

In this issue...

- **DCAA Guidance on COBEC FAR Rules: Impact on Internal Controls**
- **Estimating Indirect Rates: How Much Support is Enough?**
- **DoD-IG Receipt of Mandatory Disclosures Under FAR 52.203-13**
- **Lobbying Costs**
- **Training Opportunities**



newsletter

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DCAA Guidance on COBEC FAR Rules: Impact on Internal Controls

The Defense Contract Audit Agency issued a July 23, 2009 guidance memorandum to its auditors outlining how new FAR revisions related to Contractor Code of Business Ethics and Conduct (COBEC) will affect audits of contractors' overall accounting controls and the control environment.

FAR revisions were made on two occasions affecting contractor responsibilities for maintaining an effective business code of conduct and making disclosure of violations of various statutes. The first rule, effective December 24, 2007, moved the code of conduct provisions formerly contained in DFARS into the FAR, and added more specific requirements for maintaining a rigid code of business ethics, sufficient internal controls, and display of hotline posters. The second rule, effective

December 12, 2008, added the disclosure requirement for violations of certain laws and overpayments. Contract clauses that were amended as a result are FAR 52.203-13 and -14.

As expected, DCAA's audit program related to the accounting control environment has been expanded to include additional audit steps for verification of contractor compliance with these new or amended COBEC requirements. Audit guidance within the DCAA Contract Audit Manual (CAM), Section 5-306, has also been revised.

The guidance memo specifically instructs auditors to validate that:

- Contractors have a written code of business ethics program (to include applicable internal controls) "suitable to the size of the company and extent of involvement in Government contracting", and that COBEC training be provided to contractor employees;

- Internal controls be sufficient in facilitating "timely discovery and disclosure of improper conduct...", and;
- Controls include a means to ensure corrective action is quickly carried out

This guidance memo places specific emphasis on auditor actions that must be taken if, during audits for compliance to the COBEC rules, auditors find instances where contractors fail to report "wrongdoing" to the applicable agency OIG, when credible evidence supports such wrongdoing; in this case, auditors are required to report such failures as internal controls deficiencies (presumably either as a "flash report" or part of an ongoing overall control environment audit), with audit reports on these issues copied to the DCAA Justice Liaison Auditor.

A by-product of this guidance is a DCAA formal request for extensive contractor information pertaining to compliance with COBEC provisions that is being submitted to some contractors. As previously discussed in our July 2009 newsletter ("DCAA and Access to Contractor



Records: The Continuing Saga of Rewriting the Regulation”), DCAA has blended its own interpretation as to “disclosure” required by contractors (FAR 52.203-13(c)(2)(ii)(C)), specific situations requiring disclosure, and to what entity disclosure is to be made. In that DCAA request for information, DCAA intimates that written disclosure of any violations of the contractor’s code of conduct must be identified and submitted to DCAA and the ACO.

Problem with DCAA’s rhetoric in its request for information is that no disclosure is required regarding code of conduct violations (unless issues are those related to violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 U.S.C. or a violation of the civil False Claims Act (31 U.S.C. 3729-3733)). Unless violations of the contractor’s code of conduct rise to this level, no disclosure to DCAA or anyone else is required.

Further, DCAA wrongly asserts that DCAA and the ACO are the hall monitors and recipients of violation notifications. When disclosure of wrongdoing is required, the FAR 52.203-1(c)(2)(ii)(F) is clear that the procuring agency OIG and Contracting Officer are the parties to whom disclosure must be provided—not DCAA, not the ACO, not Santa Claus, and not the Easter Bunny.

At this juncture the guidance issued by DCAA pertains only to “major” contractors; however the guidance memo notes that additional guidance will be provided related to non-major contractors in September 2009.

Fallout of this guidance is expansion of internal controls audit scope (for both large & small contractors); increased likelihood of more audits with “inadequate” opinions, and; more administrative burden on contractors to maintain code of conduct documentation to demonstrate to DCAA compliance with the COBEC provisions.

It remains to be seen if and when a contractor (more than one contractor) will not provide access demanded by DCAA (yet not supported by the regulations), and whether this denial issue will be elevated to an access to records issue and a contract dispute. It also remains to be seen if DCAA (or DCMA or DOJ) will still pursue the issue if a ruling unfavorable to the government would presumably force DCAA to back-off from requesting such information.

Estimating Indirect Rates: How Much Support is Enough?

In the world of government contracting, most contractors, at some point prior to getting a contract, must submit a “cost” proposal to the government customer for evaluation. And cost proposals, by definition, require the contractor to identify individual costs comprising the proposal, with a regulatory requirement, thus a contractor promise to have adequate supporting documentation behind the cost estimates.

Recognizing that estimates are a matter of judgment, and that no one factor drives accuracy and relevance of any cost estimate, we’ve seen, with one particular

cost element, where government auditors are misapplying regulatory references in challenging the level of information required by government contractors to “adequately support” its cost estimates. That specific element is “indirect expenses”.

Auditors often insist on detailed budgets (rate forecasts) for all fiscal years in which the effort proposed in a bid proposal is expected to be performed. Thus, if a contractor is proposing a work scope going over five years (FY 2009 – 2013), the expectation is that the contractor develop and use detailed rate projections for each of those five years as a basis for estimating proposal costs. Auditors specifically cite the regulations associated with proposals requiring “cost or pricing data”, discussed in FAR 15.408, Table 15-2, Section II, Para. C. The specific verbiage used by auditors for insisting that such detailed forecasts are required states:

“Indicate how you have computed and applied your indirect costs, including cost breakdowns. Show trends and budgetary data to provide a basis for evaluating the reasonableness of proposed rates. Indicate the rates used and provide an appropriate explanation”

Thus, assuming your proposal requires “cost or pricing data”, are detailed budgetary estimates supporting proposed indirect rates (projections of individual cost elements comprising indirect cost centers and allocation bases) projection required by regulation? Can contractors instead utilize detailed current or next year projections only, and straight-line those projections into out years of the performance period for bidding? How about using the most recently completed fiscal year actual rates as a basis for projections?

Answer to this question: The FAR 15.408 Table 15-2 (paragraph C.) does not

require development of individual out-year indirect rate forecasts (with detailed budgetary data for each year). Although the statement says “show trends and budgetary data”, this does not prescribe out-year detailed budgetary data supporting all proposed annual rates. In many cases, the solicitation actually defines the “trends” as historical trends (e.g. the last three fiscal years) as opposed to future trends.

The overriding theme of paragraph C is to provide a verifiable basis that allows evaluation of the “reasonableness of proposed rates”. The key to following these regulations when preparing a proposal with several out-year performance periods, and avoiding a detailed budgetary preparation process, is to demonstrate that other information, such as current year or prior actual rates, historical trends, or a current fiscal year budget is a logical basis for projecting into future periods, and that such data/basis is verifiable.

Auditor requests for detailed budgets often overlook the fact that other information (historical trends, etc.) used as basis for proposed future year rates not only adequately supports those forecasted rates, but also allows audit evaluation. Moreover, attempting to prepare detailed indirect rate forecasts for future fiscal years can be a meaningless exercise given that most companies cannot reasonably estimate with any degree of accuracy business events and costs for three, five or ten years out. Certainly if a contractor’s business base relies on government contracts, government estimates, particularly funding, aren’t worth much if anything; hence, out year forecasts, high level or highly detailed, can be an exercise in futility.

One should also understand Table 15-2 represents instructions only for proposals where Cost or Pricing Data is required

(TINA)—this FAR regulation does not apply to proposals where “information other than Cost or Pricing Data” is permitted.

We recommend, however, that all companies, large or small, prepare indirect rate forecasts using detailed budgetary data for at least for the current and next fiscal period. It also becomes more important for companies, whose future period costs and business base will be significantly impacted by the contract award resulting from the bid proposal to carefully examine the impact of a multi-year award on its current rates. In this case, historical rates and trends may not be adequate to support the reasonableness of forecasted rates; thus a more detailed analysis and presentation of forecasted rates may be in order, albeit a high level summary analysis.

And for what it’s worth, contractors have also found that DCAA accepts detailed out year forecasts including those which simply take a current year or next year detailed forecast and provide the same level of detail (e.g. by cost account) in the out years merely by application of an escalation factor to the individual cost accounts. In other words, preparing a high level out year forecast, such as overall pool/base, but then extrapolate projected summary level data back to the detailed account level. However, the key is to present the data at the detailed level notwithstanding that the projection (the out year rate(s)) is exactly the same. Such would be a case of form over substance, but nonetheless one potential solution.

DoD-IG Receipt of Mandatory Disclosures Under FAR 52.203-13

A spokesperson for the Department of Defense, Inspector General’s Office (DoD-IG) announced recently that more

than 50 mandatory disclosures had been received since mandatory disclosure went into effect in December 2008. Specifically, 56 such disclosures and that fewer than 10 had been referred to investigative agencies (which fails to identify the number which have become active investigations).

Of note, most disclosures came primarily from outside counsel as opposed to those using the ultra-convenient DoD-IG reporting portal; explained in part by the inherent risk in reporting under FAR 52.203-13 and in part by the fact that the DoD-IG has added reporting fields which are non-existent in the regulations. Unfortunately, government oversight agencies, including the DoD-IG and DCAA (reference to the first article in this newsletter) can’t seem to help themselves in terms of avoiding the temptation to add their own touches to the regulations.

With respect to the 56 disclosures to-date, most were categorized as having been related to single employee misconduct, for example where an employee charged time to the wrong contract or surfed the internet for three-four hours (for the last three months). The end result, the contractor has to credit the government contract and adjust (reduce) billed costs.

In addressing these disclosures, the DoD-IG indicated that it has added staff to handle the disclosures but that the greatest challenges lie within the need to coordinate with the Department of Justice, and coordination with a massive bureaucracy to determine what response is appropriate.

The DoD-IG spokesperson never states (nor could he/she safely state) that the mandatory disclosure rule never envisioned many of these types of disclosures. Although the FAR Councils did indicate that they did not expect a deluge of reports with immaterial



violations, upon finalizing the rule and responding to public comments, the FAR Councils refused to provide a materiality threshold. Given that a contractor's failure to make mandatory disclosure comes with a direct threat of debarment or suspension, it appears that contractors are playing it safe. No doubt at significant cost to themselves, the DoD-IG, the DOJ and ultimately the taxpayer. Perhaps at some point someone will courageously step forward and provide some materiality thresholds, but for now, it appears that the DoD-IG expects that contractors keep those mandatory disclosures coming!

Lobbying Costs

The Federal Acquisition Regulations, FAR 31.205-22 in particular, have deemed lobbying and political activity costs to be unallowable. Not only is lobbying unallowable for those contracts subject to FAR part 31 (and numerous OMB Circulars), but lobbying also involves reporting requirements which are over and above criteria which limits allowability. However, in testing the success of the reporting requirements, one needs only consider that the American Recovery and Reinvestment Act requires that federal agencies disclose their contacts with lobbyists; yet very little has been reported.

As noted in a Washington Post article, the entire government reported only 8 such lobbying contacts in the month of August and the Department of Defense

(DoD) only one such contact for the entire year (that being a query by a lobbyist regarding the military homeowner's assistance program).

Although only one reported DoD lobbying contact seems incredulous, the answer(s) reside in the details of the reporting requirements not the least of which is the requirement that only registered lobbyist are required to report contacts with federal officials. By implications, lobbying by company executives and other "non-lobbyists" is not reportable as lobbying, but is it lobbying for purposes of determining FAR 31.205-22 allowability?

Costs which are unallowable are not limited to activities undertaken by registered lobbyists, and to be certain government audits (e.g. DCAA) will most likely disallow any activity undertaken by a contractor employee or contractor consultant or agent which even remotely resembles lobbying. All too often audits challenge anything which resembles lobbying costs and actually presume that a contractor's Washington DC office is primarily involved in lobbying activity (hence, unallowable unless a contractor can clearly demonstrate that portion of the Washington Office activity which is not lobbying).

In spite of the DCAA Director's recent insistence that DCAA opinions are always correct thus the audit opinion should be mandatory (reference to her August 11, 2009 testimony to the Wartime Contracting Commission) all Washington Office costs (or costs associated with visits to Washington Offices) are not unallowable lobbying activity. FAR 31.205-22(a)(6) clearly indicates that costs are unallowable if incurred in attempting to improperly influence an employee or officer of the Executive Branch to give consideration or act regarding a regulatory or contractual matter. But what about costs in attempting to "properly influence" a

government employee on a contractual matter, and what is "proper influence"? In part the answer resides within FAR 31.205-22(b) which identifies activities which are excepted from the unallowable coverage including **technical and factual presentations** (emphasis added) on contract performance (actual or future) made to Congress in response to a written Congressional Request. Additionally and similar to the exception in 31.205-22(b), FAR 3.401 defines improper influence as that which is on any basis other than the merits of the matter.

SHAZAM! We now have the distinction between allowable and unallowable lobbying/political activities, but how does our discussion of the very limited reporting of lobbying contacts directly relate to the discussion of unallowable or allowable lobbying-related costs? The answer lies within the specific actions being undertaken by federal officials to avoid lobbying contacts; thus avoiding the mandatory reporting or such contacts.

As noted by a lobbyist for a supplier of heating and cooling systems attending a technical meeting with the Department of Energy, the lobbyist was only allowed to "participate" by listening while the others addressed existing and new technologies. These actions created "a line in the sand" or firewall between the technical meeting/discussions and any unallowable lobbying. No lobbying was allowed to occur, thus removing the government official from the burdensome reporting. Although unintended, the specific actions of the government official not only protected themselves from the nuisance of reporting lobbying contacts, but it also becomes the basis for claiming (as allowable) the costs of contractor attendees. In spite of the presence of the lobbyist the activity was tightly controlled to avoid any lobbying. In fact, one could assert that in the absence of any lobbying activity, even the consultant (lobbyist)



costs are allowable; however, we will save that discussion for another day.

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)

2009 Federal Publications Sponsored Seminar Schedule

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October 20-21 – Las Vegas, NV

A Manager's Guide to EVMS

November 5-6 – Washington DC

December 2-3 – Las Vegas, NV

Government Contract Accounting Systems Compliance

October 6-7 – Washington DC

December 8-9 – Las Vegas, NV

Instructors

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

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

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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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