billing system is deficient.
- Review significant accounts that, by nomenclature, raise audit risk—e.g., accounts that are considered more prone for inclusion of unallowable costs (examples include business development, meals, business meetings, travel, professional services, legal fees, employee morale, and advertising).
- Understand that auditors will likely utilize variable statistical sampling techniques to quantify ICP claimed costs that are unallowable (to include non-allocable and/or unreasonable). Both judgmental (non-statistical) sampling and materiality (or immateriality) are passé which means that DCAA will be expecting transaction journals or data dumps (to facilitate statistical sampling) and cost questioned (at the transaction level) will have no lower limits because DCAA’s strategy is to project **all** sample exceptions to a transaction universe (see the article on DCAA Statistical Sampling).
- Auditors will question anything where, in their opinion, sufficient evidential data is not available to support the allowability, allocability or reasonableness of those costs. If you anticipate this will be a potential problem with certain

accounts or transactions, determine what data you need to better support (document!) cost allowability.

- If you do nothing else, ensure that the ICP schedules reconcile to the general ledger and to each other within the ICP framework—for example, indirect expense schedules and final rates should tie to Sch. H, and Sch. H should tie to Sch. I, etc.

Because ICP audits are not high priority (lack of audit resources, and considered “discretionary”), audit commencement of your 2010 ICPs will not begin anytime soon. Notwithstanding DCAA’s lack of resources and delays in completing these audits, contractor ICPs for FYEs Dec. 31, 2010 are required by regulation no later than June 30, 2011 and DCAA will perform a preliminary adequacy review shortly after receiving your ICP. If you are new to this requirement or simply unsure that your ICP(s) will meet DCAA expectations, consider contacting us for timely and cost effective assistance.

DCAA Guidance on Contractor Notification Letters

DCAA recently issued guidance to its auditors that “notification letters” must be sent to contractors to fully comply with GAGAS (Government Auditing Standards) 6.07 during the audit planning phase, either prior to, or shortly after, the entrance conference. Such letters apply to all audits, whether or not the audit was requested by a government procurement office. The guidance memo also states that this formality does not replace the entrance conference, e.g. a notification letter will not necessarily include the substance of all information that needs to be addressed at an entrance conference.

Under GAGAS, the following information must be communicated to the contractor:

- Nature, timing and extent of planned testing and reporting
- Level of assurance the auditor will provide
- Any potential restrictions on the audit report

The DCAA memo includes an enclosed sample “Contractor Notification Letter” which specifies the purpose of the audit and the issues/proposal to be addressed; high level audit scope descriptors; benchmark regulatory provisions used to determine compliance aspects; anticipated start and completion dates; level of opinion/assurance, and; specific restrictions on report release.

The notification letter is simply that—a written statement informing the contractor that an audit will be performed, and

the general parameters in which that evaluation will be conducted. The notification document will not contain a detailed outline of audit procedures, nor specific evidential data to be tested.

Also understand that the purpose and scope, and other commitments, identified in the letter could change after the audit has begun. DCAA's past history of its inability to conclude audits within initially designated time frames is one indicator that a commitment included in the letter will probably change for discretionary audits—that is, the start and completion dates. Also, you may expect that the scope of some audits may change as the audit progresses—example, evaluation of cost proposal indirect rates (requested by a procurement command) is elongated into a full proposal review if the auditor can support a higher level of risk, and can push the PCO into accepting the expanded scope.

Contractors should carefully review all notification letters, and maintain these for later reference; especially if the auditors deviate from the initially outlined purpose and scope (e.g. the auditor request for data seems to have no connection to the stated audit objectives). Should this occur, contractors should request an explanation as to why audit parameters have changed. If DCAA initiates the audit without a contractor notification letter, ask for one, but do recognize that the concept or the sufficiency of the contractor notification letters has no real connection to any contractual regulation, FAR, DFARS or CAS, thus, you should forget about delaying the start of the audit by rejecting the DCAA contractor notification letter as inadequate but do recognize that DCAA (on its own) has done an outstanding job of delaying every aspect of its audits.

CBCA Decision on T&M Billing Subcontractor at Prime Contractor Rates

In a decision dated January 14, 2011, the CBCA (Civilian Board of Contract Appeals, *Serco, Inc. vs. Pension Benefit Guaranty Corporation*, CBCA 1695) rejected a prime contractor's assertion that subcontractor services could be billed at the prime contractor's "T" rates within the Time & Material (T&M) contract schedule. Of note, the contract(s) at issue pre-date the February 2007 changes to FAR 52.232-7 (Payments under Time and Materials and Labor Hour Contracts) which prospectively required separate "T" rates for the prime contractor, any intercompany labor and each of its subcontractors (except for non-DoD contracts competitively awarded which could still use "blended" rates).

On first impressions, the CBCA decision seems to serendipitously confirm a long-standing DCAA interpretation that the February 2007 FAR "clarified" the regulations to ensure that subcontract and intercompany labor will be billed based upon each entity's "T" rates and not those of the prime contractor (DCAA Audit Guidance 07-PPD-023(R), July 31, 2007). This DCAA audit guidance also reminded DCAA auditors to review prime contractor T&M billings/invoices to assure the billings are in accordance with existing contract terms (contracts before February 2007); specifically, separate labor categories ("T" rates) for the prime, intercompany and subcontractor(s). In practice, DCAA's audit guidance has generally translated into field auditor expectations that the prime contractor will only bill its (employee) labor at its "T" rates unless an existing contract (pre-2007) clearly and explicitly incorporates language permitting subcontractor or intercompany labor to be billed using the same rates as those for the prime contractor employees. Absent specific contract language, DCAA auditors expect that subcontractor labor/costs will be billed under the reimbursable materials or "M" component of the T&M contract (along with allocable material handling or G&A if permitted by the contract).

As with most first impressions (which can be incorrect or unreliable by failing to consider all relevant facts), there is nothing in the CBCA decision which directly or indirectly confirms DCAA's audit policy. In fact, the CBCA decision is based upon solicitation and contract language which clearly prohibited the prime contractor from billing subcontractor (or purchased labor) at the prime contractor's "T" rates. As stated in the decision, the solicitation stated that offerors were not to include cost of subcontractors or temporary labor in the development of prime contractor proposed labor rates; thus subcontractor costs could only be billed based upon the amount invoiced to the prime contractor. As presented in the CBCA decision, something of an incontrovertible fact that clearly dispelled any assertion that subcontractor or purchased labor hours could be billed as if they were prime contractor labor.

Thus, in deciding the case, the CBCA cited a "pure contract interpretation" indicating there was simply no doubt that the prime could not bill subcontract labor hours under the "T" portion of the contract. In potentially relying upon this case as confirmation of DCAA's interpretation, the case only supports DCAA in those situations where a contract states that subcontract labor is only recoverable as a subcontract cost (under the "M" portion of the contract); in other words, where a "pure contract interpretation" eliminates any opportunity for a "second opinion". The case simply does not address the

significant number of contracts where a pre-2007 contract and/or its solicitation do not have any specific language which even begins to address the question. In those cases, DCAA should defer to the contracting officer to interpret the contract and we only wish that DCAA would defer to contracting officers instead of placing auditor independence above all else.

Training Opportunities

2011 Beason & Nalley Sponsored Seminar Schedule:

February 10, 2011 – Government Contractor Procurement and Audit Challenges in 2011

Webinar

February 16, 2011 – Fundamental Requirements of Cost Accounting Standards

Reston, VA

March 1, 2011 – FAR Part 31 Cost Principles

Huntsville, AL

March 2, 2011 – Cost and Price Analysis in Government Contracting

Huntsville, AL

April 27, 2011 – Understanding the Requirements for an Adequate Incurred Cost Submission (ICS)

Reston, VA

April 28, 2011 – FAR Part 31 Cost Principles

Reston, VA

May 17, 2011 – Understanding the Requirements for an Adequate Incurred Cost Submission (ICS)

Huntsville, AL

May 18, 2011 – Understanding Government Contract Audits and Dealing with Audit Issues

Huntsville, AL

June 7, 2011 – Cost and Price Analysis in Government Contracting

Huntsville, AL

November 15, 2011 – Cost and Price Analysis in Government Contracting

Reston, VA

November 16, 2011 – Understanding Government Contract Audits and Dealing with Audit Issues

Reston, VA

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

2011 Federal Publications Sponsored Seminar Schedule

February 17-18, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Arlington, VA

April 12-13, 2011 – Government Contract Accounting Systems Compliance

Orlando, FL

May 3, 2011 – The Master's Institute in Government Contract Costs

La Jolla, CA

May 11-12, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Las Vegas, NV

July 12-14, 2011 – The Master's Institute in Government Contract Costs

Hilton Head, SC

July 11-12, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Hilton Head, SC

August 1-2, 2011 – Government Contract Accounting Systems Compliance

Washington, DC

August 3, 2011 – The Master's Institute in Government Contract Costs

Washington, DC

August 3-4, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Washington, DC

October 13-14, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Orlando, FL

October 24-25, 2011 – Government Contract Accounting Systems Compliance

Washington, DC

December 7-8, 2011 – Government Contract Accounting Systems Compliance

Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
- Cyndi Dunn

Go to www.fedpubseminars.com and click on the Government Contracts tab or call Beason & Nalley, Inc. at 800-416-1946.

Specialized Training

Beason & Nalley, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Miller at lmiller@beasonnalley.com, or at 800-416-1946.

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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