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Cost Recovery Initiative Unveiled by DCMA/DCAA

The Directors of the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) issued an October 29, 2010 memo announcing a joint initiative for “aggressively targeting contractual opportunities to recover taxpayer dollars” by prioritizing, settling, and closing a large number of open DCMA/DCAA audit reportable and non-reportable issues. The initiative is focused on reportable audits, suspended and disallowed costs (DCAA Form 1s), cost accounting practice changes, and miscellaneous cost allowability and allocability issues.

The memorandum makes it clear that the first priority will be resolving outstanding issues where dollars questioned (or recommended cost avoidance) are attached to those issues. The “reportable audits” category for expediting disposition includes a number of audit types with findings, such as business system internal controls, defective pricing, claims, incurred cost/final indirect rates, and termination audits. Those audits likely to be top priority will include incurred costs, claims, defective pricing, and so forth, where overstated costs were quantified with the audit findings. Where internal control audit findings are inextricably linked to disallowed costs, those “reportable audit” issues are likely to be considered a high priority as well (a number of these are associated with contracts in Iraq or Afghanistan; hence, highly visible in large part thanks to the ongoing Commission on Wartime Contracting).

The memo notes that about 400 reportable audits and 300 Form 1s valued at \$295 million are awaiting contracting office disposition. The initiative will allow each agency to retain its own roles in disposing of open DCMA/DCMA issues/reports, and states that ACOs, in conjunction with advice provided by DCAA, will be revisiting each issue.

Although not stated in the joint initiative memo, the individual issue assessment and disposition undertaken by ACOs should include ascertaining the merits and significance of those issues, with a focus on “negotiating” a settlement of some issues, while possibly dismissing others. Given the more aggressive approach of the DCAA in challenging costs claimed and billed where such findings (based on our experience) were poorly supported, or represented no significant threat to overcharging the government, we would logically expect those issues to be first in line for dismissal or negotiation. Contrary to this notion, DCAA, in its continued posturing for internal DOD policies which would mandate DCMA resolution of audit findings consistent with the DCAA recommendations, may be reluctant in this joint initiative process to yield to settlement agreement concessions for the sake of expeditiously closing old issues.

The memorandum does nothing to rescind existing DCAA policies wherein DCMA decisions contrary to DCAA recommendations are referred to an IG (Inspector General) for review and ultimately “second-guessing” the DCMA decision. Ultimately, the joint memorandum provides few details on the comprehensive process to be employed in this initiative, but does state that such details are forthcoming in the next few weeks.

DCAA Increases Thresholds for Cost Proposal Audits

DCAA issued an October 2010 guidance memorandum which increases the forward pricing cost proposal dollar thresholds for which DCAA will respond to requests for audits. Those proposal price thresholds are now FFP proposals exceeding \$10 million, and Cost-Type proposals exceeding \$100 million. The DCAA proposal audit threshold elevation is consistent with a previous DOD policy change for requesting audit assistance (PGI 215-404-2(c)), and was precipitated to meet the DOD’s focus on, and to align audit resources to, “those areas with the greatest risk”. Risk, as defined in the context of this dollar threshold guidance, is considered proportionately greater the higher the proposal value and inherently greater for fixed price proposals where the final price is established during the proposal evaluation process (as opposed to after the fact on cost-type contracts).

The PGI guidance, however, does state exceptional circumstances explained in the request for audit may allow the threshold levels to be ignored, thus permitting audit assistance for proposals below these dollar levels. Also, DCAA may still provide pricing assistance to contracting offices for forward

pricing rate proposals, even if the proposals in which those negotiated rates are utilized may be below the new threshold levels. And the audit guidance (the specific dollar thresholds) does not apply to DCAA requests for assist audits by another DCAA office (ordinarily subcontractor proposals). In fact, the audit guidance states that if the prime contract auditor requests an assist audit (of a subcontractor), the assist auditor is to assume that the prime contract auditor has performed a risk assessment and to proceed with the assist audit. Unfortunately, this process may cause a number of lower value subcontract proposals to be drawn back into the “audit” process when the dollar value would have excluded it from audit as a prime contract.

The DOD has recognized the DCAA audit dilemma for meeting the huge challenge (time and resource issue) associated with comprehensive audits, fully compliant with government auditing standards, applied to all bid proposals within the old thresholds. As a reaction or over-reaction to criticism levied against DCAA by the GAO in 2008 and 2009 GAO reports (e.g., poorly supported audits, insufficient transaction testing, and a production output environment which overrides audit quality provisions) DCAA proposal audits now take approximately four times as long to complete (in comparison to FY2008 when the average proposal audit took 28 days). In fact, without the threshold change, the current DCAA process applied to all bid proposal audits was creating massive gridlock in terms of adversely impacting the timely negotiation of contracts.

Recalling that one of the GAO’s primary recommendations for DCAA to improve its audit quality was going to a “risk based” audit approach which DOD endorsed, this change in proposal threshold policy is one measure toward that end. In the end something had to give and it was not how to make each existing audit more efficient which would have exposed DCAA to risk of failing to comply with auditing standards. Not to be overly critical, but the GAO does not itself perform efficient audits (measured in elapsed days which would never approach 28 days) nor does the GAO or DCAA for that matter appear to understand the distinction or mismatch between traditional audits (of incurred costs; thus accounting transactions) and audits of future cost estimates and assumption.

Government contractors have much to rejoice about with the new policy, since the number of proposal audits will dramatically decrease, and most contractors will experience a huge relief in the use of its staff in supporting those audits which will now become proposal evaluations based upon price analysis which is not subject to the rigors of auditing standards.

However, contractors should recognize the hidden dragon in these threshold changes.

More comprehensive audits of bid proposals subject to the previous threshold levels were already being undertaken, with more administrative burden placed on contractors to support the audit process. As the emphasis shifts to proposals meeting the new higher thresholds, government procurement will devote more resources for the higher dollar proposals, meaning expanded audit effort with a more rigid audit approach, resulting in more questioned or unsupported costs, and possibly increased adverse opinions (rendering proposals unacceptable for price negotiations). For FFP proposals over \$100 million, or other proposals deemed high risk by the government, DCAA and procurement customers have already begun a more rigorous evaluation process, to include teams of personnel involved in walk-through pre-audit meetings, and a multi-step review process of audit conclusions within high levels of the DCAA organization before final audit conclusions are reported.

Because many proposals (subject to cost and pricing data) will not be evaluated by DCAA in the pre-award process resulting from the new thresholds, a higher likelihood of post-award audits (defective pricing) looms after contract award for those proposals left out of the proposal audit process. We believe the volume of post-award audits will likely increase to offset the lost opportunity for audits to disclose proposal overstatements during a pre-award audit evaluation process. Just because proposals are not audited due to the threshold changes does not render the resulting awards immune from the Truth-in-Negotiations Act (TINA). Contractors must be especially diligent for proposals for which audits are not performed, but nevertheless subject to TINA, in submitting cost or pricing data (and preparation of an adequate proposal) prior to award. Of course, DCAA does not appear to have the prerequisite resources to ramp-up postaward (or defective pricing) audits; but logic suggests there will be more of these audits which can be performed at any point in time within the FAR 4.700 records retention period (three years after final payment for records in general).

The increase in price proposal thresholds for requiring audit assistance does not, however, translate into contractors avoiding corresponding reviews for contractor responsibility (FAR Part 9) when their proposals submitted are under these new audit thresholds. Regardless of the proposal value, any company submitting a cost proposal may still be subjected to pre-award (or updated) accounting system reviews especially if the proposal is cost reimbursable, time and material, labor

hour, or otherwise includes payment terms based on recorded costs.

DFARS Proposed Rule on Contractor Business Systems

In January 2010, DoD proposed a rule to improve the effectiveness of DoD oversight of contractor business systems. The controversial proposed rule received a significant amount of unfavorable public comments; hence, the DAR Council has indicated that they will be issuing a revised proposed rule (which could be in the Federal Register before the end of the calendar year).

Industry associations have obtained a “marked-up” version of the proposed rule and somewhat similar to other revisions to other proposed rules, the revised rule will eliminate some, but not all of the controversial provisions within the original proposed rule. Some of the changes and/or the wording of the proposed rule as marked-up include:

- Eliminates the system review matrix which linked the proposed business systems to DCAA internal control and other system audits (in particular, the DFARS accounting system was cross-referenced to seven DCAA audits including six “ICAPS” audits). Coincidentally, while the DFARS rule is pending, DCAA is pilot testing its audit of contractor accounting and billing systems which undoubtedly involves a significant increase in its transaction testing, but does not involve a redefinition of a reportable internal control deficiency which is essentially anything with or without any identifiable impact (reference DCAA Open Audit Guidance 08-PAS-034(r), December 19, 2008).
- Eliminates the reference to “noncompliance” other than to state that the word has the same meaning as “deficiency” or “deficiencies” that adversely affect the contractor’s business system leading to a potential risk of harm to the Government
- In reporting findings, the functional specialist or auditor shall describe the deficiencies in sufficient detail to allow the contracting officer to understand the deficiencies and the potential adverse impact to the Government.
- If the contracting officer determines that there are no deficiencies that adversely affect the system, the contracting officer shall promptly notify the contractor in writing that the business system is acceptable and approved.

- The mandatory withholds for systems with deficiencies will only apply to payments on contracts which are covered by new DFARS interim or final rule (the previous rule was not clearly limited to payments on contracts which incorporated the rule which would have most likely triggered “breach of contract” litigation similar to that which occurred when the executive compensation statutory cap was applied to pre-existing contracts).

Of note, the rule appears to retain certain criteria which are a tacit endorsement of DCAA audit policies which define internal control deficiencies. First, an acceptable and approved business system must have no deficiencies. Secondly, a deficiency is that which adversely affects the contractor’s business system leading to a potential risk of harm to the Government. At best nebulous terminology which will most likely be applied with very conservative audit interpretations designed with bias towards erring on the side of protecting the Government. By implication, reinforcing DCAA’s current pass-fail audit criteria wherein a system is deemed inadequate for nominal gaps in internal controls albeit with no defined impact.

Unless the revised rule is revised to incorporate wording which requires more tangible criteria (than a “potential risk of harm”), the revised rule will have done little to inject any practical solution. It appears that DoD will have no tolerance for anything which could be categorized as conditional approval wherein a less than perfect business system is nonetheless acceptable subject to corrective actions (which exists today as applied to CPSRs).

Government Contracts and Small Businesses

The SBA (Small Business Administration) has published a Small Entity Compliance Guide to the Women Owned Small Business (WOSB) Program in advance of the new WOSB program effective February 4, 2011. The new program will authorize contracting officers to set aside certain contracts or requirements solely among WOSBs or EDWOSBs (economically disabled WOSBs). These set-asides will apply if:

- The solicitation applies to a specific North American Industry Classification Systems (NAICS) code where WOSBs are underrepresented as designated by the SBA (currently 83 NAICS codes),
- The Contracting Officer reasonably expects two or more WOSBs or EDWOSBs to submit offers (“rule of two”),
- The award value does not exceed \$3 million or \$5 million for manufacturing,

- The Contracting Officer determines the WOSB bid to be a fair and reasonable price (always a requirement in government contracting).

The SBA’s compliance guide addresses eligibility criteria including the basic requirement that a WOSB must be at least 51% owned and controlled by women who are US Citizens. The EDWOSBs eligibility has similar requirements as well as impaired ability to compete due to limited capital or credit. In addition, the EDWOSB eligibility includes net worth limitations (less than \$750,000 excluding a personal residence, retirement account and the equity in the ESWSB) and limits on income (no more than \$350,000 in each of the preceding three years).

The final rule noted that other small businesses, not qualified as WOSBs or EDWOSBs, would be ineligible to compete on these set-aside awards (as is currently the case for other set-asides including 8(a), HUB Zone and/or Service-Disabled Veteran Owned small businesses). In other words, the new law impacting WOSBs and EDWOSBs does not change the aggregate goal (Congressionally Mandated) which remains that 23 percent of federal government prime contract and subcontract values awarded to legitimate small businesses.

The Cost of Manipulating the Small Business Rules and False Claims Act

As was noted in the preceding article, Congress has an aggregate small business contracting goal which specifically refers to “legitimate” small businesses. This is by any measure an intentional statement which recognizes that there is a long and rather unfortunate track record of illegitimate small businesses. Over the years, the GAO and Inspector Generals have identified and reported numerous instances wherein small business awards have been made to other than legitimate small businesses including a June 2008 GAO report on HUB Zones which found a number of non-existent locations (e.g. street address was a vacant lot or empty building). In November 2009, a similar report was issued with respect to SDVOSB awards wherein a frequent issue was the use of a SDVOSB as a “front” for a large business wherein the large business performed all of the effort under the small business award. In one case, a large company was caught (using a Joint Venture), but after being caught, then used a different Joint Venture to effect the same manipulation.

More recently, an issue arose between the SBA and GTSI, the latter being accused of noncompliances with the small business eligibility rules; in particular, those which require the small business (prime contractor) to perform at least 51% of

the contract effort. In order to convince the SBA to remove it from suspension, GTSI reached an agreement with the SBA which resulted in the removal or three year suspension of a number of key personnel as well as invoking a three year independent monitoring program. GTSI will be required to provide office space for the independent monitor and GTSI will pay for all fees including legal fees. Of passing interest other government regulations, specifically FAR 52.203-13, will effectively prevent any of the ex-GTSI key personnel from employment in similar positions with other Government contractors (paraphrased, this FAR expressly requires an internal control which would prevent the employment of someone whose past behavior would be at odds with a contractor's code of ethics).

Directly related to the GTSI issue, very recently the SBA suspended two more firms as the SBA expanded its investigation of small businesses which may have been "fronts" for large businesses to secure a small business contract award. In both cases, the SBA has alleged that the small business was a conduit, passing the work to the large business. In one case, the small business is a subsidiary of an Alaska native corporation, a small business designation whose eligibility to secure government contracts was unlimited (not limited in terms of contract value, which as an aside, is now being challenged under a bill introduced by Senator Claire McCaskill).

As it pertains to the FCA (False Claims Act), a recent District Court (Eastern District of Virginia) decision serves as a reminder of the potential cost of violating the FCA. The defendants to the fraud allegations had already plead guilty to conspiring to defraud the government and were challenging the amount of the government's loss. As reported by the District Court, the defendants had admitted that the government's loss was \$865,000 and the defendants were attempting to subsequently challenge that amount. The obvious question was why challenge after pleading guilty; the obvious answer, the government claim for damages is at least partially based on the amount of the loss. In this case treble damages in the amount of \$2,595,000 for the FCA violation in addition to civil penalties of \$6,413,000 for allegedly falsifying 583 invoices to which the maximum penalty is \$11,000 each. Finally, the legal costs are not recoverable under FAR 31.205-47 and more than likely similarly addressed (as unallowable and non-recoverable) in the initial pleading. Although the damages have not yet been resolved, the potential monetary impact is easily ten to one (penalties and non-recoverable costs equal to ten times the amount of the government's loss).

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