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# Government Procurement & Audit Challenges for Government Contractors

Annual Newsletter for Calendar Year 2013

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The Redstone GCI CY 2013 annual newsletter contains our forecast of government contract procurement and oversight trends and issues, focused largely on accounting and pricing matters, which we believe could have a significant impact on government contractors during calendar year 2013. The contents of our newsletter were written to better prepare contractors in dealing with the procurement and audit challenges to come. Our 2013 newsletter addresses a wide range of topics impacted by legislative and executive department actions, DOD contract regulations and cost reduction initiatives, and Defense Contract Audit Agency (DCAA) audit policies and priorities. As with each annual newsletter, there is no certainty in terms of guaranteeing that a topic/issue will evolve into, or continue to attract a high level of Government interest or oversight. However, we recommend that all government contractors consider their financial management and compliance processes measured against the challenges that are discussed herein.

## DCAA Audit Priorities for GFY 2013

In its August 31, 2012 Staff Allocation Plan for government fiscal year (GFY) 2013 (beginning October 1, 2012), DCAA identified its top audit priorities commensurate with allocated dollars for the DCAA mission, equating to about 5,300 work years. The audit priorities for GFY 2013 are a product of DOD customer demands, which include, for example, expediting contract close-outs; providing demand bid proposal audit reports more timely; supporting DCMA's Cost Recovery II initiative, and; addressing DCMA's prioritized list of incurred cost proposals and DCMA's list of negotiated pricing actions at risk for defective pricing. Other priorities include those of DCAA's choosing, such as completion of pilot testing of internal controls audits (using updated audit programs). Another factor driving DCAA's selection of its priorities is the continued shortage of audit personnel—hence, the need, as stated in the staffing plan, to use a risk based approach in establishing those priorities.

For the past three years, DCAA has purportedly not had the resources it requires to perform all audit services, in a manner which complies with General Accepted Government Audit Standards which, in DCAA's opinion, demands more extensive audit planning and transaction evaluation than was previously considered necessary. Two GAO reports (issued in 2008 and 2009) castigated DCAA for failing to meet professional auditing standards in properly planning and executing its audits, and consequently, DCAA implemented more rigorous audit policies which dramatically expanded the scope of all audits, slowed the process of audit completion, and expended slightly increased audit resources (funding) resulting in the completion of far fewer audits and consequently creating huge backlogs of

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"discretionary" audit work. In an attempt to provide relief to DCAA's staffing shortages, the Defense Contract Management Agency (DCMA) and Defense Procurement Acquisition Policy (DPAP) increased bid proposal dollar thresholds requiring field audits (by DCAA), and shifted certain bid proposal responsibilities as well as financial capability, EVMS, and purchasing system reviews to DCMA.

Our experience with clients for the past three months indicates that DCAA has stuck with the priorities stated in its August 2012 staffing memo; however, there has not been any noticeable reduction in the extensive number of audit hours incurred to complete any given audit and it remains to be seen if there has been any significant reduction in the days to complete an audit. Although DCAA continues to pontificate in its guidance to auditors to utilize a risk based approach for planning and executing audits, there has been no observable change (reduction) to audit scope or hours incurred for any audit type, nor, to our knowledge, has DCAA given any reconsideration in determining how GAGAS should apply or not apply to certain audits whereby less audit effort might be expended without sacrificing audit results which adequately protect the taxpayer. While pondering the following audit priorities for 2013, and our cautionary risk comments, recognize that there will likely be no dramatic decrease in the amount of time it will take to complete any given audit for the vast majority of DCAA audits during CY 2013.

DCAA top audit priorities for CY 2013:

- DOD demand requests for bid proposal and forward pricing rate reviews; proposals for which DCAA currently is authorized to undertake are FFP or cost reimbursable proposals equal to or exceeding $10 mil and &100 mil, respectively
- PCO or ACO demand requests for pre-award accounting system audits, which is a FAR Part 9 requirement for qualifying a contractor for obtaining a contract for which payment for services will be based on actual costs incurred
- Supporting DCMA in its Cost Recovery Initiative, Phase II—includes resolution of outstanding CAS or incurred cost proposal findings
- Billing and accounting system audits begun at pilot testing sites, and specific high risk locations
- Specific post-award (defective pricing) audits for defined pricing actions identified by DCMA-- considered high risk (high profit margin)
- CASB disclosure statements with revisions not yet audited
- Incurred cost proposals, prioritized as follows:
    - Reach-back and DCMA identified high risk proposals not started, or ones in progress
    - Audits in progress at the end of GFY 2012
    - OMB A-133 audits
    - High risk ICPs submitted by contractors formerly or currently with overseas contingency contracts
    - Corporate, group or service centers for which costs flow into segments with reimbursable contracts
    - Incurred cost proposals identified as "high risk" in the DCAA sampling audit process and those ICPS of higher dollar value not subject to sampling process, starting with earlier years to be audited first
- Any other audits not discussed above that were in process at the end of GFY 2012 (September 30, 2012)

Cautionary notes on DCAA priorities and audits that will take last place:

- Incurred cost audits will indeed take a high priority for completion, given DCAA's goal for getting "current" (all ICP backlog is audited) by GFY 2016. DCAA has implemented a more aggressive low risk ICP sampling plan (further discussed in "Incurred Cost Pro-

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posals (ICPs) and Contract Close-outs") with an implicit goal of programming and completing as many "low-risk" ICPs available through contractor fiscal year 2008 as possible. ICP audits for FY 2009 or later are not in the plan and all ICP audits are discretionary, subject to discontinuation for sake of higher audit priorities.

- Business Systems audits or other internal control audits for major contractors are only mentioned in the context of those to be programmed for "high risk" companies; hence, we believe these will be few and far between and/or those based upon pre-existing conditions as separately discussed in the DFARS Business Systems.
- Post award or pre-award accounting system audits required to validate corrective action due to prior audit reported deficiencies are not discussed as a priority; however, see discussion below, "Accounting System – Non-Major Contractors".

Defective Pricing audits will be limited to negotiated pricing actions specifically targeted by DCMA as high-profit unless DCAA unexpectedly finds surplus audit resources and adds defective pricing audits for FFP pricing actions over $100 mil. Other audits may be prioritized as a function of civilian agency prioritizations accompanied by reimbursable funding for DCAA; however, the last few years have shown that civilian agencies have been seeking alternatives for contract audits (displacing DCAA).

## Forward Pricing Rates and Bid Proposals

We predict little change in the DCAA audit approach for conducting aggressive and detailed audits of cost proposals or Forward Pricing Rate Proposals (FPRPs), to include microscopic "adequacy" reviews of proposals before going forward with audits, detailed testing of supporting cost information, insisting on sometimes literal and often times highly interpretive compliance with FAR 15.408, Table 15-2 (proposals requiring cost or pricing data), and taking exception to any and all estimated costs (ignoring immateriality) not adequately supported, superseded by more current data, interpreted to be expressly unallowable, or based on complex calculations that auditors simply could not understand.

As reported in our last year's newsletter, DCAA's responsibilities for proposal audits was reduced to cover only DOD FFP or cost reimbursable proposals over $10 mil or $100 mil, respectively. In January 2011, DPAP initiated a shift in proposal cost analysis to relieve DCAA from an overwhelming audit work load purportedly caused by shortages in audit resources (actually caused by the exponential growth in audit hours to complete any given proposal audit). DCMA assumed cost analysis duties for all other proposals (DOD) and began hiring additional price/cost analysts to fill the DCAA void. This responsibility shift away from DCAA to DCMA was criticized in a November 2012 Department of Defense Inspector General (DODIG) report. However, it is apparent that neither DOD nor DCAA have any declared intention for reverting to prior proposal value thresholds for DCAA audits.

Notwithstanding a reprieve from audits of lower cost proposals, DCAA has a lingering problem in meeting customer due dates for issuing cost proposal reports to procurement offices. In its FY 2011 report to Congress, DCAA reported an embarrassing 120 average elapsed days in turning around a bid or rate proposal audit report to DOD procurement offices. DCAA asserted that its languid performance was attributable to contractor delays in providing requested data during the audit as well as the audit tests required to fully comply with GAGAS audit quality standards. DCAA issued a February 2012 policy which made a commitment to establish and monitor agreed-to audit completion dates with the customers, to include setting milestones and maintaining communication with the customer; the memo also suggests that establishing mutually agreed to due dates could be a negotiating process, particularly if customers demanded a more expeditious time frame than DCAA believed they

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could meet given the depth of effort DCAA expected would be required in completing proposal audits.

DCAA updated its audit program for FPRPs in September 2012, and prepared an "adequacy checklist" specifically tailored to cost elements ordinarily rolled up into proposed rates, as well as the unique budgetary aspects often undertaken by contractors in projecting out year rates. Of passing interest, this nine page checklist is supported by a grand total of two very general sentences in FAR 15.408. The audit program was revised to encourage the use of regression analysis as "an efficient method to assess" proposed rates; however it (inefficiently) requires the auditor to test the historical data used as the baseline for budgetary projections. Our experience has shown that DCAA applies highly subjective interpretations in using one or both of the checklists making it appear that contractor inadequacies are a major contributor to delays in procurements (getting from bid proposal to on-contract). In an imperfect world of projecting future costs reflected in contractor bid proposals, seeking a perfectly structured and supported cost proposal is analogous to chrome plating the outside of an artillery shell—all for show and having absolutely no practical value. Unfortunately contractors are dependent upon PCOs to re-direct or otherwise influence DCAA in a situation wherein DCAA (in response to GAO criticisms in 2008) has declared its audit independence from the influence of ACOs or PCOs.

Consistent with all other audits, DCAA will conduct time-consuming and untimely audits of rate and cost proposals using extensive planning effort, to include a walk-through of most proposals prior to audit in addition to adequacy reviews, and utilize a team approach (two or more auditors) in accomplishing the field work.

Our predictions of challenges facing government contractors for forward pricing actions:

- Consistent with adequacy analysis, auditors will expect strict and/or highly interpretive compliance of proposals to FAR 15.408, Table 15-2; typical problems auditors cite as non-compliance aspects with that table are absence of consolidated bills of materials, failure to identify competitive quotations (and in some instances, asserting that contractors should have actually solicited quotes from vendors, as opposed to using purchase history), insufficient supporting budgetary data supporting rates (see bullet below), flawed proposal organization (cost or pricing data not clearly identified), and lack of written basis for costs that would make it easy for auditors to determine pricing resources and how costs are calculated.
- Auditors will demand detailed budgetary cost information to support forecasted indirect rates for each year of the prospective award, notwithstanding that out-year forecasts are nothing more than guesstimates. Auditors prefer to audit details ignoring the unpredictable nature of future cost forecasts and the futility of converting vague business goals into verifiable data. Nonetheless, should budgetary data and assumptions not be satisfactory for the auditor, DCAA may reject the entire forecast (rates) as questioned or unsupported and/or issue an adverse opinion that the proposal cannot be relied upon for negotiating a fair and reasonable price.
- For FPRPs, auditors will likely embrace recent DCAA guidance encouraging use of regression analysis in ascertaining if contractor projections (usually indirect rates) appear to be reasonable; be aware that auditors often "blindly" use the regression analysis for questioning indirect rates without analyzing the contractor's budgetary assumptions ignoring valid assumptions such as future business conditions which are projected to be significantly different than historical trends used in regression analyses.
- Contractors will be expected to demonstrate cost and price analysis of its subcontractor's cost proposals, where the criteria of FAR 15.404-3 (b) & (c) are applicable.

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- Auditors will continue their trend of exhaustive proposal analyses procedures, to include variable sampling techniques and in-depth evaluation of any historical information used as a pricing basis.

## Accounting Systems – Non-Major Contractors

Government contractors not otherwise categorized as "major contractors" (ADV is lower than $120 million annually—e.g. non-major contractors) subjected to pre-award and post-award accounting system audits (DCAA activity codes 17740 and 17741, respectively) will probably face a relatively new trend reducing very comprehensive (and unnecessary) audit tests. Although "a" significant deficiency can still be the basis for DCAA's opinion that an accounting system is not adequate (FAR Part 9.104), DCAA has dramatically changed the scope of the audit for a pre-award accounting system limiting that audit to an evaluation of the system design (capabilities opposed to actual operations). The end result, the audit is far less intrusive eliminating the opportunity for detecting errors (inconsequential or otherwise) and more contractors will be getting their foot under the door in terms of having a favorable DCAA pre-award audit based upon a relatively high level audit evaluation of a contractor's self-assessment using the SF (Standard Form) 1408.

DCAA appears to be responsive to pressures from DOD customers (implicitly to have more contractors at least eligible for bidding on cost-type contracts) honoring requests for pre-award accounting system audits, and in its GFY 2013 staffing allocation plan established these audits at the same priority level with bid proposal audits since both accounting system and proposal evaluation are interrelated as a condition for new contract award.

DCAA remains less predictable in terms of post-award accounting and billing system audits, including those audits to verify contractor corrective actions in response to a previously issued DCAA audit report citing one or more deficiencies. DCAA will not self-initiate post-award audits or any follow-up audit for corrective action, unless requested (actually demanded) by a government procurement office. However, recent client experience with DCAA follow-up post award audits has been refreshingly positive, at least in terms of the end result (a "clean bill of health" so to speak). It remains to be seen if this trend will continue, and a contractor cannot assume that issues will magically disappear. In order to achieve success on the follow-up audit, the contractor must have implemented policies and procedures responsive to DCAA's initial findings and take the time to provide DCAA with a "walk-through" of these changes. However, it does appear that DCAA auditors are more tolerant of inconsequential deficiencies as well as disinclined to look for new issues. We optimistically suspect that DCAA has recognized that it has been devoting (wasting) resources on initial audits reporting very minor deficiencies which has then forced DCAA to devote (waste) resources on the follow-up audit.

Contractors should remember the distinctions in audit scope and objectives between the pre-award and post-award audits. A pre-award survey should be limited to an evaluation of the "design effectiveness", meaning that detailed transaction testing is not required to fulfill the intent of this audit. In contrast, a post-award accounting system audit scope includes evaluating the operating effectiveness of the system, which would include transaction testing to ascertain that the system is working as intended. Auditors may tend to expand the pre-award into some transaction testing procedures, but the fact is that their audit program (17740) gives them some flexibility and if there ever were a time to work with your DCAA auditor, it is now as they seem to have taken a different (less intrusive) approach to pre-award accounting system audits.

Summary predictions for accounting system audit challenges for CY 2013:

- A much more condensed pre-award accounting system audit built upon the system

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design and the basic requirements on a SF1408

- Reported accounting system deficiencies and the basis for those audit findings will sometimes be flawed; however, there are early indicators that DCAA may finally be recognizing and not reporting immaterial or inconsequential deficiencies leaving far more contractors with adequate accounting systems as required by FAR Part 9.104
- Post-award cost accounting system audits including follow-up audits of contractor corrective actions will likely involve transaction testing which may entail attribute sampling of historical cost transactions. However there are early indicators that DCAA is scaling-back on the level of transaction testing suggesting that DCAA is no longer looking for that proverbial "needle in a haystack"
- Contractors who are told by procurement contracting offices that awards or cost payments are being withheld until demonstration of an adequate accounting system (via DCAA audit) should contact the procurement office and request their intervention in getting DCAA or a contracting office price analyst to perform the initial review or the review of corrective actions.

In any case, the absence of formal written procedures is cited as the most frequent significant deficiency, even if actual cost accounting practices are functioning with absolutely no indication of any noncompliance with respect to government cost accounting expectations.

## Incurred Cost Proposals (ICPs) and Contract Closeouts

As noted in the subsection "DCAA Audit Priorities in GFY 2013", DCAA has increased its resources and made a commitment to more aggressively initiate and complete ICP audits with a goal of significantly reducing the unaudited ICP backlog and allowing the close-out of contracts that have long since been physically completed. Although several initiatives are in place to accomplish this task such as the expansion of the low-risk ICP pool and the encouragement of multi-year audits, the agency nonetheless continues with a mindset of never-ending and exhaustive testing of documentation supporting the ICP, which translates into significant audit effort and delays the finalization of annual indirect rates. Add to the expansive audit process the fact that ICP audits are still discretionary subject to delays or postponement because audit staff may be redirected to contracting office demand work.

DCAA goals established for completing incurred cost proposals are driven largely by DOD customer requirements, i.e., contractors having DOD contracts or subcontracts requiring settlement of indirect rates. For contractors with government reimbursable contracts awarded by civilian agencies only, be aware that audits of those ICPs may take a back seat to predominantly DOD contractors, and that accomplishment of civilian agency ICPs is also contingent on interagency funding available for those civilian agencies to pay the DOD for DCAA's services.

Events, regulations, and policy directives in place during CY 2012 that will have an effect on ICP audits follow:

- DCAA revised its ADV threshold from $15 mil to $250 mil for qualifying ICPS as "low risk" that could be subjected to a sampling selection process. (ADV means annual dollar volume of costs incurred by a contractor for flexibly-priced or reimbursable contracts or subcontracts). To qualify for audit sampling, DCAA policy stipulates that ICPs below the $250 mil ADV level must be (1) deemed adequate (using current adequacy checklist) and (2) meet DCAA's low-risk proposal criteria. Any proposal within the ADV range not meeting the criteria will be considered high risk and audited. The change in low-risk sampling policy was designed to reduce ICP backlog and beginning in late 2012, contractors are already being notified

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that they are low risk and that indirect rates for multiple ICP years will be accepted and finalized as submitted. Although there is still some subjectivity involved in defining low risk, the end result will be a significant and unprecedented increase in contractor auditable dollars which are essentially unaudited (accepted as certified by the contractor)

- Changes to the FAR contract close-out regulations were implemented in May 2011 to, among other things, define criteria for an "adequate" proposal submission; specifically the provision, implemented in FAR 52.216-7, Allowable Cost and Payment clause, stipulated the specific schedules and data required upon submission to meet the adequacy requirements (FAR 52.216-7(d)(2)(iii)), while clearly stating that other data (FAR 52.216-7(d)(2)(iv)) did not require submission with the ICP to be adequate (but could be requested as needed after the submission). DCAA has since modified its ICP adequacy checklist which now delineates, as a matter of determining adequacy, only those schedules/data required per the new FAR rule.

  Client experience, however, has shown that DCAA auditors apply the checklist attributes much too rigidly, and in some cases, request supplemental data not required in the checklist; consequently a significant percentage of ICPs are still returned as inadequate. In many cases, the adequacy review is several years after the ICP submission date and the inadequacies are miniscule and immaterial issues such as minor mathematical errors, or note that schedules are out of order. Rejections of ICPS as inadequate based on minutia and/or overly-complex review process inexcusably delays accomplishment of audits and works against the contracting office objectives for closing out contracts.

- DCAA continues to use "virtual" ICP audit teams with the sole responsibility for auditing ICPs which appears to be significantly reducing instances of the stop and go process.

- DCAA sends mixed messages to its auditors in guidance directives, on one hand, encouraging auditors to streamline the audit process via multi-year audit techniques, use judgmental sampling techniques when appropriate and exercising individual judgment when scoping an audit based on risk. However, in a May 2, 2012 memo, auditors were informed they are not performing adequate detailed testing of transactions to identify those which should have been question due to inadequate contractor support or as expressly unallowable, or do not document judgment as to audit risk or sampling and testing methodologies.

- DCAA auditors continue to "over-audit" by testing massive numbers of cost transactions, requesting general ledger transaction "data dumps" to enable variable sampling, and insisting on multiple layers of documentation to support those costs; supporting detailed data requests often tend to be documents the auditors believe should have been created, rather than the accounting information the contractor generated. Moreover, information requested by auditors to support cost transactions go well beyond what is really required to verify the allowability of costs—requests for personnel files, human resources policies, and evidence of electronic transfers of payroll amounts to employees' checking accounts to verify contract labor charges are not ordinarily necessary unless internal controls deficiencies exist.

- DCAA auditors are using vague cost allowability concepts such as FAR 31.201-3 (Reasonableness) and FAR 31.201-2(d) (adequate documentation) as "wild-cards" to

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question costs which had previously been accepted by DCAA in ICP audits (those predating the 2008/2009 GAO reports).

High risk ICP issues for contractors to be aware of in CY 2013:

- If your company meets the ADV criteria DCAA has now established that may qualify any of your ICPs subject to the low-risk sampling process, after you have submitted the ICP, ask the auditor if the ICP is considered adequate and if it meets the low-risk criteria. Although DCAA seems to have this process well managed and internally well-publicized, you need to know the status of your ICPs and to ensure auditors do not begin an audit if it meets the low-risk standards unless it has been selected for audit from the sampling pool.

- Auditors will continue to use strict "adequacy" standards in accepting or rejecting ICPs for audit; contractors should double check all ICPs carefully before submitting; above all ICPs should be submitted on time (within six months after the fiscal year end). A reminder, under the new FAR close-out rule and as acknowledged In DCAA ICP adequacy checklist, there is no requirement that contractors use the ICES or any format, leaving it optional for the contractor to present the required data within its own spreadsheets, , schedules or reports as long as the substantive data under the regulations is provided.

- Expect auditors to extensively test transactions, request detailed supporting documentation going beyond traditional top level cost information, and challenge costs based on lack of documentation (using FAR 31.201-2(d)). Contractors should anticipate that if an auditor requests specific data and the contractor does not provide that specific data, DCAA will question those costs and the debate over adequate documentation will only be resolved with the contracting officer.

- Although auditors have improved communicating preliminary ICP audit results with contractors, interim or draft audit results are likely to be insufficient in fully describing the regulatory basis for the questioned costs. However, auditors frequently demand from contractor responses (concur or non-concur) in a compressed time frame; hence, we caution our clients to request additional time, additional DCAA explanations and to generally non-concur if the audit findings are ambiguous, incomplete or erroneous.

- Where ICPs are to be audited for fiscal years going back several years, DCAA will require all original documentation, although some original records may no longer exist. Provisions of FAR 4.705 do not require retention of certain financial, pay, labor charging, and acquisition data to be maintained beyond a stipulated period after the fiscal year in which the transactions occurred. Although auditors have absolutely no authority to override the contractual retention periods, contractors should expect these challenges because DCAA field auditors are being directed by DCAA policies to question costs unsupported by requested original documents. Issue resolution will likely be deferred to the contracting officer.

- Specific high risk cost categories will be reviewed if your ICP is audited—as discussed in "Cost Allowability" which follows, those may include business travel, executive compensation, professional/consulting fees, legal costs, bonuses, business meals and meetings, public relations/advertising, and anything that smells like employee entertainment.

- If reimbursable subcontracts are a cost component of the prime contractor's final

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year-end costs subject to ICP audit, primes should be aware that the government will expect a satisfactory subcontract management process during the performance of those subcontracts. Auditors may have reviewed this during a DCAA prime contractor billing or accounting system reviews; however, this typically resurfaces as auditor requests during an ICP audit for policies, procedures and other documentation of subcontract management.

## Cost Allowability

Our predictions of cost categories that remain at highest risk of review and challenge have not varied significantly over the past several years. Based on our experience with clients in 2012, the cost elements discussed below, in our opinion, represent those most likely to be audited and questioned during ICP and bid proposal audits.

**a. Employee Compensation**

Contractors should be aware of important trends which continue to focus on contractor executive compensation. Throughout 2012 and within the 2013 NDAA (National Defense Authorization Act), there are continuing pressures to reduce allowable executive compensation and bonuses.

During 2012, Congressional leaders, the White House, Federal employee labor unions, and government spending watchdog groups increased their demands for lower caps on executive compensation. To date, there has not been any change in the regulations or the basis for determining the cap for executive compensation, whereby statutory ceilings are established for the top five most highly paid personnel in management positions (FAR 31.205-6(p)-- the current annual cap is $763,029 for contractor fiscal year 2011 for costs incurred after January 1, 2011; a cap for FY 2012 has not yet been established). In the 2012 NDAA there was a change which will expand the cap to all executives (not just the top five), but that has yet to be implemented and it appears that when implemented, it will only apply to DOD contracts. Although the 2013 NDAA dropped any other revisions to the cap, it did include a requirement for the GAO to "study executive pay rates and their impact on recruitment of industry talent." Suffice to say that the debate will continue and the GAO study will predictably reinvigorate the debate "adding fuel to the fire", but there is no way to accurately predict the end result.

During 2012, the DCAA's audit approach in evaluating executive compensation for reasonableness took two hits from the ASBCA which ruled in two separate decisions that DCAA's compensation benchmarking and/or statistical techniques used to question incurred executive compensation costs were flawed. While one would think that DCAA would withdraw and revise its approach in analyzing contractor compensation costs for reasonableness, our recent client experience shows no changes to DCAA's statistically flawed benchmarking which is little more than a highly subjective and narrowly-focused approach solely designed to maximize questioned costs.

We predict that auditors will continue to deploy the exact same benchmarking techniques during annual ICP audits and aggressively question costs as if the ASBCA cases never happened. Contractors are cautioned to anticipate these challenges and to obtain and to maintain reliable wage survey information which annually measures the reasonableness of executive compensation to the wage survey data.

Finally, employee bonuses will remain a high priority for audit review during ICP audits. The FAR 31.205-6(f) bonus allowability

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criteria: (1) awards or payments must be supported by an agreement between contractor and employee, or an established practice or plan must be consistently followed by the contractor, and; (2) the basis for the award is supported. During 2012, auditors have shifted to a new tactic which is to question costs using the second criteria—that the basis for the awards was not supported. Although well beyond anything required by the regulation, DCAA auditor expectations included employee performance targets mapped to employee appraisals and similar detailed formulas and detailed metrics for measuring bonus amounts for each employee. Contractors should be prepared to support the basis for employee awards at least on an aggregate basis.

**b. Professional and Consulting Fees**

Auditors historically focused on the FAR 31.205-33(f) requirement for documentation as a condition for allowability—adequate agreement, invoices identifying time expended and evidence of services provided (such as work product if applicable). More recently, DCAA appears to have expanded its audit criteria utilizing 31.205-33(d) which delineates eight other factors in determining the allowability of costs; in particular, a documented determination that the services cannot be more economically performed in-house.

Functions generating professional costs fees which are high on the list for audit evaluation include business development & marketing, attorney's fees, political activity or legislative interface, and changes in the financial structure or ownership of a company (all potentially involving expressly unallowable costs such as lobbying, legal defense against a government proceeding or organization costs).

**c. Public Relations and Advertising**

Contractors should expect that any costs associated with trade shows, public display of products, advertising of company capabilities (sometimes framed as an allowable employment notification), and re-configuration of logos/trademarks (due to company acquisition) will be sought out and likely questioned by auditors.

**d. Employee Morale, Welfare, Gifts and Entertainment**

Auditors have been more myopic in evaluating and challenging any cost that appears to be entertainment or recreation in nature. Given a recent ASBCA court ruling (Thomas Associates, Inc., Case 57795) which upheld the disallowance of flowers for employees for certain occasions (wedding, birth, funerals) as expressly unallowable "gifts provided to employees at no cost", contractors are put on notice that certain employee welfare costs, traditionally considered allowable, albeit in the "gray zone", may experience challenges of such costs. Examples include the monthly birthday cake, food served during or after a business meeting, or bottled water and coffee provided at no cost to the employee.

**e. Business Meetings and Conferences**

Auditors continue to question costs associated with business meetings and conferences primarily because in the auditor's opinion, there was insufficient documentation to substantiate the nature and purpose of these activities. Questioned costs have most frequently arisen during incurred cost proposal audits, and examples of questioned costs due to lack of documentation include (1) in-house training event—employee sign-in sheet was not available, although completion certificates, instructor agenda & power point presentation, and internal requisition to procure services with a consulting

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agreement were in place; (2) rental of hotel conference room—company did not have formal requisition and company purchase order in place for the rental facility (total rental cost--$900).

In the absence of very detailed documentation, auditors simply presume that events are entertainment; hence, unallowable costs under FAR 31.205-14. In fact this was also an issue in the Thomas Associates, Inc., ASBCA Case 57795 where a one hour business meeting followed by a 21 hour company party was deemed to be entertainment in its entirety.

**f. Employee Business Travel**

Thanks to the high-profile GSA scandal where that agency was accused of incurring $835,000 in excessive and unnecessary travel and other business training expenditures during a Las Vegas training/meeting event, government contractors will draw more audit scrutiny of travel and business related expenses. OMB issued revised travel policies as a result of this debacle to alleviate risk of excessive business meeting and travel expenses—examples, sharing rental autos and negotiating reasonable hotel rates. Even before the GSA disaster, government auditors have always considered travel expenses as an easy target for questioning costs. During audits of ICPs, audit interpretations of FAR 31.205-46 provisions are one of the most frequently misapplied of the cost principles by government auditors in determining unallowable vs. allowable costs.

Given our experience during 2012, the types of travel expenses most likely to be reviewed:

- Auditors may expect a demonstration that contractors justify air fares charged to the government for business travel are the "lowest available to that contractor" during business hours; DCAA guidance suggests that a policy on advance travel planning be in place and that documentation of lowest fares were sought (multiple sources for airfare quotes) be available, both expectations of which are not required by the regulations.
- Business or first class airfare costs will be challenged even though contractors may meet the provisions of FAR 31.205-46(b) which provide a few conditions where air fare costs above the lowest available may be allowable. DCAA simply asserts that the documentation was insufficient to support the exception to the "lowest available airfare" FAR cost principle.
- Per diem (lodging plus meals & incidentals (M&I)) amounts above the FTR, JTR or State Department travel regulations' ceiling amounts continue to be challenged by applying individual ceilings for lodging and for M&I; the application of this provision from FAR 31.205-46 requires per diem (lodging and M&I) to be calculated as a daily total which is actually stated in DCAA's Contract Audit Manual.. For contractors which reimburse actual meal costs, DCAA has frequently asserted that detailed counter receipts, rather than summary credit card receipts or statements, are required.

Auditors will continue to challenge all employee travel expenses if documentation requirements stipulated in 31.205-46(a)(7) which require the date and place of the expenses, trip purpose and traveler name and association with the contractor are not evident.

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## Contractor Business Systems

The DFARS was changed in May 2011 (interim rule) to incorporate the Contractor Business Systems rule (DFARS 252.242-7005) including the definition of the six business systems and the adequacy criteria for each applicable system. The rule became final in February 2012; however, the substance of the rule was not changed from the May 2011 interim rule at which point DCMA prepared relatively comprehensive training materials (publicly accessible) which provided a reasonably complete and accurate discussion of the rule as well as DCMA's initial plans to administer the rule. DCAA waited until April 2012 to issue its publicly accessible audit policy, 12-PAS-012, which only pertains to one of the six business systems (the accounting system) with a promise that future policies would be issued dealing with other business systems for which DCAA has cognizance. DCAA has not kept its promise; hence, there is no way of knowing if or when DCAA will issue audit policies on other business systems.

In discussing business systems vis-à-vis the DFARS rule, it should be recognized that the rule and its business systems requirements only apply to DOD contracts which are CAS covered; hence, the vast majority of government contractors are not subject to the DFARS business systems rule. However, all contractors are potentially subject to FAR Part 9 and the contractor qualifications including an adequate accounting system for which DCAA audit criteria will likely invoke most of the DFARS 252.242-7006 accounting system criteria..

As to the evolution of DCAA audits of contractor compliance with the DFARS Business Systems rule, a very few audits have been in process or completed as "pilot tests" of DCAA's comprehensive audit of the contractor accounting system. Additional contractors have been advised that their accounting system will be audited in 2013 and in all cases, those contractors can expect a fusillade of DCAA requests for data along with the audit request for a contractor walkthrough of the accounting system. In particular, that walkthrough should be designed by the contractor to focus on the DFARS 252.242-7006 accounting system criteria (18) and the contractor policies and procedures which reasonably assure compliance. Beyond the walkthrough, DCAA will perform seemingly endless substantive (transaction) tests, but a contractor is dead on arrival if it has not consciously mapped its policies and procedures to the relevant systems criteria.

In addition to the accounting system for which DCAA appears to be solely responsible for the fieldwork to evaluate contractor compliance, all of the other five systems will logically involve DCMA testing for compliance. Whereas "Government Property" will almost exclusively involve DCMA, Estimating Systems will be primarily if not predominantly a DCAA evaluation. The other systems, EVMS, MMAS, and Contractor Purchasing will involve a mix of DCAA and DCMA evaluations, but in all cases the Contracting Officer (typically DCMA) is the government official solely responsible for determining if the contractor is compliant with the system criteria. This includes a determination of the existence or absence of a "significant deficiency" defined as a shortcoming in the system that materially affects the ability of officials of the DOD to rely upon the information produced by the system". In other words, for all six business systems, DCAA is clearly an advisor to the contracting officer. DCAA's advisory role is not as clearly defined in other applications, including the accounting systems for non-major contractors wherein FAR Part 9 simply does not explicitly limit the auditor to an advisory role.

As DCAA and DCMA begin the process of planning for the evaluation of a contractor's compliance with applicable business systems, both agencies have identified a more expedient means to effect a 5% withhold (for a system with a significant deficiency, DFARS states that the government shall withhold 5% of interim payments). Lacking the resources for comprehensive evaluations, both agencies have made note of the fact that their knowledge of pre-existing conditions could also serve as the basis for asserting that a significant deficiency exists; thus the 5% withhold. DCMA's training material presented this

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in a "Q&A" format, where DCMA knowledge of previous issues should be supplemented by a current re-assessment to determine if the previous issue(s) still exist. In fact, that strategy has been evident within a number of EVMS issues where the DOD issued press releases identifying contractors with EVMS "significant deficiencies" and the amounts that were being withheld under the new DFARS Rule.

However and much to DCMA's credit, not every pre-existing condition has led to a with-hold under the new DFARS Rule. A number of sources have reported that DCAA has presented DCMA with 15 audits citing current business systems deficiencies; however, DCMA, through its internal coordination and review board process, has only agreed with 5 of those DCAA audit reports. Purportedly, a number of the rejects were for issues previously reported by DCAA for which the contracting officer had previously disagreed with DCAA's interpretations and opinion. Although this is barely a beginning, this is a great indicator that DCMA is making an independent determination and not merely rubber-stamping the findings within the DCAA advisory audit report.

As previously noted, regardless of one's previous success with government evaluations of a business system, we suggest that compliance will depend upon an internal contractor process which (for each applicable business system) reviews the current regulatory criteria, independently self-assesses for compliance with each criterion and documents that self-assessment to serve the dual purpose of demonstrating internal management reviews and creating the basic framework for that all important future "walkthrough" for DCMA and DCAA.

## Cost Accounting Standards (CAS)

Cost Accounting Standards have seemingly fallen off the radar notwithstanding the fact that two years ago DCAA and DCMA announced an initiative to recover hundreds of millions on outstanding CAS issues. As a matter of a publicly stated policy, DCAA no longer audits for CAS compliance other than as a secondary consideration within a different audit; for example, compliance with applicable standards is embedded within a DCAA audit of an annual indirect cost rate proposal which does not prescribe any specific audit tests. In fact, this is a DCAA internal resource issue whereas nothing in CAS has actually changed other than i) the long awaited change in CAS 412/413 for the pension harmonization with the PPA (Pension Protection Act) and ii) the elimination of the CAS exemption for contracts and subcontracts executed and performed entirely outside the United States.

The pension harmonization is of great interest to contractors with Defined Benefits pension plans; however, the complexities of CAS 412/413 as well as the pension harmonization do not lend themselves to discussions in an annual newsletter other than to say that if applicable, a contractor needs to closely read the CAS revisions and to set aside any thoughts of immediate and total cash flow equalization. The "harmonization" effectively permits the contractor to recover (presumably) increased pension funding over a period of years analogous to amortization periods for actuarial gains and losses.

The elimination of the foreign CAS exemption (directed by Congress) will most likely impact prime contractors who issue subcontracts with foreign companies for which DCAA has publicly stated that it is the prime contractor's responsibility to manage subcontract CAS compliance. As US Prime Contractors issue subcontracts to foreign entities who will now be subject to certain CAS (401 and 402) and more awkwardly, the requirement to submit a CAS Disclosure Statement, we can hardly wait for the non-value added time and effort spent to deal with backlash from foreign subcontractors (subject to international financial accounting & reporting standards) who are told to prepare US GAAP based CAS DS (Disclosure Statements). Although the CAS Board originally declined to eliminate the foreign CAS exemption, Congress essentially told the CAS Board, "wrong answer" leading to the new and unwieldy requirement. US Government prime contractors should appropriately charge these contract specific administrative costs directly to the applicable prime

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contract even if such cost accounting treatment requires a change in the prime contractor CAS DS (a change required to comply with a new regulation).

In terms of business as usual, any contractor subject to CAS must be fully aware of the individual standards and the administrative provisions of FAR Part 30. Failure to comply with CAS can be expensive inclusive of punitive interest accrued back to the date of an alleged noncompliance including any impact on administratively closed CAS covered contracts. Equally important, failure to comply with CAS could be a DFARS Business Systems issue (criterion #18 within the accounting system criteria) and perhaps most important, a "past performance" black mark.

We suggest that minimizing the risk of CAS non-compliance begins with internal expertise in tandem with roles and responsibilities which effect internal oversight. In some cases, the CAS compliance "task master" may be at odds with those who would prefer maximum flexibility (e.g. business development and capture managers), but the fact is that CAS invokes an over-arching constraint in cost estimating and bidding strategies which must be consistent with the cost accounting structure. Intentional or unintentional non-compliances carry the same risks and potential financial penalties; long-gone are the days when an intentional noncompliance had more severe implications.

## T&M (Time and Material) Contracts

T&M contracts are considered the least desirable contract type (i.e. FAR 16.601(d): the contracting officer prepares a determination and findings that "no other contract type is suitable"). T&M contracts are assumed to be high-risk to the government and low-risk to the contractor because the contractor has no other incentive but to incur hours and to bill those hours up to the contract funding. Until February 2007, there was one additional government risk which was that of a prime contractor providing labor hours by substituting subcontractor personnel; qualified, but at a lower cost than prime contractor personnel resulting in government perceptions of a "windfall profit" to the prime contractor.

In February 2007, FAR was changed to preclude "mixing and matching" (billing subcontractor employees at prime contractor rates or at blended prime/subcontractor rates). Since 2007, subcontractors must now have separate and distinct "T" rates and in all cases before or after 2007, an employee (prime or subcontractor) must be qualified for the "T" (labor category) to which that employee charges his/her time. In conjunction with the FAR changes, DCAA issued its audit policy, 07-PPD-023, *Audit Guidance on Time & Material (T&M) and Labor Hour (LH) Contracts*, citing the new FAR 52.216-29, 30 and 31 along with expectations that during incurred cost audits, auditors will selectively verify that claimed amounts are in accordance with applicable contract terms (the new FAR) and for contracts executed before February 2007, that claimed amounts are in accordance with existing contract terms.

Although it was relatively easy for DCAA and everyone else to interpret the restrictive contract clauses effective after February 2007, DCAA's reference to existing contract terms (pre-February 2007) was something of a secret code which is only now being "de-coded" as DCAA audits pre-2007 incurred costs. In the context of the DCAA incurred cost audits, it should come as no surprise that there actually is contractor risk that the DCAA auditor will disallow previously recorded, invoiced and paid T&M billings along with an after-the-fact government demand for repayment. In most if not all cases, these issues are long after the fact (services provided and billed by the contractor and long-since accepted and paid by the government customer) and few contractors (if any) established any provisions for contingent liabilities (for billings in excess of final cost recovery).

As DCAA executes the long delayed incurred cost audits, there are at least two fundamental issues or contractor risks; i) subcontract employee hours billed

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at prime contractor "T" rates and ii) documentation supporting the prime contractor employee qualifications vis-à-vis the contract specific qualifications for each labor category (i.e. years of relevant experience and education level). Regarding subcontract employees, unless the T&M prime contract (pre-dating 2007) explicitly states that subcontract employees are billable at a prime "T" rate, DCAA will automatically disallow all subcontract hours billed at prime "T" rates even if the prime contractor can demonstrate that its proposed "T" rates are inclusive of subcontractor employees (e.g. blended rates). If DCAA disallows subcontractor hours, DCAA should allow at least a partial offset to those questioned costs, which would equal the subcontract costs billed as a reimbursable cost under the "M" component of the T&M contract (subcontract costs billed to the prime contractor plus any allocable prime contractor indirect costs). In most cases, the subcontractor costs are less than subcontractor hours billed at the prime contractor "T" rates; hence, the end result (of the DCAA audit) is that the prime contractor will owe the government a partial refund.

The other issue is documentation sufficient to convince the DCAA auditor that the selected employee was qualified for the "T" rate at the time the hours were incurred and billed to the government. This documentation invariably involves personnel files which are typically designed for HR purposes and only coincidentally designed to achieve clear mapping to a contract specified labor qualification. Most troublesome is documentation supporting the "years of relevant experience" particular to a specific contract because DCAA auditors are seemingly incapable of deductive thinking. Even if the documented facts and corroborating (deductive) information implicate that the employee was qualified, DCAA auditors only rely on "black and white" documented data and rarely (if ever) do DCAA auditors consult with government customers for help in interpreting the deductive or intuitive information. Many contractors have been blind-sided by significant cost disallowances because the contractor does not have that crystal-clear and precise personnel documentation sufficient to convince a non-technical DCAA auditor that an employee met all contract stipulated qualifications. The significant disallowances are 100% of the amounts invoiced for that employee (auditors do not allow any offsets such as re-computing the hours billed at a lower rate labor category).

We suggest that contractors or subcontractors with T&M contracts are anything but risk free and that anyone with T&M contracts is well served by reviewing personnel files and when necessary, obtaining and retaining additional documentation which "maps" an employee to the employee qualifications contained in the T&M contract. The concept of mapping to rate categories should be deployed prospectively and that process should be start-to-finish process beginning with the documentation supporting the bid proposal and flowing into the documentation for cost accounting and ultimately for records retention until contract close-out.

## Documentation, Records Retention and Access to Records

Government contracts commonly invoke FAR 52.215-2, *Audit and Records--Negotiations* which is the clause which has frequently been renamed the "Access to Records Clause" which allows the government access to contractor (or subcontractor) books and records associated with government contract performance (costs incurred) and/or certified cost or pricing data (proposed costs). Interrelated with the contract clause are FAR 4.700, *Contractor Records Retention* and FAR 31.201-2(d) *Determining Cost Allowability* (specifically the "contractor responsibility for maintaining records adequate to demonstrate costs claimed have been incurred are allocable and comply with applicable cost principles").

Historically, the primary challenge has been defining those records to which the government is entitled with an obvious example of "non-entitlement" being commercial items and services; self-evident because commercial contracts do not even include FAR 52.215-2. For contracts which do include this clause,

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the historical government-contractor disagreement has been on those records which do not directly support contract costs with examples being Board Minutes, Tax Returns, Financial Statements and Internal Audits. With the exception of Internal Audits, litigation has established the government's audit access rights to everything else; however, the 2013 National Defense Appropriations Act (NDAA), section 832 requires that DCAA revise its guidance on access to defense contractor internal audit reports (including the Contract Audit Manual) to include documented requests for internal audits, the contractor response (if access was not granted) and (audit policy) assurances that contractor internal audits cannot be used for any purpose other than evaluating the efficacy of contractor internal controls and the reliability of the associated contractor business system.

Although the 2013 NDAA stopped short of expressly requiring contractors to release internal audits to DCAA, it should be noted that the DFARS Business Systems rules include requirements for contractor internal management reviews or internal audits which seems to "seal the deal" for those contractors. Specifically, contractors subject to the DFARS rule must perform and provide evidence of performing internal reviews (or audits) on the applicable business systems and if a contractor ignores this requirement or refuses to provide the internal report, assume a very obvious risk of being cited for non-compliance with the DFARS rule. Unfortunately, the 2013 NDAA does not begin to answer all of the likely questions and DCAA-contractor disagreements in terms of exactly which contractor internal audits apply to the "associated contractor business systems" and to what extent anyone can assure a contractor that DCAA will restrict its usage of the internal audits to evaluating the "efficacy of the internal controls". Moreover, the 2013 NDAA does not extend the DCAA access (contractor internal audits) to civilian agency contracts (non-DOD) which coincidentally do not include any explicit requirements for six business systems.

All contractors subject to DCAA audits should anticipate DCAA auditor requests for access to "internal audits" and those who view life as "the glass is half full" may perceive this as the chance to convince DCAA to reduce its audit scope through some reliance on contractor internal audits (as suggested by the 2013 NDAA). We believe that DCAA may be more likely to partially rely on internal audits, but the only sure thing is that DCAA will request them and once DCAA has access to an internal audit report, it will be difficult if not impossible to control DCAA's usage of that internal audit report. If DCAA actually relies on a contractor internal audit or management report, it may be invisible because DCAA will simply apply a pre-determined total number of audit hours to complete the audit with or without access to "relevant" internal audits. For those contractors who refuse to provide internal audits, the 2013 NDAA may not compel the contractor to provide them, but based upon a 2012 DCAA audit policy, the contractor should anticipate a DCAA assertion of a "denial of access to contractor records".

Beyond the debate over access to internal audits, another access to records issue, newly created by virtue of a 2012 DCAA audit policy, is DCAA access to attorney-client privileged documentation. In contrast to long standing audit policies which recognized that FAR 52.215-2 cannot possibly trump attorney-client privilege, DCAA auditors are now required to report contractor assertions of attorney-client privilege as a denial of access to records (assuming the contractor and auditor cannot agree on some alternate records which will satisfy the auditor's request for data). We suggest that contractors be aware of this new challenge coming from auditors who are merely told to request data even though the agency should know that it is "barking up a tree". One other caution is that more than one auditor has stated (to a contractor) that you can give me the privileged data and still retain the attorney-client privilege. Perhaps well intentioned, but absolutely wrong and the auditor has no business providing such assurances on a legal topic. As is often said, if it doesn't sound right, it probably isn't.

As if contractors don't have enough challenges, documentation has become one of DCAA's "wild

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cards", using FAR 31.201-2(d) in challenging cost allowability on incurred costs going back years and years (e.g. the earliest unaudited incurred cost year, in some cases back to 2004 or earlier). DCAA auditors are requesting multiple forms of documentation to support a transaction. For example, in support of a labor transaction, data including the labor distribution report, the payroll register, cancelled check, employee personnel file, employee W-2, employee photograph/driver's license, employee contract or agreement as if "all of the above" are required by 31.201-2(d). If the contractor provides 5 of 6 data items, the auditor will question the cost notwithstanding the overwhelming evidence supporting cost allowability and more egregiously, ignoring certain records retention regulations (FAR 4.705) which explicitly state that a specific record need only be retained for a period of time (which has long since lapsed).

Perhaps the last full measure of DCAA's intentional disregard for regulations pertains to original records versus scanned records for which FAR 4.703 only requires the original to be retained for one year after scanning. As a matter of policy, DCAA asserts that it cannot rely on scanned records because DCAA did not audit the scanning process. Although DCAA could have evaluated the scanning process at any point in time, it never bothered to do so and nothing in FAR provides any requirement for "audit validation".

We suggest that contractors anticipate both the old and the new DCAA challenges involving access to internal audits or management reports, records retention and documentation. In some cases, it may be feasible and affordable to supplement historical data with additional documentation in advance of a DCAA audit; however, in any case, contractors subject to DCAA audits should re-visit current processes to prospectively create and retain documentation sufficient for DCAA. It doesn't matter that DCAA is "out on a limb" with its expectations; ultimately if it is feasible and affordable, the path of least resistance is the preferred path when dealing with DCAA on ill-defined and/or highly subjective audit interpretations. This does not apply to attorney-client privileged documentation nor does it apply when the cost to satisfy DCAA expectations is unaffordable or it is simply impossible to supplement historical records or to re-create originals.

We are optimistic that DCMA will not sustain DCAA in those situations where a DCAA assertion is inconsistent with explicit wording of a regulation (e.g. scanning). However, there will be many situations where the regulations are not explicit and the pressure (on DCMA) to sustain DCAA obviate all other considerations. In those cases, more and more issues will probably find themselves in the CDA (Contract Disputes Act) backlog.

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