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newsletter

Government Contracts Consulting

Provided by Beason & Nalley, Inc.

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FAR Council Rules and Proposed Rules Issued October 14, 2009

Earlier this month, the FAR Councils issued a number of rules including the following:

- FAR Case 2008-026, final rule giving GAO Access to Contractor Employees as required by the FY2009 Defense Authorization Act. The final rule amends FAR 52.215-2 and FAR 52.214-26, Audit and Records-Negotiation and Audit and Records-Sealed Bids, respectively. The rule does not extend employee access to commercial items, FAR 52.212-5, because the law did not specify commercial items. However, it should be noted that access to employees has been in existence under certain conditions including 52.212-4(i)(4), with respect to commercial T&M contracts for employees whose hours have been included in any invoice and FAR 52.203-13(c)(ii)(G), with respect to full

cooperation with Government agencies responsible for audits, investigations or corrective actions under the mandatory disclosure provision. The final rule published on October 14, 2009 is designed to cover situations wherein a contractor does not voluntarily make the contractor employees available for interviews; hence, the FAR Councils believe that the new rule will not have a significant impact. The rule only requires that the contractor make its employees available for interviews and nothing in the new rule nor FAR 52.203-13 compels the contractor employee to participate in the interview (for further discussion, refer to the November 12, 2008 Federal Register which published the rule applicable to FAR 52.301-13).

- FAR Case 2007-008, final rule *Limiting Length of Noncompetitive Contracts in "Unusual and Compelling Urgency" Circumstances*. The time period is limited to the period of the compelling urgency, the time period to enter into a contract using competitive procedures

and may not exceed one year unless the agency head determines that exceptional circumstances apply. Of passing interest, with respect to the seven public comments with recommendations, the FAR Council non-concurred to all seven.

- FAR Case 2008-031, interim rule on *Limitations on Pass-Through Charges*. This interim rule combines previous statutory requirements applicable to DoD (FY2007, Section 852) and more recent requirements for other executive agencies (FY2009, Section 866). The interim rule requires offerors and contractors to identify the percentage of subcontracted work and provide information on indirect costs and profit/fees and value added when the subcontracted work will exceed 70%. The rule requires the contracting officer make a determination that pass-through costs are not excessive at the time of contract award or during contract performance (timing depends upon when the contractor notifies the government that subcontracting is

expected to exceed 70%). The rule is intended to protect the government from contracting with a contractor to perform the work, but the contractor subcontracts substantially all of the effort during contract performance. However, nothing in the rule expressly prevents increased subcontracting during contract performance. In any case, once subcontracting is expected to exceed 70% of the total contract costs, the contracting officer must make a determination of “value-added” from pass-through costs. Of note, the definition of value added by the prime contractor was vetted during the iterative rule making applicable to DoD and it is basically value added in the absolute as opposed to value added as a relative measure. Hence, a determination of “value added” in any particular contract should not be measured against the total indirect cost allocations because the rule is to be applied consistent with existing CAS and FAR.

GAO Report on Government Agency Insourcing Efforts

The GAO (Government Accountability Office) issued a report on October 6, 2009 indicating that government civilian agencies have failed to implement or even develop insourcing procedures as otherwise required by the 2009 Omnibus Appropriations Act (Public Law No. 111-8). In contrast, the Department of Defense (DoD) has been proceeding with insourcing, but within the earlier requirements of the Fiscal Year 2008 defense authorization act with DoD implementing guidance issued as early as April 2008.

In all cases, the first step for all agencies has been or will most likely involve the inventorying of outsourced functions (contracted services). Logically, each

agency must have such an inventory as a starting point if for no other to measure the results of migrating from outsourcing to insourcing notwithstanding that a spokesperson for the DoD and for that matter spokespersons for virtually all government agencies have publicly stated that insourcing for the sake of insourcing is not the goal. In all cases, the insourcing process will be presented as a function of each respective agency's evaluation of the current mix, those functions which are inherently governmental, those which are not inherently governmental, and those which may or may not be inherently governmental. In other words, “black, white and grey”, in terms of defining the contracted services which could be insourced.

The question of inherently government or closely associated functions arguably has no real significance because any contracted service could otherwise be performed by a government employee whereas inherently governmental services should only be performed by government employees. Thus, there should be no presumption that insourcing will only involve the movement of inherently governmental functions back to government employees (for what it's worth, inherently governmental functions should never have been outsourced).

Perhaps the first of many obstacles or clarifications; does one define a goal as a reduction of the total of the contracted services or is the reduction measured against a subset of the contracted functions such as those which are inherently governmental or closely associated with inherently governmental functions? We can surmise that the answer lies in part within the degree of difficulty in measuring one versus the other and in this case total contracted services is readily measurable whereas measuring a subset first requires one to define the subset in a manner in which it can be consistently measured.



Although insourcing may not be publicly presented as a percentage goal (insourcing for the sake of insourcing to achieve a percentage goal), such goals appear to be operating within the DoD and those unpublished goals appear to be measurable against all contracted services. The quiet, behind the scenes development of “percentage goals” is quite understandable given that DoD outsourcing goals (mid to late 1990s) were percentage goals even before anyone had fully inventoried the universe of functions which could be outsourced. As some may recall, the initiative to outsource (other than inherently governmental functions) gave way to protracted debates as to what is or is not inherently governmental. The experience seems to support a simple truism that governmental (or virtually any organizational) goals which are a fundamental redirection (in this present case from outsourcing to insourcing) are more likely to happen if conveniently stated as a numerical (percentage) goal against an easily defined universe. In contrast, if such goals are more conceptual; first requiring study, evaluation, and planning before executing, it is entirely possible that the “study” will never make it to “execution”.

But what are the real implications of the GAO report issued October 6, 2009 and innocuously titled: Civilian Agencies' Development and Implementation of Insourcing Guidelines? We believe that the current administration and Congress



has clearly directed that contracted services be reduced in favor of functions being performed by government employees with the first expectation (Section 736 requirement) that federal agencies devise and implement guidelines for insourcing new and contracted-out functions by mid-July 2009. Of note, the GAO report, based upon interviews held from July to October 2009, indicated that no civilian agency had developed or implemented insourcing guidelines. At some point agency inaction will become the obvious issue, particularly when no civilian agency has developed any insourcing guidelines in spite of the Public Law (so much for "requirements" applicable to federal agencies).

Perhaps civilian agencies have ignored the statutory requirement (to devise and implement insourcing guidelines by July 2009) in anticipation of OMB guidance which requires a planning pilot report by

April 2010. However, that OMB guidance was issued on July 29, 2009 which suggests that the OMB guidance could not have been the basis for inaction by civilian agencies. At some point, the typical solution to inaction by executive branch agencies to implement legislative branch mandates is additional "help" from outside the agency(ies). This help could be in the form of arbitrary goals (percentage reductions and timelines) or more directly, appropriations which simply realign an agency funding, shifting from acquisition funds to employment funds.

Lastly, there is one fact (or that which is being presented as fact) which could easily move this initiative from delayed planning to execution; specifically, a statement made at a recent PSC (Professional Services Counsel) meeting wherein a Government representative stated in the absolute that an outsourced service costs 50% more than the same services by a government employee. His point of reference is his budgeting data which provides costs per FTE (full time equivalent government employee) inclusive of payroll and benefits in comparison to the acquisition cost for the same or equivalent contracted service. As long as data purportedly shows this differential, it could be difficult to derail the insourcing initiative notwithstanding that the data (the 50% differential) cannot be validated.

DCAA and the GAO: The Unintended Consequences

As reported in our September Special Edition Newsletter, the DCAA has once again been on the receiving end of a highly critical review and report from the GAO. In brief, the GAO reviewed 69 audits conducted between 2004-2006 and concluded that 4 were compliant with government auditing standards (GAGAS). Stated differently, 65 of 69 were not compliant which is a 94% rate of failure. In the wake of a GAO report which is as

unfavorable as the July 2008 GAO report, there have been the usual hearings including the October 15, 2009 Hearing (House Armed Services Defense Acquisition Reform Panel) wherein the lack of compliance was attributed to a "clear disparity between (DCAA) resources and requirements" (GAO statement). The staffing disparity has or will result in approximately 500 new DCAA auditors in 2009/2010; hence, government contractors can anticipate more auditors but not necessarily more audits because DCAA's then-Director also stated that DCAA now takes on fewer assignments and going forward will focus on predominantly high-risk contracts.

Unfortunately the DCAA Director's statement appears to be inconsistent with DCAA planning guidelines for 2010 which instructed the field offices/regional offices to identify absolutely all "required audits" and the resources to execute those audits. The result, resource requirements which exceed those identified just one year earlier within the 2009 planning process. It appears to be a rather obvious strategy by DCAA to seize the moment wherein the GAO has publicly stated that DCAA needs more resources. Perhaps the focus on predominantly high-risk contracts and the need for fewer auditors will occur after DCAA completes its 50 (or more) internal reforms to its structure, culture and processes in response to GAO findings.

Although we can anticipate more auditors (including a new DCAA Director on November 9) and the satisfaction of knowing that we will all help with on-the-job training for these new auditors there are the unintended and perhaps unexpected consequences stemming from the GAO reports. For those audits which were specifically reviewed by the GAO (and found noncompliant with government auditing standards), DCAA has apparently decided to supplement

those audits with additional fieldwork, but before doing so, has apparently withdrawn the previously issued audit report(s). A case in point, a 2006 incurred cost audit which had been completed inclusive of the formal rate agreement letter which not only incorporates final indirect rates, but allowable direct and indirect costs on specific government contracts.



Although the concept of a rate "agreement" letter suggests a binding agreement, that simply isn't the case. In attempting to determine if a rate agreement letter is binding, we located a DoD-IG Report (PO 97-032, issued June 27, 1997) which is rather unsettling in terms of the finality of a rate agreement letter. In debating the government's ability to recover expressly unallowable costs found in a later year (but determined to also be applicable to a "settled year"), per the DoD-IG report, DCAA made the following statements:

"DCAA stated that the final rates, once properly established, are binding and not subject to adjustment, absent special circumstances such as fraud". However, DCAA agreed that the statutory prohibition on payment of expressly

unallowable costs allows the Government the right to recover the expressly unallowable costs without adjusting the rates".

The implications should be obvious, that the Government (both the DoD-IG and DCAA) believe that they can pursue the recovery of the costs (additional unallowable dollars) while leaving the agreed-to rates in-tact. But there is also a more subtle but equally unsettling phrase which is "once properly established". A rate agreement letter premised upon a noncompliant audit has not been "properly established". Ultimately it doesn't matter, because if DCAA reopens an audit for a year which already has a final rate agreement letter, all bets are off. It should be obvious that if DCAA reopens an audit inclusive of additional audit field work and finds additional unallowable costs; it will change the audit results and issue a revised audit report. If DCAA did not revise the audit report based upon the additional fieldwork, they would be setting themselves up for another GAO visit and one more GAO report citing DCAA for noncompliance with government auditing standards.

The GAO has identified other DCAA audits which were noncompliant with government auditing standards, notably DCAA's ICAPS audits (audits of contractor internal controls). As a result, DCAA is rescinding the previously reported results and should be supplementing fieldwork when necessary to sufficiently test the contractor internal controls. Unlike an annual incurred cost audit, it would be illogical and non-value added to supplement audit fieldwork by attempting to audit controls back in the original timeframe, 2004-2006; hence, DCAA should be performing audits of current internal controls. Unfortunately,

the audit criteria used to evaluate contractor internal controls will be that which reflects DCAA's relatively new definition of a significant internal control deficiency. As defined in March 2008 and further clarified in December 2008, a reportable internal control deficiency is a contractor failure to accomplish any single DCAA control objective unless there is less than a remote probability that the deficiency will result in unallowable costs on government contracts. In practice, virtually any internal control deficiency currently identified in a DCAA ICAPS audit is being categorized as a reportable deficiency along with an audit opinion that the system is inadequate.

As contractors become aware of the fact that DCAA will be re-auditing with respect to these previously issued, but GAGAS noncompliant internal control audits, these contractors are recognizing that there is substantial risk that the end result will be a DCAA opinion that the contractor accounting system is inadequate. An inadequate accounting system is problematic given that FAR Subpart 9.104 implicates that a responsible, prospective contractor must have an adequate accounting system. In some cases, contractors are reporting these circumstances within their SEC 10K in the context of full disclosure of facts which may adversely impact the contractor's ability to obtain future government contracts.

As it stands, DCAA failures to comply with government auditing standards have had and will continue to have unintended and/or unanticipated consequences in terms of both the retroactive and future adverse impact on government contractors. And at least for the moment, there seems to be no light at the end of this tunnel.



Training Opportunities

2009 Beason & Nalley Sponsored Seminar Schedule

FAR Part 31 Cost Principles Basics Class and Advanced Workshop

Date: November 17-18, 2009

Location: Beason & Nalley, Inc.
Huntsville, AL

Time: 8:15 am – 4:45 pm (each day)

DCAA Hot Topics & Current Updates Training

Date: November 18, 2009

Location: The Broadmoor Hotel
Colorado Springs, CO

Time: 1 pm – 6 pm

2009 Federal Publications Sponsored Seminar Schedule

A Manager's Guide to EVMS

November 5-6 – Washington DC

December 2-3 – Las Vegas, NV

Government Contract Accounting Systems Compliance

December 8-9 – Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Chad Braley
- Courtney Edmonson
- Cyndi Dunn
- David Miller

Go to www.fedpubseminars.com and click on the Government Contracts tab.

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. Sandra Baker at sbaker@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.

Beason & Nalley, Inc. provides accounting, business, financial and consulting services with a focus on serving government contractors. Beason & Nalley, Inc. goes well beyond the bounds of what one would normally consider to be "typical" services. We provide services such as government contracts services, outsourced accounting, audit, tax and Deltek Costpoint® consulting and more. Our goal is to provide the business owner with options for their financially related administrative needs. Our service list is comprehensive. Contact us.



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