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Status on DCAA Executing Low Risk Incurred Cost Proposal Audit Process

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

The Defense Contract Audit Agency (DCAA) continues to pursue expediting “completion” of incurred cost proposal (ICP) audits utilizing its policy guidance delineated in its September 6, 2012 memorandum (12-PPD-023(R)). That policy defines criteria for identifying, stratifying, and randomly selecting adequate low-risk ICPs for audit. All low risk ICPs deemed adequate based upon DCAA’s ICP adequacy checklist, included within the stratified sample pools that are not selected for audit are to be closed by DCAA with a memorandum to the contracting officer. The exception to this rule is that if one low-risk ICP is selected for audit, other ICPS included in the sampling pools for the same contractor will not be unilaterally dismissed from audit until the selected ICP audit is completed.

Recent experience with many of our clients, especially those with ICPs that are several years old, are indeed receiving notifications from DCAA that their ICPs were considered low-risk, not selected for audit, and to be closed via an executed ACO (Administrative Contracting Officer) rate agreement letter with the client. The DCAA notification process may be via a formal letter to the contractor, or a less formal method such as an email. In any event, once the rate agreement letter for each ICP fiscal year are signed by the contractor, no audit effort should be expected by the government contractor for those ICPs.

DCAA has also continued the practice of utilizing virtual field audit offices (FAOs) with the single mission of closing out ICP audits—that task includes auditing high risk ICPs and ultimately the disposition of both low risk and high risk ICPs.

The ICP low-risk sampling process does not extend to any proposal with an annual dollar value (ADV) at $250 million or higher; and of course any proposal deemed high risk, regardless of annual dollar value, will be audited. Contractors with ICPS valued at $100 mil to $250 mil ADV will face mandatory ICP audits every third year after the preceding ICP audit, even if all ICPs are considered low-risk.

THIS ISSUE:

- Status on DCAA Executing Low Risk Incurred Cost Proposal Audit Process
- DOD-IG: DOD Threshold for DCAA Proposal Audits Cost Taxpayer $249.1 Million Annually
- DOD Withholds $47 Million from Lockheed Martin for EVMS Flaws
- DOD BBP (Better Buying Power) 2.0
- OIG Finds DHS Non-Compliant with Cost Type Contract Selection Criteria
- So DCAA Has Disallowed A Cost: Should You Kiss The Money Good-Bye?
  Guest Author: Jerry Gabig, Attorney, Wilmer & Lee
- Training Opportunities

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Contractors whose fiscal year ICPs are repeatedly below $100 million in ADV and deemed low-risk could theoretically escape audits forever. For the moment, it behooves all government contractors with the possibility of its ICPS falling into a non-audit category to utilize due care and diligence in preparing its ICPs consistent with the FAR regulations and DCAA expectations. Although not addressed in the DCAA policy, if the initial fiscal year ICP is deemed inadequate and returned to the contractor for correction, DCAA could simply view the need for ICP corrective action as a high-risk indicator and therefore not eligible for low-risk sampling.

DOD-IG: DOD Threshold for DCAA Proposal Audits Cost Taxpayer $249.1 Million Annually

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

In typical fashion, the DOD-IG utilized very superficial and controvertible assumptions to conclude that DOD's failure to properly document a business case resulted in a cost to taxpayers of as much as $249.1 million annually. The undocumented business case applies to the 2010 DOD decision to raise the threshold for proposal audits by DCAA; $10 million for fixed price proposals and $100 million for cost-type proposals. As noted by DOD in 2010 and as confirmed in the DOD-IG report, the change was a "risk-based" resource issue allegedly driven by DCAA's inability to audit every proposal which required an audit under the previous DOD policies (to which the DOD-IG is now recommending that DOD return pending a business case supporting any change in thresholds).

In addition to the lack of a business case supporting the 2010 change, the DOD-IG also reported that DCMA was neither staffed nor trained to assume this responsibility for proposal evaluations which was transferred from DCAA to DCMA. The DOD-IG was "sort of" accurate with respect to DCMA which acknowledged that it had to reinstate and staff its price and cost analysis function; however, it should be noted that DCAA proposal evaluation training is the equivalent of two weeks of formal training supplemented by "OJT" (on the job training). In other words, DCMA may have lacked the staff, but training comparable to DCAA auditor training could be accomplished in less than a month.

A notable weakness within the DOD-IG report is its simplistic assertion that the transfer of proposal evaluations to DCMA resulted in a cost to the taxpayer of $249.1 million. Obviously meant to be an eye-catching headline, the DOD-IG assertion is based upon the estimated hours (132,133) that DCAA would have spent had it audited proposals below the $10/$100 million thresholds applied to DCAA's ROI ($1,885 per audit hour). It is amazing that the DOD-IG accepts as accurate DCAA's ROI notwithstanding that the DOD-IG has never audited DCAA's ROI.

Further calling into question the legitimacy and reliability of the IG's assertion of lost taxpayer money, the IG did not evaluate any statistics comparing the results of DCAA audits to DCMA price/cost analysis for fiscal years after the policy change to determine if there actually was a net cost to the taxpayer—the calculation that the IG utilized is solely based on the DCAA "questioned costs" (not sustained savings) for 2009, before the new policy took effect, with no comparative analyses of that 2009 information to DCAA/DCMA audit statistics for periods after the shift in DCAA and DCMA cost proposal responsibilities. It is all too obvious that the DOD-IG's $249.1 million estimate conveniently ignores the fact the DCMA cost or price analysis also yielded net savings (negotiated contract prices which are lower than the contractor price proposals). Noting that DCMA performs its cost or price analysis far more efficiently than does DCAA, it is entirely plausible that DCMA's ROI is as good as or even better than DCAA's ROI. DCMA does not spend thousands of hours doing bloated risk assessments involving teams of auditors, nor does DCMA spend untold hours auditing historical data, and DCMA price or cost analyses do not require multiple, redundant levels of review prior to issuing the report, a practice utilized by DCAA.

With the exception of DCMA which largely agreed with the DOD-IG, DPAP (Defense Procurement and Acquisition Policy) and DCAA disagreed with the DOD-IG. That said it is highly unlikely that there will be any change in the DCAA proposal audit thresholds, at least not during FY2013 for which DCAA has already aligned its audit resources with its audit priorities based upon DCAA's risk-based planning. DCAA is not going to voluntarily divert approximately 90 to 100 audit staff years to "low risk" proposals which would simply add to the incurred

cost audit backlog and/or translate into delays in accomplishing other higher risk audits.

For what it's worth, neither the DOD-IG, the GAO, nor any other competent independent reviewer have noted that DCAA's alleged resource issue is self-created; specifically, that DCAA audits are grossly inefficient as evidenced by DCAA's overly expansive transaction testing which has lost sight of any concept of materiality. Audits which once took 200 hours now take 2,000 hours and in many cases, the initial risk assessment, a prelude to the actual audit, exceeds the 200 hours previously required to perform the entire audit. Even if the previous audits (200 hours) were insufficient, there is absolutely nothing which justifies the 10-times growth in hours during a time when DOD is trying to wean itself of non-value added administrative costs. However, assessing the "should cost" versus the "actual cost" audit hours is admittedly a more complex challenge; certainly more of a challenge than the DOD-IG's simplistic and highly controvertible assertion that higher proposal audit thresholds have cost the taxpayer $249.1 million. Until the DOD-IG, the GAO or a competent independent evaluator actually assesses DCAA's audit scope and audit hours, the real issue (DCAA's absurdly time consuming risk assessments, exhaustive audit scope/bloated hours and redundant review processes) will continue to evade scrutiny.

DOD Withholds $47 Million from Lockheed Martin for EVMS Flaws

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

The Department of Defense (DOD) has re-announced that it is withholding $47 million in payments to Lockheed Martin Corp (LMT) under two government contracts due to persistent problems with its Earned Value Management System (EVMS) which have hindered that system's ability to adequately track scheduling and costs for the F-35 fighter program.

The Defense Contract Management Agency (DCMA) found the system deficient in 19 of the 32 EVMS regulatory standards during a 2007 review and problems with the EVMS have persisted leading DCMA to decertify the system this year, and withholding of payments on billings pending satisfactory corrective action. Pentagon officials reported in June 2012 that Lockheed had incurred huge cost overruns in the Joint Strike Fighter program, an 80% increase over the initial estimated cost for the program. The Pentagon attributes the loss of control over management of the program's costs and funding to a flawed EVMS and characterized the issue as "a systematic corporate level problem."

The withholding of payments to Lockheed was invoked using the newly applicable DFARS business system rules which allows up to a five percent reduction of billings if significant deficiencies in any one of the six systems defined in DFARS are found. The EVMS is one of those systems where general requirements for an acceptable system are defined (DFARS 252.234-7002).

The DCMA decision to decertify Lockheed's system and invoke billing payment withholds should be a wake-up call to both large and small government contractors with DOD contracts containing the EVMS tracking requirements and the DFARS Business Systems Rule. The Lockheed problems will no doubt elevate the DOD's interest in EVMS capabilities for many other contractors especially where overruns in original contract cost estimates are an on-going problem. In fact, DOD's actions to withhold funds on previously identified business system's issues also confirms DCMA/DCAA statements that they will first look for previously identified deficiencies as the most immediate step in implementing the withholds.

DOD BBP (Better Buying Power) 2.0

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

In a memorandum dated November 13, 2012, the Under Secretary for Defense, Acquisition, Technology and Logistics, issued BBP (Better Buying Power) 2.0. Categorized as a preliminary version of BBP 2.0 and promising a more detailed version with specific goals, the latest BBP essentially restates the DOD strategy to "do more without more". In particular, to "wring every possible cent of value for the Warfighters we support from the dollars with which we are entrusted by the American taxpayers".

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BBP 2.0 includes seven focus areas which are anything but new (e.g. Achieve Affordable Programs, Control Costs, Eliminate Unproductive Processes and Bureaucracy, Promote Effective Competition, Improve the Acquisition Workforce) with the possible exception of "Improve Tradecraft in Acquisition of Services". However, even the superficially new focus on "Tradecraft" isn't all that new based upon its more detailed description which includes "improving requirements definition/prevent requirements creep" and "increase small business participation".

In terms of translating BBP 2.0 into its impact on defense contractors, it will add pressures on contracting officers to obtain lower contract prices regardless of actual cost history (reference to the concept of "should cost" as opposed to historical or actual cost assuming that actual costs include inefficiencies whether identified or unidentified). Translated, defense contractors can expect lower government pre-negotiation pricing positions with or without any rational basis for those prices. Additionally, the use of fixed price incentive contracts displacing cost plus fixed fee contracts, a change which would dramatically shift contract cost and performance risk to the contractor. Finally, in promoting effective competition, DOD will continue to seek or demand full technical data rights, opening the door to multiple potential sources for follow-on program support.

Although DOD has publicly stated that it is not interested in lowering defense contractor profits, but merely reducing the prices to DOD. Unfortunately, the collective impact of BBP 2.0 will impact (reduce) contractor profits unless one believes that defense contractors have been "holding back" in terms of reducing costs. In fact DOD doesn't really care about the details as long as it ultimately obtains more without paying more.

OIG Finds DHS Non-Compliant with Cost Type Contract Selection Criteria

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

The Office of Inspector General (OIG) for the Department of Homeland Security (DHS) issued a report citing the DHS procurement authorities for awarding cost reimbursement and other non-fixed-fixed-price contracts (collectively referred to as "other than firm-fixed-price contracts) to government contractors without adequate justification or appropriate management oversight. Such contracts include those for which payment to government contractors are based entirely, or partially, on actual contract amounts incurred, and encompass cost reimbursement, time and material, and labor hour contracts.

The OIG reports states that DHS did not consistently comply with the FAR provisions, specifically those implemented by FAR Case 2008-030 (*Proper Use and Management of Cost reimbursement Contracts*); the rule requires documenting the basis for selecting an other than firm-fixed-price contract and ensuring adequate oversight of such awards. Specifically, DHS's acquisition plans did not always contain contract-type selection data specifically justifying cost type awards nor did DHS consistently designate qualified Contracting Office Representatives (CORs) prior to award.

Of particular interest, the report noted that in some cases contracting officers "did not properly ensure the adequacy of the contractor's accounting system" in the cost reimbursement award process—one example given was a DCMA contracting officer allowing a contractor to self-certify its accounting system as adequate without any validation by a third party. Based on our recent client experience the DCMA has begun using this self-certification process more frequently to expedite accounting system approval (for lack of DCAA audit resources to perform pre-award audits in a timely manner) although such certifications purportedly require verification by a price analyst or auditor.

The results and recommendation of the DHS OIG were based on the review of 59 acquisition plans documenting the basis for awarding cost reimbursement type contracts.

Cost reimbursement/other than firm-fixed price (FFP) contracts are considered more prone to contractor "wasting or misusing taxpayer funds". Such vehicles by nature, at least in the Government's opinion, particularly Congress, are not effectively managed to ensure efficient use of obligated funding, therefore frequently resulting in cost overruns; also, those contract types require more government administrative oversight from award to closeout. FFP awards, on the other hand, "provide the contractor with the greatest incentive for economical performance control of costs" while imposing

minimal administrative burden on the government. The report specifically notes that cost reimbursable and T&M contracts require the government to pay based solely on incurrence of costs, rather than the delivery of completed product or service, and such arrangements have historically been awarded without sufficient justification or oversight.

Congress addressed these concerns within the *Duncan Hunter National Defense Act* (FY 2009) which stipulated that FAR include circumstances in which cost reimbursement contracts were appropriate; require a supporting acquisition plan supporting the decision to use a cost type vehicle, and; ensure a qualified government oversight workforce that could administer and award these types of contracts. Following a 2009 White House directive and a OMB memo directing agencies to reduce the use of "high-risk contracts", the FAR was amended placing barricades before government procurement offices in awarding cost reimbursable (other than FFP) contracts.

So DCAA Has Disallowed A Cost: Should You Kiss The Money Good-Bye?

Guest Author: Jerry Gabig, Attorney, Wilmer & Lee

You have received a DCAA Form 1 "Notice Of Intent To Disallow Costs". You have argued with your DCAA auditor but she is unbendable. The decision to disallow a cost ultimately belongs to the contracting officer. However, as a practical matter, rarely will a contracting officer go against a DCAA recommendation. First, the contracting officer generally lacks expertise in accounting and, hence, is inclined to defer to the DCAA auditor. Second, DCAA auditors who wish to second guess the contracting officer can take the matter directly to the DOD IG (reference DCAA audit guidance 09-PAS-004(R), Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials). This direct route to the DOD-IG has an intimidating effect on contracting officers who might otherwise disagree with the DCAA. In light of the above, should you kiss the money good-bye?

Maybe not. Sometimes the DCAA creates standards that exceed those that are required by the Federal Acquisition Regulation. Consider time keeping. For cost-reimbursement contracts, DCAA is adamant that a contractor have a thorough time keeping system. DCAA's Pamphlet Information For Contractors states:

> 4. Labor Charging System
>
> Timekeeping procedures and controls on labor charges are areas of utmost concern. Unlike other costs, labor is not supported by external documentation or physical evidence to provide an independent check or balance.
>
> 4.b. Timesheet Preparation
>
> Detailed instructions for timesheet preparation should be established through a timekeeping manual and/or company procedure.

Simply put, the DCAA will disallow any labor costs unless a contractor contemporaneously documents the labor through a credible time keeping system.

The FAR, (§ 31.201-3(a)), merely requires the contractor to be able to prove by preponderance of the evidence that claimed costs were actually incurred, that they were properly allocable to the contract or grant, and that they were otherwise reasonable. Stated differently, under the FAR, a contractor can recover labor costs without a time keeping system if the contractor can otherwise prove that it performed the labor hours.

The Court of Federal Claims decision (51 Fed Cl. 464 (2002)) in Thermalon Industries, Ltd is insightful. Thermalon was awarded a Phase II Small Business Innovative Research (SBIR) grant by the National Science Foundation (NSF). The grant incorporated by reference the federal cost principles in FAR Subpart 31.2. The government auditors stated Thermalon's financial data was inconsistent, unreliable, and "failed substantially to comply with even the most basic requirements for sound grant management." The Final Audit recommended that the NSF seek repayment of $125,591.

The majority of the disallowed costs involved the labor of Mr. Miller, the sole proprietor. The decision explains the primitive nature of Thermalon's accounting system:

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> Mr. Miller himself would write checks for plaintiff's expenses from his personal account. While Mr. Miller claimed that he kept all receipts for plaintiff's purchases, he admitted that he did not maintain an organized system for tracking them. Nor did he use a recognized accounting method for calculating indirect costs, such as overhead. Instead, he merely estimated the costs reimbursed to him. Apparently, it has never been plaintiff's position that this system of salary reimbursement was adequate, and Mr. Miller maintained that, prior to the audit, he did not understand accounting concepts such as indirect costs, provisional rates, and the like.

At the trial, Mr. Miller produced his "day-timer" to document his labor:

> The day-timer records consist of individual daily calendar pages on which appear handwritten notations signifying appointments and phone numbers. On top of certain pages, "NSF" appears, followed by a number. Some numbers are followed by the notation "hrs.," for example, "NSF 6 hrs." The color of ink varies among days and sometimes differs between the NSF entry and the remainder of the page.

The government auditor was unwilling to accept the day-timer because it did not account for 100% of Mr. Miller's time. The Government also argued that the day-timer did not adequately support the hours worked on the NSF project since there was no description of Mr. Miller's daily activities. Despite not having a system acceptable to the government auditors, the Court of Federal Claims awarded Thermalon Industries 82% of Mr. Miller's salary.

Litigating at the Court of Federal Claims can be expensive, but there is a cheaper way. Once the Contracting Officer issues a final decision disallowing a cost, appeal within 90 days to the appropriate Board of Contract Appeals (*e.g.*, the Armed Services Board of Contract Appeals or the Civilian Board of Contract Appeals). Unlike the Court of Federal Claims, there is no filing fee to appeal to a Board of Contract Appeals.

Congress set up the Boards of Contract Appeal to "provide informal, expeditious, and inexpensive resolution of disputes" (41 U.S.C. § 7105(g)(1)). If the amount in controversy is less than $50,000, there is a small claims procedure. If the amount in controversy is less than $100,000, there is an accelerated procedure. To avoid the expense of a hearing, a contractor can elect under Rule 11 to seek a decision without a hearing.

Perhaps most encouraging of all is that the Administrative Law Judge will decide the case "*de novo*" which means the conclusions of the DCAA and the Contracting Officer are given no weight. Nevertheless, the contractor still has the burden of proof that the disputed cost is allowable.

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April 10-11, 2013 – Accounting Compliance for Government Contractors
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In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

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