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## **GAO REPORT ON DCAA: PART 2**

As reported in our July 2008 Newsletter, the GAO (Government Accountability Office) issued its report *GAO-08-087; Allegations that Certain Audits at Three Field Offices did not meet Government Auditing Standards (GAGAS)*. In the wake of this report, DCAA has made immediate changes with more to come. As previously reported, the most obvious change is DCAA's movement away from any and all "teaming" scenarios involving DCAA and the contractors. Specifically, Integrated Product Teams (IPTs) designed to accelerate the bid proposal and contract award process, but viewed by the GAO as incompatible with the "independence" auditing standard. This is an unfortunate turn of events given that IPTs were successful in accomplishing multiple goals including

the accelerated proposal process and a contract based upon a fair and reasonable price. Perhaps more unfortunate is DCAA's broader movement to protect auditor independence (above reproach) as evidenced by DCAA's abandonment of 1) long-standing but informal agreements concerning cost allowability and documentation requirements, and 2) informal discussions on future contractor accounting options/changes. More than one contractor has found itself relying on long-standing, but informal agreements, only to be told (during a current DCAA audit) that unless the agreement was written, it does not exist (occasionally this is presented more aggressively, e.g. "I'm the new auditor and I don't care what the prior auditor accepted").

Similarly, a number of DCAA auditors have unilaterally raised the bar in terms of their expectations for documentation. Examples include auditor insistence on "original" documents (having previously accepted scanned copies) and additional expectations for documentation to justify offsite business meetings as well as to justify consultant travel costs. Interrelated with the movement away from teaming, DCAA auditors are likely to avoid informal discussions involving "what if" scenarios including contemplated changes in cost accounting practices. Historically, contractors were well served by briefing DCAA (and contracting officers) on pre-implementation strategies and alternative strategies involving CAS Disclosure Statements and/or allocation methods. Currently, DCAA is more likely to avoid such "pre-implementation" discussions to avoid any appearances of influencing the contractor decision which could implicate a lack of auditor independence. It's now

less likely that potential issues can be eliminated before one goes through the process of "formalization" such as selecting an alternative and formally submitting a revised CAS Disclosure Statement before receiving any reaction from DCAA. That doesn't mean that a contractor should not attempt the informal route; however, the process may be avoided (by DCAA) "because of the GAO Report".

DCAA's changes are self-described as designed to improve the audit quality. Unfortunately, "audit quality" does not predictably translate into any improvement in the overall government procurement process or any reduction in the cost of products and services acquired by the government.



Although the July GAO Report associated contract cost growth with a contractor's estimating system deficiencies (deficiencies that were not reported by DCAA); however, the GAO report made no attempt to develop or validate the cause and effect. Arguably, the GAO report should not have presented contract cost growth data leading the reader to infer that the cause was the alleged "unreported" estimating deficiencies without sufficient evidence to

support the cause and effect (but that's another story for another day).

Buried within all of these bad times for DCAA are the implications of significant changes in terms of DCAA expectations (for contract compliance) notwithstanding the fact that not one procurement regulation has changed. Contract terms and conditions are the same before and after July 2008; however, that may be lost on any contractor subjected to significantly different audit expectations and a more difficult and time consuming audit resolution process.



## LEGAL COSTS (FAR 31.205-47) AND THIRD PARTY LAWSUITS

Third party lawsuits (civil actions) are generally not covered by FAR 31.205-47 (with the exception of third party lawsuits in the name of the United States under the False Claims Act). The gap in coverage of third party lawsuits has led to numerous audit issues and litigation, the latest being the Ninth Circuit reaffirmation of disallowed fees incurred by Southwest Marine in defending a Clean Water Act third party lawsuit. The Clean Water Act permits both private and government lawsuits as well as the government to intervene in a lawsuit brought by a private party (coincidentally similar to a Qui Tam). Thus, the decision relied on the fact that the costs are similar to those unallowable in FAR 31.205-47(b) which is applicable under FAR 31.204.

Although this decision provides some interpretation of third-party lawsuits vis-à-vis 31.205-47, it is based upon facts which may not match other third party lawsuits. Regardless of case specific facts, DCAA will likely question legal costs if there is a material amount of a "settlement" and DCAA's basis may be reasonableness, allocability, or allowability or combinations thereof but without any reference to "case law" as the basis for the audit exception (with rare exception, DCAA policy is to avoid such references). These settlements may involve employee(s) or potential employee(s), individual or class action lawsuits for wrongful termination, discriminatory hiring, firing, or promotions, etc. The amount of the settlement costs are known to the auditor (by virtue of the contractor claiming the costs or by virtue of the contractor voluntarily deleting the costs), but the other details of an out of court settlement are almost always non-releasable.

Typically the details of the case are "privileged" attorney client work product and it is impossible to release privileged documents just to DCAA (once released, the documents are no longer privileged). For any settlement, this conundrum invariably repeats itself with the only predictability that an auditor will question the costs unless the contractor can provide documentation sufficient to establish that the contractor would have prevailed had the action not been settled through ADR, mediation or otherwise "out of court". One can argue that the typical DCAA audit exception is mixing and matching cost principles (i.e. third party lawsuits aren't covered by FAR 31.205-47); however, FAR 31.204 is the link. Regardless, one must anticipate the "audit challenge" and fully understand that the auditor (and more importantly government auditing standards) requires that the audit conclusion is based upon sufficient, relevant evidentiary matter and a contractor asserting that "we would have prevailed, but we saved legal fees by settling", doesn't satisfy the auditing standard.

## FAR 31.201-4 ALLOCABILITY AND THE AFTER-THE-FACT INCURRED COST AUDIT

As a government contractor, one of life's most difficult challenges is the after-the-fact audit exception to an indirect or G&A allocation method. For example, a current audit of a prior year incurred cost proposal concludes that you've been incorrectly allocating facilities costs (e.g. depreciation, utilities and maintenance) over direct labor hours when it should have been allocated over square footage occupied by direct and indirect employees. It's more perplexing when the existing method has been audited and apparently accepted for incurred costs as well as for pricing bid proposals. Unfortunately, the after the fact (incurred cost) audit uses FAR 31, including FAR 31.201-2, determining allowability, as its audit criteria. In that context, costs that are not allocable are not allowable. Long gone are DCAA's unwritten, but routinely applied ground rules that a judgmental call on allocability was best resolved prospectively as opposed to retroactively (to the extent an existing method had been audited and tacitly accepted).

The fundamental reason for prospective change (i.e. beginning with the next fiscal year) was that the government had known and tacitly accepted the existing methodology. As "unwritten" DCAA ground-rules change, we've assisted contractors with retroactive allocation challenges and the first line of defense pertains to the specific reason for DCAA's challenge. Is it simply categorized as a "better" allocation method or is it stated as an allocation method which is not compliant with FAR? FAR 31.201-4 does not require a better or best method, merely an acceptable method and the fact that a methodology has been previously accepted gives credence to the assertion that it is a method which is compliant with 31.201-4

(assuming relevant facts have not significantly changed over time).

A second line of defense is the significance of the issue in terms of retroactive cost impact which will be limited to government flexibly priced contracts (under FAR differentiated from CAS). If you retroactively effect the change, how many dollars shift from flexibly priced contracts to fixed price or commercial (is it significant)? In one case, the auditor was very actively pursuing an allocation issue for a small 100% government contractor with annual revenues of approximately \$15M, but flexibly priced contracts were only 6% of the total. Although the audit opinion may have been academically sound, its retroactive impact was arguably immaterial (and the prior year's auditor had accepted the methodology). As we've noted in prior newsletters, don't assume that the auditor has considered the practical significance or materiality.



## TRAINING OPPORTUNITIES

October 28  
**FAR Part 31 Cost Principles Training Course**  
 Beason & Nalley, Inc.  
 Huntsville, AL

Go to [www.beasonnalley.com](http://www.beasonnalley.com) to register.

### Sponsored by Federal Publications Seminars Calendar Year 2008 Schedule

September 17-18  
**A Practical Guide to Incurred Cost Submission (ICS)**  
 E-Street Conference Center  
 Washington DC

October 1-2  
**Government Contract Accounting Systems Compliance**  
 Marvin Conference Center  
 Washington DC

October 22-23  
**A Practical Guide to Incurred Cost Submission (ICS)**  
 Flamingo  
 Las Vegas, NV

November 13-14  
**A Manager's Guide to EVMS**  
 Marvin Conference Center  
 Washington DC

December 9-10  
**A Manager's Guide to EVMS**  
 Flamingo  
 Las Vegas, NV

December 11-12  
**Government Contract Accounting Systems Compliance**  
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Go to [www.fedpubseminars.com](http://www.fedpubseminars.com) and click on the Government Contracts tab or call Beason & Nalley at 256.533.1720.

### Specialized Training

Beason & Nalley 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](mailto:sbaker@beasonnalley.com), or at 256.533.1720.

### Reader Inputs for Future Newsletters

Beason & Nalley develops its topics based upon recent regulation, 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 [sbaker@beasonnalley.com](mailto:sbaker@beasonnalley.com).

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