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DCAA 2012 Year in Review

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

In a 28 page document published at www.dcaa.mil (DCAA's website which has a "new look"), DCAA's Director reports that DCAA had the best year ever in terms of net savings to the Government. Represented as a return on the taxpayer's investment, Mr. Fitzgerald reported $4.2 billion in net savings yielding a ROI of $6.70 for each dollar "invested". In addition, the report identifies other statistics including those which are selectively compared to prior period statistics in support of self-congratulatory statements filled with hyperbole and absent any statement or data suggesting that DCAA's performance is anything but superlative.

Although DCAA has reported some very impressive sounding statistics meant to convince the taxpayer (& ultimately Congress) that all is well (or better than well), a critical analysis of DCAA's annual report should lead a reader to understand that DCAA's annual report is a one-sided representation, that all of DCAA's data is "unaudited" and that DCAA's annual report is basically a self-serving and otherwise unnecessary public relations statement. The document is particularly unnecessary because DCAA will shortly issue its 2012 Report to Congress which will address DCAA results in a format required by Congress (albeit without any audited data or statistics and equally replete with performance superlatives and falling short of anything close to an unbiased annual report). If DCAA is totally focused on protecting the taxpayer and maximizing its ROI, why would DCAA divert precious resources to its 2012 Year in Review noting that DCAA has publicly stated and restated that it only has the resources to complete but a relatively small percentage of all of its audit requirements?

The most fundamental flaw within DCAA's Year in Review, written as if it is something of an annual report to its investors (US Taxpayers), is that it has not been prepared in accordance with any standards of reporting, particularly standards which would require full and complete disclosure of both the "good and the bad". That said, DCAA simply reports the "good" and in some cases seriously misrepresents the "good". One example, DCAA states that it issued over 6.700 audit reports, but conveniently fails to mention that in 2011 it issued over 7,000 audit reports. Moreover, in 2011 DCAA issued 300 more audit reports with 267 fewer auditors; thus continuing a trend wherein DCAA issues fewer audits in spite of ever increasing resources leading one to conclude that DCAA just might not be

THIS ISSUE:

the most cost effective or cost efficient alternative to effective contract audits.

DCAA also states (in 2012) that it provides definitive recommendations to contracting officers with nearly 7,500 contractors in a typical year; oddly enough DCAA only issued 6,700 audit reports suggesting that 2012 was short of a typical year (considering that DCAA issues multiple audit reports on major contractors, DCAA's 6,700 actual reports equates to no audit reports for a large number of its 7,500 contractors).

Perhaps the most misleading statement, which is actually a highlight in the 2012 Year in Review, is DCAA's statement that "DCAA completed 2,700 incurred cost years—a six fold increase over 2011". This comparison to 2011 involves one of the worst years on record; specifically, DCAA only completed 349 incurred cost years in 2011 and an undisclosed number of those were "desk reviews" which are not audits. Hence, DCAA's representation of a "six-fold increase" is nothing more than a comparison to a miserable year and void of any disclosure of any data or information which would lead the reader to understand that 2011 cannot be a standard for any meaningful comparison. In no context could an annual report prepared under any reporting standards (e.g. GAGAS or Financial Reporting under SEC guidelines) include incomplete data or information which results in a significant comparative misrepresentation of DCAA's 2012 incurred cost accomplishments.

In contrast to its incurred cost performance wherein DCAA compares 2012 to 2011, DCAA highlights its 2012 audit results for contractor equitable adjustments and terminations reporting examination of $6.4 billion and $405 million in audit exceptions but conveniently fails to make a comparison to 2011 wherein it examined $2.5 billion with $1 billion in exceptions. The cost exception rate in 2011 was 40% which was conveniently not juxtaposed with the cost exception rate in 2012 which was only 6.3%. Again, any authoritative reporting standards would require meaningful and consistent comparative data in contrast to DCAA's selective, incomplete and ultimately misleading comparisons.

Finally, DCAA's Year in Review contains some of the most bizarre and most likely unsubstantiated statements including:

- "During the initial coordination phase, DCAA sent its auditors offsite to the location where the contractor maintained its records, which enabled them to better assess complex material pricing data". Editor's comment: In no context is sending auditors to the location of the contractor records anything but a typical, logical and hardly worth mentioning audit strategy—how else would an auditor attempt to audit contractor assertions?
- DCAA identified "cost exceptions that included duplicate labor expenses and inflated stock benefits". Editor's comment: In the context of employee stock benefits, valuations can involve a significant degree of interpretation; hence, "inflated" is likely a misrepresentation of differences which can occur when valuing stock benefits.
- DCAA makes reference to its "One-Audit Approach" and its benefits which include "no redundant information requests to contractors" and "no unnecessary levels of management review". Editor's comment: Virtually every contractor subjected to DCAA audits has experienced redundant information requests as a by-product of "start-stop" audits, assigning multiple auditors to the same audit, and audit cancellations. Regarding management reviews, DCAA's inability to cost effectively or timely complete audits has been caused in part by bloated and non-value added management reviews which are in some cases "form over substance" based upon the quality of DCAA audit reports (actually the lack of quality including basic failures to cite appropriate regulations, misquoting regulations, and applying regulations which actually do not apply to the contractor).

Unquestionably DCAA does have an audit mission which involves protecting the taxpayer in the form of assuring that contractor cost estimates and cost incurred comply with applicable regulations. However, DCAA's audit mission does not include authoring fictional works in the form of a Year in Review or at the very least, including full disclosure in its "Year in Review" that the data and representations are unaudited and that this annual report has not been prepared in accordance with Government Auditing (reporting) Standards (or any authoritative reporting standards).

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DOD IG Issues Outdated Report on DCAA Work Quality Improvement

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

The Department of Defense Inspector General (DOD IG) issued a March 7, 2013 report charging that the Defense Contract Audit Agency (DCAA) failed to "exercise sufficient professional judgment", i.e., adhering to generally accepted government auditing standards, while performing certain audits between 2006 and 2010.

The DCAA Director, Patrick Fitzgerald and Pentagon Comptroller Robert Hale were caught off guard by the report, since the IG reported findings are based on testing of two to three year old audit file data for fifty DCAA reports issued between October 2009 and March 2010. The extensive time span between the period during which IG tested adherence to professional standards and the release of the 2013 report (two to three years) renders the IG findings and recommendations suspect to being outdated, obsolete, and therefore of little value to DOD since the IG report does not factor in DCAA corrective action long since taken for many of the issues reported.

Mr. Fitzgerald stated that the IG's report fails to "reflect current (DCAA) operations" and IG findings ignore the improvements made over the past three years. Mr. Hale's comments were more forceful, directly questioning the release of a report that "reflects old data and replicates findings" reported long ago. He stated, "I question the usefulness of a report that is being issued four years after the DCAA work was performed."

DOD IG's report, almost 100 pages in length, outlines professional judgment lapses in 37 of the 50 DCAA audit reports and work-paper files tested. The report identifies instances of DCAA audit judgment issues which include external impairments to independence; inadequate planning; insufficient communication with audit requester and contractor personnel; insufficient audit file documentation to support significant judgments and conclusions; poorly trained and/or inexperienced auditors undertaking assignments above their level of competence; unsupported or untimely reports; insufficient contractor evidential data reviewed to support conclusions, and; ineffective supervision and quality control.

The IG report acknowledges that completion of its audit and issuance of a report was "substantially delayed due to shift in in our primary oversight of DCAA from reviews of audit quality to the review of hotline referrals during January 2010 through January 2012". "Substantially delayed" is an understatement, and the insistence of the IG to nevertheless release a report, throwing DCAA against the wall based on outdated facts, is nothing short of the frog (IG) calling the toad (DCAA) ugly.

One example of the hypocrisy of IG's decision to release this report, based on review of outdated data, is a DOD IG September 21, 2011 report citing DCAA's lack of adequate agency guidance on the currency of audit testing. In that 2011 report, DOD IG affirms that if the data tested supporting the auditor's conclusions is not current in relation to the time the report is released, then the data is not sufficient to support those findings, hence a GAGAS circumvention. Conclusion drawn from that IG report—if the DCAA field work on which findings are derived is outdated, a report should not be issued without updating testing—if the report has been issued, and results are outdated, the report should be rescinded, which has been a DCAA practice in such circumstances since the 2008 and 2009 GAO reports.

A specific IG recommendation to DCAA, which reflects IG's double standard for reporting credible and current audit findings, is its recommendation that DCAA rescind those 37 reports where deficiencies were stated (issued between Oct 2009-March 2010)—DCAA's response addressed this recommendation as unnecessary since reported actions were corrected or reported findings are now "irrelevant due to subsequent events or the passage of time."

The DCAA response was respectful, but lukewarm, to the IG's recommendations, and many DCAA response comments stated "concur in principle" followed by a discussion of the added or revised audit policies or practices already implemented between 2010 and 2012 to rectify the very problems presented in the IG report—of course, had the IG updated its testing to include review of more current DCAA audit report before release of the its report, many of the deficiencies and recommendations would likely have been omitted.

At the very least, the DOD IG needs to examine its own practices in conjunction with releasing reported findings based on current data (e.g. violation of auditing standards), and

rethink their decisions leading to a blundering, transparent mistake by using a different professional standard for ensuring valid findings that are based on current information. The extensive amount of IG auditor time and expense that went into preparing a detailed report with sixty plus pages of DCAA "professional judgment" findings, many of them probably no longer relevant, is mind-boggling.

The DOD IG should never have released the report, and its decision to do so calls into question its motives with regard to DCAA. The obvious explanation would be to avoid criticism for not producing a final product with such a huge investment of audit effort even though the findings are probably useless since DCAA began implementing changes to the IG's outdated findings over three years ago.

Based on our client experiences, problems still exist with DCAA's audit policies, particularly with respect to reasonable audit scope and testing; auditor experience and knowledge of cost regulations; materiality and "significant deficiency" judgments, and; timely completion of audits. Government contractors need not quickly assume an even more rigid and extensive DCAA audit process as a result of this IG report, since it does not reflect the current state of the agency's ability to meet professional auditing standards. Nonetheless, contractors should be aware that the IG's report will at least mildly stoke the fire among some procurement officials for changes in DCAA's audit policies.

Legislators Continue Push Toward Lower Allowable Government Contractor Employee Compensation

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

Government Congressional legislators continue their crusade to lower allowable government contractor employee compensation during government fiscal year 2013, most recently via a March 6, 2013 letter from three U.S. Senators to the Senate Committee on Appropriations requesting that allowable compensation ceilings contain "commonsense limits" in the next appropriations vehicle.

The current annual statutory cap on any contractor employee salary that will be reimbursed under certain government contracts is $763,029, as stipulated in FAR 31.205-6(p), but that ceiling, according the Senators Boxer, Grassley, and Manchin, is excessive and "unsupportable" and places an unreasonable burden on taxpayers "at a time when most Americans are seeing little or no increase in their paychecks…". The letter noted that "most Americans would be shocked to know that under current law, government contractors can charge taxpayers $763,029 per year for salary reimbursements", and that the current ceiling is "nearly double the salary earned by the President of the United States."

The rhetoric within the letter is not only misleading, it is laced with paradoxical hyperbole intended to inflame the general public to support legislative initiatives that would, if implemented, largely reduce contractor employee salaries to those of public servants. The Senators' letter completely ignores a central cost principle (FAR 31.2065-6(b)) which, regardless of the $763K maximum salary cap, restricts government payment of government contractor employee salaries above annual amounts when measured against the commercial market place for similar positions and industry environments—referred to as the "reasonableness" regulatory test. An example of the application of that principle: if a "reasonable" annual salary for a contractor employee serving as a contracts administrator via use of reliable and relevant salary survey data is $40,000, the government would be under no obligation to share in reimbursement of more than $40,000. Contrary to the Senators' inferences that all contractor employees could be paid a $763K salary, allowable salaries are held to those which are reasonable in the commercial market place (measured against comparable functions, most of which are non-executive with salaries well below the $763K statutory cap).

More interestingly, continued attempts by our public servants to use the compensation levels of government executives as a benchmark for "reasonable" public sector compensation may eventually be met with complete skepticism. Before taking on further measures to lower the reimbursement of government contractor employee (public sector) to those of White House, Cabinet, or Legislative Branch officials, perhaps our legislators should consider if the compensation of any official whom continuously mismanages the financial posture of a public sector entity (such as the United States) and deems himself accountable to no one has earned a salary equal to that of a

private entity official whom is held accountable to its stockholders, investors, and the SEC for financial health and longevity.

The Senators' March 6th appeal for restraint in reimbursing government contractor salaries follows a lengthy, historical string of proposed legislative measures, appeals from government unions, and pressure from the White House to roll back contractor salary caps, asserting that increases in statutory salary caps have far exceeded the rate of inflation over the past few years. The Senator Armed Services Committee included within the FY 2013 National Defense Appropriations Act (NDAA) verbiage that would have lowered the annual compensation ceiling for defense contractor employees from $763,029 to $230,700, but that provision did not receive House approval. Further, a proposed reduction to non-defense contractor annual employee compensation was concurrently submitted that would have reduced annual caps to $400,000, but was not confirmed within the most recent Continuing Resolution.

Failure to Maintain Records Can Be Costly

By: Guest Author: Jerry Gabig, Attorney, Wilmer & Lee

Failure to maintain records can be costly. The leading case, JANA Inc. v. United States, makes clear that the Government is entitled to play "hard ball" if a contractor cannot support an invoice. JANA Inc. has been awarded two Time and Materials (T&M) contracts by the Navy. Two years after the work had been completed, DCAA performed a routine audit at the request of the Navy. The audit showed large discrepancies between the number of hours that JANA had billed and the number of hours that JANA could document as worked. The DCAA issued audit reports for each contract that questioned $343,622 and $220,164 for the unsubstantiated hours.

Each JANA employee filled out "time cards" listing time worked on various jobs. The time each employee recorded for a given job was transferred to a "labor recap sheet." JANA could not produce the records needed to substantiate the hours that JANA had charged. Although the Navy had awarded the contract before the FAR was issued, the pre-FAR regulation was essentially the same as FAR § 4.705-1 "Financial and Cost Accounting Records."

In deciding this leading case, the U.S. Court of Appeals for the Federal Circuit stated: "The real issue in this case then is *how long* JANA was required to maintain the records that supported labor charges it invoiced." Relying on the predecessor to FAR § 4.705-1, the Federal Circuit concluded that the missing documents were subject to a four year retention period. Accordingly, the Federal Circuit held that JANA was liable to the Government for the overpayments.

The table below summarizes FAR § 4.705-1:

Type of Record	Retain
Accounts receivable invoices, adjustments to the accounts, invoice registers, carrier freight bills, shipping orders, and other documents which detail the material or services billed on the related invoices	4 years
Material, work order, or service order files, consisting of purchase requisitions or purchase orders for material or services, or orders for transfer of material or supplies	4 years
Cash advance recapitulations, prepared as posting entries to accounts receivable ledgers for amounts of expense vouchers prepared for employees' travel and related expenses	4 years
Paid, canceled, and voided checks, other than those issued for the payment of salary and wages	4 years
Accounts payable records to support disbursements of funds for materials, equipment, supplies, and services, containing originals or copies of the following and related documents: remittance advices and statements, vendors' invoices, invoice audits and distribution slips, receiving and inspection reports or comparable certifications of receipt and inspection of material or services, and debit and credit memoranda	4 years

Type of Record	Retain
Labor cost distribution cards or equivalent documents	2 years
Petty cash records showing description of expenditures, to whom paid, name of person authorizing payment, and date, including copies of vouchers and other supporting documents	2 years

In candor, FAR § 4.705-1 can lure contractors into a false sense of security concerning the retention of records. FAR § 4.705-1 arguably conflicts with FAR § 52.215-2 Audit and Records – Negotiations. FAR § 52.215-2 is a mandatory clause for all negotiated contracts over the simplified acquisition threshold.[1] FAR § 52.215-2(f) requires records be retained "until 3 years after final payment." With DCAA being five years behind on many incurred cost audits, retaining financial and cost accounting records for nine years, could, in some instances, be prudent.[2]

Stated differently, any contractor who relies on FAR § 4.705-1 could be in for an unpleasant and expensive surprise. FAR § 4.705-1 does nothing to change the fact that a contractor has the burden of proof that any cost the contractor seeks the Government to reimburse is, in fact, allowable:

> A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

FAR § 31.201-2(d).

Returning to the lead decision of JANA Inc. v. United States, at the time of the DCAA audit, JANA Inc. no longer retained the employee time cards nor the labor recap sheets. JANA Inc. was held liable for overpayments. If your company finds itself in a predicament like the one that JANA faced, do not automatically jump to the conclusion that the Government's claim for an overpayment will prevail. In the November 2012 issue of Redstone Government Consulting's Insights is an article I wrote entitled *"So DCAA Has Disallowed A Cost: Should You Kiss The Money Good-Bye?"* The essence of the article is that, although DCAA may not be satisfied, there may be alternate ways of meeting the burden of proof. For example, if the employees worked in a secured location while performing work under the contract, perhaps there is a log of when the employees entered and departed the facility. The log could serve as an alternative means of meeting the contractor's burden of proof that the employees worked the hours claimed.

To summarize, Justice Oliver Wendell Holmes statement that "Men must turn square corners when they deal with the Government" is especially true when performing contract types such as cost-reimbursement or time & materials. The FAR has some rigid documentation requirements for cost incurred in performing such contracts. DCAA is vigilant in enforcing the documentation requirements. As shown in the JANA Inc decision, failure to comply with the FAR requirements to retain adequate records when performing cost reimbursement contractor or T&M contracts can be very costly for a contractor.

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[1] FAR § 15.209(b). The clause must be flown down to subcontracts such as cost-reimbursement and T&M that are in excess of the simplified acquisition threshold. FAR § 52.215-2(g).

[2] The nine years consists of six years to obtain final payment under FAR § 52.216-7(h) and an additional three years pursuant to FAR § 52.215-2(f).

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August 5-6, 2013 – Accounting Compliance for Government Contractors
Washington, DC

August 7-8, 2013 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Washington, DC

August 7-9, 2013 – The Masters Institute in Government Contract Costs
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
Arlington, VA

December 4-5, 2013 – Accounting Compliance for Government Contractors
Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
- Cyndi Dunn
- Wayne Murdock
- Asa Gilliland
- Adam Collet

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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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