

# Government Contracts INSIGHTS

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## DCAA Audit Guidance on Limitations on Pass Through Charges

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

In its February 18, 2011 audit guidance memorandum (11-PSP-003(R)), DCAA has once again demonstrated its proclivity to significantly expand and/or reinterpret a contractual requirement. Although nothing in the Federal acquisition regulations or the rulemaking process allow DCAA to expand or reinterpret the regulations, DCAA has evolved into this practice as a by-product of ultra-conservatively interpreting DCAA's internal requirements to comply with GAGAS (Government Auditing Standards).

In terms of the audit guidance that speaks to limitation on pass-through charges on subcontracts, the guidance correctly restates the FAR (52.215-22/23) which defines the affected contracts to only include cost reimbursable contracts for civilian agencies while inexplicably including all DOD contracts except competitively awarded or commercial fixed price contracts ("inexplicably" because oddly enough, the roots for this rule trace back to the widespread use of multiple tiers of subcontractors primarily associated with FEMA contracts in the aftermath of Hurricane Katrina and the last time we checked, FEMA was a civilian agency under the Department of Homeland Security, not DOD; but let's not cloud the issue with the facts).

DCAA's audit guidance also correctly states that the FAR requires the contractor to identify in its proposal the total cost of work to be performed by the offeror and by each subcontractor and when more than 70 percent of the total cost of work to be performed is subcontracted, FAR requires the prime to identify its indirect costs and profit applicable to the work performed by the subcontractor and to provide a description of the "added value". Lastly, DCAA correctly states that there is a FAR reporting requirement when the subcontract value during contract performance changes (increases) to now exceed 70 percent.

After correctly stating the FAR, DCAA's audit guidance significantly expands DCAA's role beyond anything contained in the FAR. In particular, the FAR only requires the contractor "to provide a description of the added value it will provide" and FAR even provides examples of the added value (e.g. processing orders,

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maintaining inventory, reducing delivery lead times, managing multiple sources, coordinating deliveries, performing quality assurance). In contrast to the minimal requirements explicitly stated within the FAR, DCAA directs its auditors to “evaluate the reasonableness of the contractor’s description and supporting documentation of the added value”. There is absolutely no requirement for supporting documentation or any extension of FAR reasonableness criteria (31.201-3) to the limitation of pass through costs. Not only does DCAA grossly overstate the requirements of FAR 52.215-22/23, DCAA adds that a proposal inadequacy (based upon DCAA’s overly expansive reinterpretation of the FAR) could be considered the basis for an estimating system deficiency.

Regarding incurred costs including DCAA audits of final vouchers, DCAA again overstates the requirements of FAR 52.215-22/23 by stating that the auditor should perform procedures to determine that the contractor is performing its added value functions and if subcontract costs are expected to exceed 70 percent of total contract costs, the auditor should request the contractor to provide a description and a demonstration of the added value by the contractor related to the subcontract work.

In its most egregious misstatements of the FAR, DCAA directs its auditors to question the indirect costs and profits added by the contractor “if the contractor cannot demonstrate its added value efforts” and that “functions/costs not determined excessive under FAR 31.203(i) are still subject to the general (FAR 31.2) allowability, allocability, and reasonableness criteria”. By implication, DCAA is telling its auditors that if they cannot succeed in challenging the costs under FAR 31.203(i), consider the more general criteria in FAR 31.2 which we believe will lead auditors to challenge allocability incorrectly using “relative” value as opposed to no or negligible value.

In fact, FAR 52.215-22/23 requires very limited information concerning the added value provided by the prime contractor (or subcontractors who are also subject to the 70 percent test for subcontracting to lower tier subcontractors). The history of this regulation has resulted in a final rule which should be innocuous; specifically, there is almost nothing required other than a description of the added value (which is defined as more than “no or negligible value”). The rule as originally proposed implicated reasonableness tests applied to allocated costs; for example a 10 percent G&A rate applied to a \$1,000,000 subcontract would require some demonstration of relative added value associated with the resulting (allocated)

\$100,000 G&A. Any such requirement (implied or express) was removed from the final rule making the final rule nothing more than a requirement for a description of the value added as the only basis for satisfying the added value test.

As with virtually any new DCAA audit policy, DCAA simply cannot restrain itself from adding its own interpretations in total disregard for the final regulation and the history of that regulation and as long as no one in DOD hampers DCAA in its quest for perfect GAGAS compliant audits (in absolutely all audits), we will continue to encounter DCAA audit policies which are unrestrained and DCAA audits which seemingly have no bounds (duration, auditor and contractor hours to execute/support the audit, or anything approaching strict adherence to the FAR). Until some external force actually restrains DCAA and confines DCAA to auditing in accordance with the FAR, contractors need to anticipate very expansive audit tests including those for excessive pass through costs applicable during audits of bid proposals, incurred costs, and final vouchers (one can only wonder how/why DCAA overlooked these tests on interim vouchers unless DCAA “accidentally” failed to mention in its public document that DCAA will in fact be making such tests on interim vouchers).

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## DCMA Expands Contract Audit Follow-Up (CAFU) to Track DCAA Audits of CAS Disclosure Statements

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

DCMA utilizes a contract audit follow-up (CAFU) system to track the receipt and disposition of certain audits which have included some CAS noncompliance audit reports, but not audit reports concerning the adequacy or compliance of initial or revised CAS Disclosure Statements (DS) which are identifiable as DCAA 19100 audits. In conjunction with a joint DCMA-DCAA cost recovery initiative (memo issued in October 2010), DCMA is now going to track “19100” audits because “typically a revised CAS DS includes changes to cost accounting practices”. Assuming there is a change in a cost accounting practice, the government will not pay any increased costs associated with that change on CAS covered contracts unless the change is required or desirable.

Hence, when the contracting officer receives a revised CAS DS, it is his/her responsibility to determine if the change is desirable vs. unilateral, request and obtain the general dollar magnitude of the cost impact, and make a final determination and issue a demand for payment (if applicable). The reason for tracking these audits is to more timely recover funds to the benefit of the taxpayer.

Although we can understand and appreciate the logic for DCMA's actions to include "19100" audits into its CAFU tracking process (ostensibly to result in more timely recovery of monies owed the government), we find it impossible to reconcile this timeliness strategy with DCAA's inability to perform or complete timely audits of a contractor CAS DS. In those cases where a contractor had made major or minor changes applicable at the beginning of its fiscal year on successive CAS Disclosure Statements, it is not uncommon for DCAA's backlog of unaudited CAS Disclosure Statements to involve most of those successive years. In other words a "queue" involving multiple, sequential unaudited CAS Disclosure Statements for any particular contractor.

Similar with DCAA's inability to timely audit contractor incurred cost proposals (submitted annually), DCAA has demonstrated that it cannot timely audit CAS Disclosure Statements which means that timely tracking and resolution of CAS cost impacts cannot even begin until years after the CAS DS was revised. DCMA's strategy of tracking these "19100" audits (if and when these are issued) is an example of the cliché of the "tail wagging the dog" simply because in the overall scheme of contract administration, nothing will be timely until DCAA can actually complete audits on a timely basis.

## Draft Executive Order: Government Contractors to Disclose Political Expenditures

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

In perhaps one of the most peculiar and controversial executive orders issued by the White House, government contractors submitting offers for federal contracts would be required to disclose certain political expenditures and contributions that they have made for the previous two years. The April 13 executive order, still in draft form, asserts that such disclosure is required to ensure the contracting process



“be free from the undue influence of factors extraneous to the underlying merits of contract decision making such as political activity or political favoritism”.

The order states that contractor political expenditures present a perception that those contractors may achieve better standing in obtaining federal awards, thus presumably impairing the regulatory process and criteria stipulated to accomplish fairness and objectivity in selecting a qualified contract award recipient while attaining a fair and reasonable price.

Disclosure of political donations and expenditures that would be required includes:

- All amounts given to or on behalf of federal candidates, parties, or party committees made by the bidding entity, its directors or officers, or any affiliates or subsidiaries within it control, and;
- Any amounts given to third-party entities with the intention or expectation that those third parties would use the contributions to “make independent expenditures or electioneering communications”.

The order's most significant change to political activity disclosure rules is the requirement for reporting political donations beyond current disclosure requirements to the Federal Election Commission—that change is the third-party entity disclosure provision. Although third-party recipients are not defined in the order, these could be any person or organization that is traditionally active in promoting federal election campaigns. Examples are non-profit 501(c)(4) organizations that often actively campaign for candidates attached to political parties, including the U.S. Chamber of

Commerce which would be required to disclose all donors under the order if implemented.

The order would require companies bidding on contracts to provide a list of contributions or political expenditures that total in excess of \$5,000 to a political recipient during a given year. The order also stipulates that disclosure of such data be publicly available, mandates that the FAR Council adopt rules to carry out this order before the end of calendar year 2011, and requires all contracting agencies to cooperate with the Council in preparing implementing procedures to execute the order.

The order has stirred up a hornet's nest of controversy among industry officials and Congressional legislators, many of whom feel the President's order is purely political. Republican representatives and spokespersons of the government contracting community are asking how the disclosure of political contributions/spending improves the contracting process—in short, what would government contracting officers gain from this data to enable the procurement process. Moreover, many private and public sector officials tied to federal contracting can't help but believe that the executive order is designed to provide campaign intelligence information to politicians, rather than to enhance "transparency" with the taxpaying public and government procurement officials.

Another contentious point, supporting the notion that the order was motivated by politics, is that public-sector labor unions or grantees are exempt for the disclosure rule, and it is a well-known fact that those groups largely support Democrats during federal election campaigns.

Up until the landmark Supreme Court "Citizen's United" decision, federal contractors had to disclose political activity and campaign expenditures to the Federal Election Committee. That ruling cleared the path for unlimited campaign donations and removing any disclosure requirements. The President's Executive order is viewed as a means to reinvigorate parts of the "Disclosure Act" presented by Democratic senators after the Supreme Court ruling, which, had it not stalled in the Senate, would have revived some of the disclosure requirements that were undone by the high court's decision.

Campaign reform advocates have lined up behind the order, asserting that disclosure of federal contractor campaign donations will somehow improve the integrity of the contracting process. What no advocate group has succeeded in doing

thus far is to clearly connect the order's disclosure requirements to elevating the stature of the contract award selection process, which is indeed the one and only focus of the President's order (which apparently many advocates have not read).

Contrary to the order's assumption that disclosure of political expenditures and contributions will remove favoritism in federal awards and improve the acquisition process, it is clear that the President's order will likely have the opposite effect. An unnamed source stated that the timing of the required contractor disclosure, prior to contract award, suggests that political contributions would now indeed be a major factor during the contract award process. Stan Soloway, president of the Professional Services Council, noted that disclosing such data to government procurement officials, who would never otherwise deem political contributions an issue in the selection process, will now "inject politics" into that process.

Representative Sam Graves, R-MO, sent a letter to the President, in which he stated that small businesses would be intimidated by the order, essentially putting pressure on these companies to "contribute to the party in power" if they want to receive federal contracts. Graves also states that the Order limits free speech which contradicts the Supreme Court's rulings on First Amendment rights.

Nonetheless, the administration is standing by its decision to carry out this order, convinced that it will actually improve transparency in and remove bias from the procurement process. It stands to reason that the Executive Branch officials are either blind to the manner in which the federal procurement process currently works, ignorant of the Federal Acquisition Regulations (federal law), distrustful of its contracting agencies and their representatives, or exercising a populist approach as a campaign strategy for the next federal elections.

Opponents of the order have a good case that the disclosure requirement is "political gamesmanship" in that it does not connect the disclosure of political donations and campaign expenditures to enhancing the procurement process, but rather inhibits the regulatory process of selecting the best recipient for a contract award regardless of political party affiliations.

Finally, in crafting this requirement for transparency by requiring disclosure of political contribution, it appears to have been totally overlooked that these costs are unallowable under

FAR 31.205-22. One would have to believe that full transparency would require at least a footnote that government contractors cannot recover these costs on government contracts but apparently the Executive Branch does not want to confuse the issue with a very important and relevant fact.

## DOD IG Accuses DCAA Field Managers of Abusive or Unprofessional Conduct

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

In a DOD Inspector General's April 15, 2011 report, the IG substantiated four of six complaints filed by a DCAA auditor that the auditor's field office manager and certain supervisors exhibited abusive and unprofessional behavior or did not follow certain personnel and audit guidelines. The complaints were filed by the employee through the DOD Hotline network.

Allegations by the complainant included:

- DCAA security officer harassed the employee after the employee was overheard expressing frustration about her supervisor;
- DCAA unnecessarily delayed the complainant's promotion;
- Complainant's performance rating was based entirely on productivity metrics;
- Supervisor improperly removed an audit finding from one of the complainant's reports without properly documenting the difference of opinion;
- Complainant was not provided adequate supervision, and;
- Field manager made inappropriate, unprofessional, and disrespectful remarks toward employees on numerous occasions.

The IG dismissed two of the complaints (DCAA security officer having harassed the employee and employee's performance was based on productivity), after the IG very carefully reviewed the basis for those complaints. Interestingly, the IG's report comments which addressed the dismissed security office complaint noted that the complainant was counseled by management to utilize the "Employee Assistance Program", but the reason was not stated.

Two of the infractions investigated (removal of a finding without discussion, and lack of adequate on-the-job training) appear to be innocuous, and such issues are certainly not unique to the government audit profession alone. Nonetheless, given the uncomplimentary reviews of DCAA's conformance to professional auditing standards by the General Accountability Office (GAO) over the past three years, all Hotline complaints regarding DCAA lapses, no matter how mundane or routine, are taken seriously by reviewing officials.

When abusive and disrespectful management behavior arises, however, such instances are not so insignificant, and prompt attention to those issues are required—especially if senior DCAA leadership turns a blind eye to resolving those problems.

The April 15 report is one of several issued by the DOD IG regarding DCAA employee complaints related to quality assurance missteps and intimidating management behavior. Obviously DOD IG takes all Hotline complaints seriously, as exhibited in its April 15 report which provided in excruciating detail the evaluation and outcome of each complaint. DCAA substantially agreed with the IG's findings, and have implemented corrective action. One corrective action taken by DCAA, related to the dropped audit report finding for an EVMS audit, was the rescission of the audit report.

## AMCOM and Contractor: DOD IG Finds Pricing and Inventory Problems

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

The DOD IG's review of the Army Aviation and Missile Life Cycle Management Command (AMCOM) inventory management process and purchases of materials from a large defense contractor disclosed significant deficiencies in the utilization of DOD materials inventories, and the process for obtaining reasonable materials pricing from the contractor. The audit focused on material purchases for the Corpus Christi Army Depot (CCAD) to determine if the partnership with the contractor minimized costs of direct materials to the depot. The Contractor/AMCOM partnership was created to "address parts availability problems and improve readiness".



The IG found that the partnership was absent due diligence from both the contractor and AMCOM. AMCOM procured parts from the contractor, when sufficient inventory of required parts were already available to DOD at lower prices, and some items purchased from the contractor were inflated due to the contractor's pricing data used to calculate unit prices for the DOD.

The IG noted that AMCOM did not use on-hand inventory items to supply the CCAD contract requirements valued at around \$339 million, but instead purchased those parts from the contractor. The DoD IG noted that AMCOM's flawed policies and procedures for managing inventory use was responsible for non-utilization of existing inventory; thus, unnecessary purchases were made from the contractor. Correspondingly, the IG found that an inventory of 1,635 consumable parts available at the Defense Logistics Agency (DLA) were not utilized due to an ineffective "material management strategy"; AMCOM unnecessarily purchased the required consumables from the contractor, without knowledge of DLA's inventory, at excess prices of 50% or more for those parts when compared to the DLA inventory unit prices for the same parts on hand.

To add insult to injury, when AMCOM procured high dollar parts from the contractor, DoD IG found that those items were overpriced due to alleged defective cost or pricing data;

moreover, the IG charged that both AMCOM and the contractor failed to perform adequate cost price analysis.

And to complete the litany of unfortunate, embarrassing events between the two partners, AMCOM overpaid incentives to the contractor for repair turnaround time improvements that were based on inaccurate performance metrics. That slip-up resulted in the contractor owing the government between \$6.3 million and \$10.9 million, with another \$538K due to the DoD since the contractor failed to meet requirements in a follow-on contract period.

## AFGE to President and Legislators Place Stringent Caps on Government Contractor Employee Salaries

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

The American Federation of Government Employees (AFGE) union has called for limiting the individual government contractor employees' annual compensation to \$200,000 for reimbursement under government contracts. The AFGE's \$200,000 ceiling benchmark purportedly represents annual salaries for current cabinet secretaries, with a specific reference to salary of the Secretary of Defense.

In a March 18, 2011 letter to the President, AFGE put forth the argument that government contractors should share in the sacrifice of federal budget constraints imposed on the government, just as federal employees and members of AFGE are being targeted to take cuts in federal employee salary, health, and retirement benefits. AFGE states in that letter, "...we can save money for the taxpayers and ensure that the highest paid contractors are finally required to make sacrifices. At the time of budget stringency, few parts of the budget and tax code should be off limits for scrutiny—and certainly not the lucrative salaries of contractors that are ultimately paid for through taxpayers dollars".

The AFGE followed up with a May 12, 2011 letter to the Senate Budget Committee iterating its proposal, and noting that "our focus is on the most lavishly compensated contractors." The letter to the Senate further states that the purpose of the reform measure is not to micromanage government contractor employee compensation but instead "...limit the amount that contractors can be reimbursed by

taxpayers for outrageously high salaries.” Contractors would be free to pay its employees whatever it pleases, however, government contracts would not pick up the tab for the allocable portion of any value about the \$200,000 annual ceiling.

The AFGE’s reform proposal would immediately implement a solicitation provision that funds will not be obligated above the ceiling; modify FAR 31.205-6(a) verbiage defining reasonableness to include a reference to the ceiling, which would be implemented in “Level I of the Executive Schedule prescribed in 5 USC 5312”, and; federal statutes and concomitant FAR provisions would be modified to stipulate that compensation ceilings will be measured annually and ceilings would apply to all contracts regardless of funding sources.

Federal statutes currently implement federal contract salary ceiling limitations for government contractor executives (the five most highly compensated in management positions) within FAR 31.205-6(p) via reference Section 39 of the OFPP Act—those executive compensation caps are changed annually, with the current cap being \$693,951. Although the AFGE’s letters do not specify salary limitations to specific contractor employee labor classes, some observers believe that the \$200,000 cap would be applied much in the same manner as FAR 31.205-6(p) intended. However, given the proposed verbiage alterations to the employee compensation cost principle and where in the cost principle revised language would be implemented (FAR 31.205-6(a)), we believe the AFGE’s proposal, if executed, would apply to all individual employees, and not restricted to the five most highly compensated employees in a management position. In fact, the results would be illogical if not absurd if the \$200,000 cap only applied to the five most highly compensated executive/management employees because it would have very little impact on reducing the deficit while also allowing compensation in excess of \$200,000 for potentially hundreds of employees for any given contractor. If it does apply to all employees, perhaps the AFGE should recognize that it could impact the allowability of compensation for hundreds of non-management employees working in Iraq, Afghanistan and other areas where extended hours, hazardous duty and other uplifts result in many employees receiving compensation in excess of \$200,000.

One final observation: although the AFGE apparently believes in its proposal to limit allowable or allocable annual compensation to \$200,000, the AFGE has not given any consideration to the impact of such a rule on the Government’s desire to eliminate barriers to new contractors entering the government contract marketplace (to increase competition yielding competitive pressures to reduce costs on government contracts). In every manner of speaking, the artificially low cap on compensation would be an absolute barrier to new entrants into the government marketplace (as if the labyrinth of existing rules and regulations is not already a barrier).

#### 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](mailto:lmiller@beasonnalley.com).

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If you need additional information, please contact Lori Beth Miller at [lmiller@beasonnalley.com](mailto:lmiller@beasonnalley.com) or 256-533-1720.

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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

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

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## Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
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## About Beason & Nalley, Inc.

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