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Brief of July 2013 DCAA Guidance Memorandums

By Darryl L. Walker, CPA, CFE, CGFM Senior Director and Michael E. Steen, CPA Senior Director at Redstone Government Consulting, Inc.

The Defense Contract Audit Agency (DCAA) released four guidance memorandums to its field auditors in July 2013 which we believe should be of interest to government contractors. The memos focus on access to contractor employees as an indirect requirement for FAR 52.215-2 (Access to Records); validating that expense accruals are paid timely, and if not, those expenses are to be questioned; alternate procedures for real-time labor verification and; detecting instances of fraud and non-compliances with contract regulations and laws. A brief discussion of each of these memorandums follows:

Access to Contractor Employees
13-PPS-015(R) July 30 2013

DCAA reiterates its right of access to contractor employees within the FAR 52.215-2 (Access to records) contract clause in performing its required oversight duties, notwithstanding that the clause language refers only to "data" access and omits any coverage giving rights of auditors to contractor employees. The memorandum was issued purportedly because some contractors have argued that the clause does not encompass access to contractor employees, and in response to those contractor arguments, DCAA states it does not agree with the "FAR" (ostensibly FAR 52.215-2), implying that DCAA believes records and people are one in the same as to its rights of access set forth within this contract clause.

The thrust of DCAA's employee access contention is prompted by the Generally Accepted Government Auditing Standards (GAGAS) which require auditors to use inquiry with relevant employees during the planning stages of the audit and in gaining an understanding of relevant internal controls (GGAGAS 5.60). DCAA also asserts, via GAGAS 2.09a, auditors must utilize employee inquiry and observations during audit performance to "provide a reasonable basis for the conclusions expressed in the report"—example, a real-time labor audit (MAAR 6—employee floor-check observations & interviews) where interface with contractor personnel is required to achieve audit objectives.

THIS ISSUE:

The memorandum recites its long-standing position that denial of access to people constitutes a denial of access to records, thus auditors should pursue obstructions by contractors to contractor employees using the agency-directed data access-denial resolution process. A prior DCAA memorandum, 08-PAS-042 (December 2008) clearly stipulated that, in DCAA's opinion, access to records included access to personnel.

While most people would agree that interface with contractor personnel is a necessary part of achieving the DCAA audit mission in performing its audit mission, there is no clear connection between the FAR 52.215-2 Access to Records clause and the audit professional standards which require contractor employee inquiry and observation procedures which renders a denial of access to "personnel" as a direct violation of the "Access to Records" clause. Although DCAA cites the inability to provide auditors timely access to personnel as a "denial of access" to records issue (within the framework of FAR 52.215-2), no reference is made within the clause to DCAA's professional audit standards mandate to interface with contractor employees, thus a disconnect between a DCAA asserted denial of access to employees and the contract clause.

Finally, it seems quite odd (and inconsistent with DCAA's continuing assertions of a regulatory right to access contractor personnel), that DCAA's FY2012 Report to Congress, within the section "Recommendation Actions to Improve the Audit Process" there is a statement that DCAA intends to propose a regulatory change to expand the access to records clause to expressly include access to contractor personnel. The need for a regulatory change is a clear indication that access to personnel does not presently exist in the FAR, but it does exist in the imagination of the writers of DCAA's audit policy.

Alternate Procedures for Real-Time Labor Verification
13-PPD-012(R) July 18 2013

Where auditors did not perform real-time labor charging procedures during the fiscal year in which those labor costs were incurred, the guidance memo stipulates alternate procedures to test the existence of employees generating labor charges, and the allocability of those costs, presumably in connection with the incurred cost proposal (ICP) audit for the applicable fiscal year. Real-time audit procedures, commonly identified as MAAR 6, includes floor-check observations and interviews with employees to ensure employees are actually at work and performing in their assigned job classification, and that their labor is charged to the appropriate cost objective.

Alternate procedures suggested to validate the "existence" of employees include inquiry of employees who were employed during the ICP fiscal year, review of personnel records of those employees who are no longer employed but generated labor charges during the ICP fiscal year, examination of third party payroll records, or verification of documents produced by the employee during that fiscal year (examples—travel records, leave requests). Suggested alternate procedures to validate "allocability" of labor charges include matching contract labor requirements to personnel labor categories in which employees were assigned or requesting contracting officers to provide evidence corroborating specific employee charges to the contracts (example—COTR labor reports).

The memo states that auditors are to determine, during ICP audit planning phase, whether alternate labor testing procedures can be utilized in the absence of real-time procedures. Where labor is a significant component of the fiscal year incurred cost proposal, and alternative labor testing procedures cannot be developed, the audit team should necessarily revise the scope of the ICP audit and go no further in attempts to validate "existence" and "allocability" of claimed direct and indirect labor costs. In the Frequently Asked Questions, Attachment 1, of the guidance memo, DCAA notes that any revision to the ICP audit scope (omission of cost elements for examination) should be coordinated with the Administrative Contracting Officer.

When labor costs are a significant element of ICP claimed costs, and alternative procedures cannot be developed to verify claimed labor costs, the audit report opinion will only cover those cost elements where sufficient evidential data is available and procedures can be applied to reach a conclusion on the allowability of ICP costs, e.g. labor costs omitted from opinion. Should this be the case, the audit report will not opine on labor costs or the final indirect rates (where labor is a significant component of the ICP), nor will the Cumulative Allowable Cost Worksheet (CACW) be included with the audit report.

Where alternate procedures can be executed, but the outcome of such procedures is insufficient to reasonably opine on claimed labor costs, the audit report will be qualified for the absence of adequate evidential data, or an overall disclaimed opinion will be issued. In reference to a disclaimer (including "not opining" on labor costs discussed in the preceding paragraph), one can only imagine a contracting officer's reaction to a disclaimer including a DCAA recommendation to "not establish" final indirect cost rates and/or exclusion of major elements of direct costs from a "CACW". In application to a contractor's properly certified ICP whose purpose is to establish final indirect cost rates, nothing is more useless than giving the contracting officer an audit report and a disclaimer (opinion) which ignores the fact that the ICP process is specifically designed to lead to contract(s) closeout. In a maneuver which is wholly based upon self-defense (of DCAA) and ignoring all of the practical implications or ramifications of a disclaimer, DCAA's audit policy (if followed by the contracting officer) will translate into a situation where the contracting officer cannot establish final indirect cost rates or cannot accept direct contract costs; in turn, the contracting officer cannot contractually close flexibly-price contracts leaving them open for perpetuity.

Testing Contractor Compliance with Certain Sections of FAR 52.216-7, Allowable Cost and Payment Clause during Incurred Cost Audits

13-PPD-013(R) July 26 2013

As noted in the opening paragraph of DCAA's audit policy, FAR 52.216-7(b)(1) provides that only allowable costs should be reimbursed when paid in the ordinary course of business (ordinarily within 30 days of the request for payment to the Government). DCAA then goes on to suggest that the audit team should question costs that the contractor never paid and more ominously, consider if this is a fraud indicator. This particular audit policy is narrowly focused on the need to verify that a claimed expense (direct or indirect) was actually paid as indicated by a discussion of audit tests to validate to source documents (e.g. cancelled checks, electronic funds transfers, bank statements or other evidence of payment) actual payment and to the extent this audit policy applies to "incurred cost audits", we can anticipate a number of audits wherein the audit policy will be at odds with the explicit regulations governing records retention. Specifically, audits of indirect cost rate proposals (as early as 2007 fiscal years) wherein the records retention clause, FAR 4.705-1, limits the retention period to four years for cancelled checks other than those for salary and wages for which the retention period is two years.

With respect to payroll and labor costs, DCAA expects its auditors to reconcile payroll totals to the labor cost distribution records; more accurately, DCAA auditors expect the contractor to provide this reconciliation along with the ICP Schedule M Reconciliation of the IRS 941 to total labor costs included in the ICP. Additionally, to test quarterly payroll taxes to evidence of payment even though the evidence of payment may no longer be required under FAR 4.705-1.

Regardless of the disconnect between DCAA audit policy and FAR 4.705-1, contractors must anticipate DCAA requests for evidence of payment for any incurred cost audit which could include a prior year ICP or a current audit of public vouchers. In the current audits, contractors should anticipate a challenge concerning DCAA's misapplication of the "ordinarily within 30 days of the request for payment to the Government" because FAR 52.216-7 specifically states that direct costs (supplies/subcontracts purchased for a specific contract) must be paid "in accordance with the terms and conditions of a subcontract or invoice" and ordinarily within 30 days of the request to the Government". In accordance with subcontract terms and conditions is (arguably) very specific whereas "ordinarily within 30 days" is at best a generality; nonetheless, auditors commonly use the 30 days reference to over-ride the explicit subcontract terms and conditions.

DCAA auditors have also misapplied the "ordinarily within 30 days" to indirect costs including accrued salaries, wages, and accrued incentive compensation in spite of the fact that FAR 52-216-7(b)(1)(ii)(F) permits reimbursement of "properly allocable and allowable indirect costs as shown in the records maintained by the Contractor for purposes of obtaining reimbursement under Government contracts". Nothing in the relevant regulation implicates a 30 day payment rule applicable to indirect costs; in fact, indirect costs should be based upon FAR 42.704, Billing rates, which should be consistent with FAR Part 31 including the requirement for compliance with generally accepted accounting principles, i.e. accrual based accounting. In fact indirect rates based upon cash-based or actual payments only would be in conflict with FAR 31.203(g) which requires the use of the contractor's fiscal year (e.g. 12 months) as the base period for calculating

indirect cost rates, thus for allocating indirect costs as an annualized rate applicable to cost objectives.

At any rate, if a contractor cannot demonstrate actual payment of claimed costs, a contractor should anticipate that the DCAA auditor will i) question those costs and ii) very seriously consider a referral to an investigative agency. Oddly enough, DCAA has yet to embrace a fairly common auditing procedure which is third party confirmations; apparently DCAA would prefer to rely entirely on documents provided by the "auditee" even though it would be relatively easy for that auditee to utilize software to create records which appear to be generated by a third party. Similarly, what's the significance (e.g. enhanced reliance) of comparing a contractor's labor distribution report and to an IRS 941 when both are self-generated by the "auditee"? Obviously, a rhetorical question.

Detecting Instances of Fraud in Attestation Engagements 13-PAS-014(R) July 30 2013

DCAA's audit policy is merely a re-affirmation of auditing standards which require the auditor to design audit tests to detect fraud within attestation engagements (DCAA's audit policy re-sequences the wording as "design examination engagements that detect instances of fraud" which implies audits specifically designed to detect fraud which is not the case). In addition to DCAA audit policy 13-PAS-014, every DCAA audit program includes a preliminary step concerning the need for the audit team to discuss risks of fraud and of course to document those discussions to avoid any risk that a third party (GAO or DOD-IG) would later challenge DCAA's compliance with auditing standards. In other words, even though the consideration of fraud and designing tests to detect fraud is a preliminary step during the risk assessment phase of the audit and very little actual fraud is ever uncovered based upon those tests, it is nonetheless the method used to document "consideration of fraud" in every audit.

In reality, effective consideration of fraud involves critical thinking and iterative audit steps which build upon information and observations during the audit opposed to those developed by a team before the audit fieldwork has been initiated. In other words, fraud is detected based upon the skills of the particular auditor(s) and rarely based upon some front-end "form over substance" audit step. Unfortunately, DCAA continues with audit steps primarily designed as defensive measures to avoid third party challenges regarding the documented sufficiency of the audit whereas fewer and fewer auditors are being trained to critically think and/or to know how to adjust an audit program to be reactive to observations. However, DCAA auditors are very good at completing adequacy checklists or more accurately creating checklist templates and expecting the contractor to complete the checklist.

Regardless, of DCAA's ability or inability to detect fraud, contractors should be fully cognizant of the contractor responsibility to have adequate safeguards and internal controls to minimize the risk of fraud and/or to detect fraud (employee or management) early in the process. Government fraud investigations are time-consuming, costly and potentially life-threatening in terms of an organization's ability to obtain new government contracts (reference to potential suspensions and debarments for which Congress continues to press for regulations which mandate debarments which would effectively eliminate any discretion on the part of a government procurement agency).

Qui Tam Relator vs. The IRS: The Qui Tam Relator Wins

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

Qui Tam Relators are the backbone of the FCA (False Claims Act) recoveries as evidenced by the annual news releases by DOJ (Department of Justice); for any given year the fraud statistics have shown that Qui Tams account for in excess of 85 percent of fraud recoveries and now represent about a $500 million industry for the Relators (e.g. the relators share of awards in government fiscal year 2011-2012 averaged $499 million). Qui Tams are detailed in the FCA and the essence of a Qui Tam is that the Relator, through his or her attorney, files an FCA claim effectively suing a named defendant on behalf of the United States (in the United States, Qui Tams trace back to the Civil War and ultimately back to 13th Century England). Although one would prefer that Qui Tam Relators are motivated by the unwritten rules of morality and doing what is best for one's country, the reality is that a relator is financially motivated to the extent he/she could be granted between 15

and 25 percent of the government recovery in addition to an award of the relator's attorney fees.

The fact that Qui Tam Relators are motivated by the potentially lucrative "informant fees" (IRS reference) is reinforced by a recent IRS case involving the treatment of expenses incurred by a Relator, Richard D. Bagley, a name recognized for his role in one of the largest (at the time) Qui Tams involving a DOD contractor. As noted in the IRS case, in 2003 Bagley received an FCA award of $27,244,000 and statutory attorney fees of $9,407,295 for a total income of $36,615,295. The total income was reported on Bagley's amended IRS tax return attributable to his trade or business (Schedule C as a "private attorney") with $18,477,815 deducted as ordinary business expenses. The IRS challenged this treatment stating that the income was "Other Income" and the $18,477,815 in attorney fees (the actual fees vs. the statutorily allowed fees of $9,407, 295) were itemized deductions; thus the IRS denied the claimed refund of $3,874,407 which was the amount at issue depending upon the tax treatment and the resolution of the "Bagley v. United States of America" tax dispute. In the conclusion of the court, Bagley prevailed for a variety of reasons not the least of which were the 5,963 hours Bagley spent prosecuting the claim while the court also dismissed the fact that Bagley had never filed for any business registrations and had never actually been an attorney.

Over and above the tax issue at hand, the case also presented "Findings of Fact" related to Bagley's employment with the contractor (TRW, the target of the FCA investigation) and his role in the accounting schemes at TRW ("accounting schemes" is the terminology used in the IRS case). As stated in the Findings of Fact, Bagley signed the 1990 and 1991 certifications on annual indirect cost rate proposals while believing that the annual indirect cost rates were incorrect (more than just incorrect in terms of being in violation of the FCA). Bagley stated that he signed the certifications to retain his job, later discussed the potential false claims with two individuals whom he believed were operating the false claim scheme and later (August 1993) Bagley was laid off. In 1994 Bagley met with private attorneys and subsequently filed the first FCA lawsuit in November 1994, followed by a second lawsuit in June 1995. The Government "timely" intervened in 1998 on two of the eight claims; Bagley dismissed the remaining claims, but unlike in baseball, a batting average of .250 (2 of 8) turned out to be "good enough" for the contractor to settle for $111.4 million and for Bagley to collect $36,615,295 in 2003 (the successor contractor Northrop Grumman actually settled the FCA).

Regardless of one's reaction to the concept of relators ("informants" per the IRS), Bagley was instrumental and may have been the only reason the government was aware of the FCA violations and ultimately recovered $111.4 million (less relator & attorney fees). Additionally, he prevailed with the IRS notwithstanding the fact that Bagley could have simply acquiesced conceding almost $4 million as a benevolent action for the greater good (after all, what's a few million here or there). At least Bagley paid his taxes unlike a different Qui Tam Relator who failed to claim his net award of $5.25 million, challenging its taxability, losing the challenge and then being assessed the tax plus a 20% underpayment penalty (article in our October 2011 newsletter).

The TRW/Northrop Grumman FCA settlement is a reminder that a government contractor's "worst enemy" is a disgruntled employee who knows the "schemes". This is also a reminder that FAR 52.203-13 and 52.203-14 require a Contractor Code of Business Ethics and Conduct along with posting certain IG Hotline posters while more importantly allowing contractors to post and to maintain internal hotline procedures. It is critical that contractors be familiar with FAR 52.203-13 and -14 and that employee internal hotline referrals be immediately and effectively reviewed, remediated and reported if required under the mandatory disclosure requirements of 52.203-13(d) (Note: Redstone Government Consulting along with local attorney Jerry Gabig, with Wilmer and Lee, will be hosting a Government Contractor Business Ethics "Lunch and Learn" on September 25, 2013: refer to the training schedule on the next page of this newsletter).

DOT Inspector General Report Cites Agency Noncompliant in Awarding "Risky" Cost Reimbursement Contracts

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

The Office of Inspector General (OIG) reports that the Department of Transportation (DOT) is not complying with

recent Federal Acquisition Regulations (FAR) provisions when awarding "high risk" cost reimbursement type contracts, thereby placing the agency and taxpayers at risk for waste and misuse of taxpayer funds given that such contracts do not provide a "direct incentive for the contractor to control costs".

The OIG August 5, 2013 report attributes the circumvention of updated FAR provisions, implemented to meet goals of the President, Congress and OMB initiative to reduce spending, to (1) lack of internal guidance for implementing these new FAR requirements, and (2) failure to exercise adequate oversight to validate agency compliance.

The FAR was revised via a March 2 2012 rule to implement Section 864 of the Duncan Hunter Act which stipulates controls and procedures for use and management of cost-reimbursement contracts in three areas: (1) circumstances in which cost-reimbursement awards were appropriate; (2) acquisition justification supporting selection of these cost type contracts, and; (3) sufficient resources necessary to award and manage these type of contracts. The legislative initiatives and subsequent revisions to government contracting parameters for protecting the general public from out of control spending in cost reimbursement contract comes from the long-standing perception that firm-fixed price contracts shift all the risk to the contractor to control costs, whereas cost reimbursable awards breed contractor inefficiencies in controlling costs and place a greater administrative burden on the government in guarding against cost overruns.

The OIG reviewed a statistical sample of 31 cost-reimbursement awards out of a universe of 655 DOT cost type awards during the period between July 1, 2011 and May 31, 2012 and found that DOT's Operating Administrations did not fully comply with acquisition planning/documentation of justifications for cost reimbursable awards, nor consistently assess oversight risks, assign adequate and qualified oversight personnel or verify adequacy of contractor's accounting systems.

Principal report recommendations for improving compliance with FAR regulations for awarding cost reimbursable include (1) updating the DOT acquisition manual to reflect FAR provisions; (2) until the acquisition manual is updated, provide guidance to assist procurement authorities in understanding & implementing the FAR requirement; (3) update the CO's "Representative Program Guidance" to include the FAR requirements; (4) initiative Operating Administrations to perform compliance reviews on a periodic basis, and; (5) require the Maritime Administration's Chief of the CO to develop guidelines for ship manager compliance with these regulations.

Of note, the DOT IG Report maintains that cost type contracts are high risk, placing taxpayer funds at risk of waste and abuse; hence, other contract types are preferable. Oddly enough, but unfortunately consistent with political initiatives based upon assumptions, a recent DOD report (based upon facts) concluded that contract type is not relevant in controlling costs (reference our July newsletter article and DOD's annual report dated June 28, 2013). Apparently, the DOT-IG has not read the DOD annual report and/or the DOT-IG objective was limited to evaluating compliance with Executive and Legislative Branch strategies to limit "high risk" cost type contracting although the cost-type contract association with waste and abuse is just one more government/political example of the Francis Bacon quotation: "We prefer to believe what we prefer to be true".

Training Opportunities

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September 26, 2013 – Current Challenges for Government Contractors
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October 22, 2013 – Purchasing System/CPSR Basics
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WEBINAR – REGISTER HERE

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WEBINAR – REGISTER HERE

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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.

Specialized Training

Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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