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2013 Defense Authorization Act

By Michael E. Steen, CPA, Technical Director at Redstone Government Consulting, Inc.

The Senate recently & unanimously passed the 2013 NDAA (National Defense Authorization Act) inclusive of a number of sections which are unfavorable to defense contractors continuing a trend which started in March 2009 when the Executive Branch issued its initial statements critical of defense spending and reached something of a rhetorical high point in late 2009 when President Obama stated that the federal government can no longer spend taxpayer's money like "monopoly money".

It should be noted that the Senate's 2013 NDAA action must now be reconciled with the House version; hence, at this point nothing is final and whatever is final, it will only be applicable to DOD contracts funded with FY2013 appropriations after a to-be-determined applicability date. Many contracting amendments included within the FY2013 NDAA were authored by Senator Claire McCaskill in her Comprehensive Contingency Contracting Reform Act for which the Senator provided self-congratulatory remarks that "Harry Truman would be proud of what we accomplished in the Senate here today". (Editor's comment: we seriously doubt that Harry Truman would be proud of any aspect of anything accomplished or more accurately delayed by either the Legislative or the Executive Branch).

The following are some of the highlights of the 2013 NDAA recently passed by the Senate:

- Prohibiting cost-type production contracts for MDAPs (Major Defense Acquisition Programs) unless the Under-Secretary certifies that a cost-type contract is required. This will potentially force early production contracts (e.g. LRIP or Low-rate of initial production) into fixed-price incentive contracts for which contractors will be assuming significant risks notwithstanding the fact that budgetary pressures will effectively prohibit contracting officers from increasing target profit rates to offset the increased contractor risk.

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- Limiting pass through costs; specifically that for services contracts, at least 50 percent of the direct labor costs will be performed by such contractor's employees or by a subcontractor specifically identified in the contract. Oddly this section was authored by Senator McCaskill who has self-proclaimed her acquisition expertise and contract audit expertise; however, the Senator confused the issue by referring to direct labor costs. In the context of FAR or CAS in application to a prime contract, subcontract labor is categorically not "direct labor costs". It is equally odd that this section made no attempt to consider the existing limitation within the current FAR 52.215-23 limitation on excessive pass-through costs.

- Limiting allowable compensation for contractor employees to $230,000 (the maximum annual aggregate pay limit for federal employees); in contrast, the current statutory cap (FAR 31.205-6(p)) is $763,029. In trying to gauge the equity of a $230,000 cap (which had been proposed by the President at $200,000), one point of reference (never mentioned by Senators, Congresspersons or the President), the legal limit applicable to compensation for the USPS (US Postal Service, an organization noted for its massive budgetary deficits) is $276,840 (as reported by the USPS' IG which also reported that in 2011 a Postal Service Officer earned $306,250 including a bonus of $61,250). One other point of comparison, during the 2009 Financial Institution (Bank) bailouts when the US Government essentially took control of the compensation for those banks which accepted significant bailout amounts, the salary cap was $500,000 plus bonuses. Apparently in the view of the US Senate, Defense Contractor Executives deserve substantially less compensation than the government controlled compensation for the "highly successful" USPS and equally "successful" US Banks which allegedly would have gone under had they not been propped-up by the US Taxpayer funded bailouts.

- Authorize DCAA access to defense contractor internal audit reports related to the efficacy of contractor or subcontractor and the reliability of the contractor or subcontractor business systems. If access to internal audits is ultimately included within the regulations, this would not add much to the existing DFARS Business Systems Rules (252.242-7005) which already include compliance criteria which reference and implicate government access to internal audits or internal management reviews. However, anything added by way of 2013 Defense Appropriations would likely be interpreted more broadly by DCAA who freely interprets any regulation to support DCAA's preferred wording. In fact, DCAA apparently believes that it already has unlimited access to government contractor internal audits (reference to DCAA Audit Policy 12-PPS-019) as well as a contractor's attorney–client privileged documents (reference to DCAA Audit Policy 12-PPS-018).

There are numerous other amendments (sections) which deal with conflicts of interest, human trafficking, no limits on set-asides for women-owned small businesses, expanded whistleblower protections and those dealing with acquisition management and program cost controls (amendments to achieve a more cost effective DOD which are a recurring, annual event suggesting that every similar prior amendment has been unsuccessful).

The 2013 NDAA included a series of sections, "Provisions Relating to Wartime Contracting", which will add numerous administrative provisions to DOD's burden of actually fighting a future war. Although contributing absolutely nothing to any war efforts, most of these amendments/sections will primarily allow the Legislative Branch to second guess the DOD and the military. One in particular, that within six months of commencement or designation of an overseas contingency operation expected to involve combat, that DOD perform a comprehensive risk assessment and risk mitigation plan which will be submitted by the Secretary of Defense to the Defense Appropriations Committee. This will undoubtedly serve as a baseline for after-the-fact criticism by the Defense Appropriations Committee as if this civilian committee has a clue in terms of mitigating risk in combat.

And one last proposed amendment (section) which apparently did not make the cut, a proposal that would have linked DOD civilian and contractor workforces to the percentage reduction

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in funding for the military drawdown. This amendment sponsored by Senator John McCain met significant opposition including a statement from the Executive Branch that any provisions requiring automatic DOD civilian and/or contractor workforce reductions would result in "staff recommendations that the President veto the bill". By all appearances, this is the President's position on the issue; however, the threatened veto would apparently be based upon "staff recommendations". Not that we endorse any automatic DOD civilian or DOD contractor reductions, but why mask it as "staff recommendations".

One other very coincidental fact, Senator McCain's recommendation (linking DOD civilian and contractor workforce reductions to military funding reductions) is coincidentally identical to a DCAA audit report in 2010 wherein DCAA, in an economy and efficiency audit report (operations audit), recommended that contractor costs are unreasonable because DOD contractors (Iraq) did not draw down their workforce in parallel to the military drawdown, ignoring the fact that contract statements of work did not allow such an arbitrary drawdown. Stated differently, in the somewhat blurred vision of DCAA, contractors should have drawn down staffing disregarding contractual requirements which could have resulted in a government invoked "termination for default".

Government Audits of Contractor Accounting Systems: Continuing Inexplicable Findings

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Redstone Government Consulting, Inc.

The Defense Contract Audit Agency (DCAA), as well as Civilian Agency audit oversight groups, continue a trend of reporting accounting system deficiencies that are either miniscule as to their impact on government contracts, absent of logic and/or the backing of regulatory provisions, wrought with subjective and preferential audit mindset of the way things should be, or simply factually incorrect and/or poorly written.

Many contractors receiving inadequate accounting system audit opinions are faced with both short-term and long-term adverse effects which may include withhold of a pending contract award or denial of payment on billings, or, longer-term, a perception of internal controls which create too much risk of overcharging the government, or an image of incompetence, both of which could push the company out of consideration for future government work.

In responding to audit findings, contractors are sometimes forced to respond aggressively to poorly supported, overstated as to significance, or simply false findings to mitigate a potential long-term damning stigma that the contractor is simply too high a risk to handle the taxpayer's money.

Conversely, many of our clients choose to suck it up, agree with findings, offer a corrective action plan, and implement that plan to present a spirit of cooperation and obviate the risk of long-term damage to the company's reputation, even though audit findings are sometimes "dumb and dumber". The frequent contractor practice of tacitly agreeing with audit findings and changing practices is precipitated by a history of Administrative Contracting Officers too frequently concurring with audit findings and mandating corrective action, regardless of any compelling contractor response rebutting audit findings with clear and factual data demonstrating findings are insignificant or not supported.

A few recent client accounting systems government audit issues are presented as follows to illustrate the discussion above:

- Contractor maintains an indirect fringe pool for a certain segment of employees in a particular product line, and allocates those fringe costs to government contracts performed by personnel within that product line; auditors state that the company must have company-wide fringe pools, where all employee fringes are grouped as indirect and allocated over all labor costs—auditor cites FAR Part 31 as basis with no specificity or further explanation. No regulation requires or even implies a defined treatment of all fringe costs in a single intermediate cost pool for allocation to all labor costs.

- Auditor opines that absence of written procedure defining unallowable cost detection practices are unsatisfactory because the words in the procedure omits "practice is applicable to ALL company work,

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government and non-government"; company has only one government contract, demonstrates that practices are effective, and that there is no reason for the applicability of capturing unallowable costs for commercial work, but the ACO agrees with auditor.

- During pre-award audit, DCAA states that company does not maintain a formal "project ledger" within the system that identifies accumulated direct contract costs, thus auditor cannot clearly determine if costs are reliable for billing; however, client maintains a subsidiary journal that shows direct costs by element and demonstrates costs included in this peripheral journal is traceable to billings and supporting data. In this case, the auditor has inserted what he/she believes to be a project ledger, but moreover ignores the fact that no regulation requires a "project ledger", but only stipulates that contractor must demonstrate actual costs by contract. This issue alone rendered the system inadequate, and the ACO withheld entire payment of invoices for several months.

- Auditors assert that absence of detailed business meals receipts (e.g., restaurant counter receipt showing what employee ordered—Big Mac, French Fries, and a Strawberry Martini) was a problem in accounting for unallowable costs (alcoholic beverages)—only credit card summary receipts were provided; assumption made by auditor, with no evidential data to justify, was that there could be unallowable costs in those meals, but the absence of detailed receipts was hiding the speculatively unallowable cost. The issue is one of "adequate documentation" for which no regulation prescribes the level of detail for business meals. Since the auditor did not have evidential data that clearly supported that alcoholic beverages were charged to the government, this should not have been an issue of capturing unallowable costs.

Other experiences in working with clients on reviewing accounting system audit findings, however, show that in many cases, auditors have legitimate issues that rise to the level of "significant", are well supported in the report dialogue, and are objective as to basis for findings. When supportable, un-biased, and significant audit issues are presented to the contractor, they must be remedied as expeditiously as possible. Unfortunately, until the continued government audit oversight mentality of "when in doubt, throw it out" is revised, contractors will continue to be challenged with some unsupportable or erroneous audit issues that will require decisions of whether to resist or to retreat.

Federal Circuit Affirms CBCA Allowability Decision of Contractor Litigation Costs

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Redstone Government Consulting, Inc.

A decision by the U.S. Court of Appeals for the Federal Circuit affirms a previous Civilian Board of Contract Appeals (CBCA) decision that litigation costs incurred by Boeing Co. to defend itself against fraud allegations under the False Claims Act (FCA) were allowable. The previous CBCA decision held that allowability of costs could be apportioned on a claim by claim basis, and determined that legal costs related solely to claims where the Government was successful were unallowable; costs related only to claims where Rockwell (Boeing) was successful are allowable, and; costs pertinent to defense of combined claims where Rockwell was successful and found liable are unallowable.

Incurrence of legal costs by Boeing (successor in interest to Rockwell International Corp) were precipitated by relator lawsuit filed in a U.S. District Court, the outcome of which was a $4.1 million judgment for the plaintiff; however, the Supreme Court found that the District Court had no jurisdiction in the matter. Subsequently, Rockwell requested from the DOE contracting officer payment of litigation costs incurred between the 1989 (point in time initial claim was filed), and 1995, the time that the government elected to intervene, but the DOE denied payment.

Rockwell appealed to the CBCA in a series of claims, and the Board determined legal costs incurred during that time frame to be allowable where Rockwell prevailed in those individual claims (absolved of any violation of the FCA). DOE appealed the decision, and Rockwell cross-appealed.

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In its decision, the Federal Circuit examined the content of two DOE contract clauses, one related to a "proceeding" provision (clause (e)(32)) where the outcome of an allegation is a condition of allowability when related to fraud issues, and the other, an Environmental Costs Clause which speaks more broadly to a claim (not connected to fraud issues). The Court separated the two clauses in examining the merits of DOE's assertions and found that the CBCA was correct in its application of clause (e)(32) in determining the applicability of contract provisions as to allowability of litigation costs incurred only where a "proceeding" was one borne of a FCA allegation.

GAO Proposed Fee for Bid Protests

By Michael E. Steen, CPA, Technical Director at Redstone Government Consulting, Inc.

In a shocking but veiled attempt to reduce the $16 trillion US deficit, the GAO is doing its part by recommending a $240 flat filing fee for bid protests (or perhaps a slightly different variable fee depending upon the number of documents filed).

The fee is a reaction to the ever growing number of bid protests and expectations of a continuation of a continuing bid protest trend as a reciprocal byproduct of declining procurement budgets. Obviously the $240 filing fee is not geared towards reducing the $16 trillion deficit; however, the GAO believes that a fee would eliminate the frivolous bid protests. Although there isn't any definition of "frivolous" vs. "legitimate" bid protests; there is one particular theory within the government (of frivolous bid protests) that incumbent contractors who are not the awardee on a "re-compete" will always file a bid protest which will force the contracting agency to extend the incumbent's period of performance during the pendency of the bid protest. Although we don't have any empirical data to prove it, we have to believe that there isn't any incumbent (which initially loses a contract re-compete) which would even blink at a $240 bid protest filing fee. Let's see, I spent hundreds of thousands in bid and proposal costs and lost a multi-year, multi-million or billion dollar contract—do I now spend $240 to file a bid protest?

In the absence of a filing fee, there is at least one reason why a contractor might balk at a bid protest; specifically that bid protest legal and related costs are unallowable under FAR 31.205-47. In virtually all cases, the amount of unallowable legal costs significantly overshadow the miniscule (proposed) filing fee; moreover, the reasons for the proposed filing fee (too many bid protests) seems to ignore the fact that bid proposal out-briefs (for unsuccessful bidders) are so limited as to provide almost no information concerning the government's source selection. For obvious reasons, such out-briefs are void of facts which could assist the unsuccessful bidder's bid protest leaving unsuccessful bidders with no choice but to file a bid protest to force government disclosure of critical source selection documentation. Rather than acknowledge government complicity as a factor causing the increase in bid protests, apparently the GAO would rather assume that the cause is the "sour grapes" behavior of losing contractors.

Independent Advisory Panel to Review Department of Homeland Security (DHS)

By Michael E. Steen, CPA, Technical Director at Redstone Government Consulting, Inc.

Congress recently passed a bill requiring an independent advisory panel review of the DHS Management Structure. In requiring this review, Congress has made note of DHS IG reports indicating continuing struggles with integrating 22 disparate legacy agencies merged (by Congress 10 years ago) into a single agency. Additionally, both the IG and the GAO have identified certain high profile DHS programs which have apparently resembled stereotypical DOD programs (i.e. significant cost growth and schedule slippages caused by promising too much too soon and at unrealistically low initial cost estimates).

If the DHS review is performed by a panel which is truly independent, perhaps the first observation and recommendation will be that the management structure of DHS is a by-product of the petulant actions of elected officials; hence, many of the ongoing issues are a reflection of the knee-jerk Executive and Legislative Branch actions (void of any planning) which resulted in DHS.

More likely, the "independent" advisory board will come up with observations and recommendations which magically

support Congressional pre-conclusions that DHS suffers from de-centralized management leading to duplication and waste along with weak oversight of major acquisition programs. DHS will then be required to track its progress and report to Congress, and we will never see any future DHS programs with significant cost growth and/or schedule slippages (it is the Christmas season and we still believe in Santa Claus).

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Orlando, FL

May 7-9, 2013 – The Masters Institute in Government Contract Costs
San Diego, CA

May 14-15, 2013 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
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Hilton Head, SC

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Washington, DC

October 9-10, 2013 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Orlando, FL

October 21-22, 2013 – Accounting Compliance for Government Contractors
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Instructors

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- Wayne Murdock
- Asa Gilliland
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