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Government Contract INSIGHTS
A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 34 DECEMBER 2013

DFARS Final Rule on Unallowable Fringe Benefits Costs

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

DFARS published a final rule on unallowable fringe benefits, more specifically, unallowable costs for ineligible dependent health care costs. As stated in the Federal Register, December 6, 2013, DFARS 231.205-6(m)(1) now explicitly states that fringe benefits costs that are contrary to law, employer-employee agreement, or an established policy of the contractor are unallowable. As with most final rules published within the last five years, this particular DFARS final rule is one more illustration of the superficial and highly predictable rule-making process wherein the "public" is allowed to provide comments on a proposed rule and the DAR council is allowed to summarily dismiss virtually all of the those public comments. It is obvious that the DAR Council under Shay Assad (Director of Defense Pricing/DDP) has no interest in giving any serious consideration to public comments which could substantively change the regulation. Apparently, this is Mr. Assad's application of the government's transparency initiative in that changes (between a proposed rule and the final rule) are so inconsequential as to be transparent (if not invisible).

Two examples of the government's cavalier disregard of public comments include the following:

Public comment: Industry-wide ineligible dependent health care costs are immaterial and thus have no impact on contract billing or pricing. Before DoD proceeds with this rule, it should review DCAA findings.
DAR Council Response: Research (unspecified) indicates the rate of ineligible dependent claims can represent as much as 3 percent of total healthcare costs. The overall costs for ineligible dependent healthcare claims which are often fraudulent, can be significant.

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Public comment: The costs of internal controls should not exceed the costs of ineligible benefits. Treating these costs as unallowable will result in increased allowable costs (to screen for absolutely all ineligible claims) in exchange for little or no net benefit or value.
DAR Council Response: Research (unspecified) indicates that cost of ineligible dependent health care often far exceeds the cost of dependent verification programs. DoD was unable to find any studies or other evidence indicating that the cost to detect ineligible health care claims is higher than the savings.

The DAR Council comments are wholly disingenuous if not outright dishonest in the context of ignoring the history of DCAA audit issues involving large government contractors and audit assertions of unallowable dependent healthcare costs. Although the DAR Council mentions unspecified research illustrating a rate of ineligible claims at 3 percent, the DAR Council knows or should know from actual data/DCAA audits and audit resolution that 3 percent is an unsupportable assertion and a gross overstatement of relevant and verified facts. Rather than depend upon unspecified and non-verifiable research, all the DAR Council needed to do was obtain data derived from failed DCAA audits.

DCAA began this charade with an auditor who had read a business periodical (magazine) advertisement promoting the cost savings which could be accomplished by engaging the sponsor of the advertisement to detect ineligible healthcare claims/costs. That advertisement indicated that these ineligible claims were in the range of 6 to 8 percent. DCAA then used that undocumented, unverified, non-accounting data to engage in a strategy of withholding hundreds of millions of dollars from large government contractors who could not initially satisfy DCAA in terms of demonstrating actual costs for ineligible healthcare benefits. After spending millions on studies to refute DCAA's wholly invalid assertions (based upon a self-promoting advertisement) we believe or understand that large defense contractors were able to demonstrate that the actual rate for ineligible dependents was negligible (well below 1% which is far below the 3 percent "shown by research" stated by the DAR Council in the Federal Register and certainly well below the 6-8 percent used in the self-serving advertisement which started this ill-conceived wild goose chase).

Rather than walk away from DCAA's embarrassing strategy which was initiated based upon a self-promoting third party advertisement (rather than audit data developed specifically from defense contractor actual experience), Mr. Assad/DDP has legitimized this fiasco by making the costs expressly unallowable.

Apparently the DAR Council is not accountable to anyone and ultimately the US Taxpayer will be on the losing end of this new DFARS rule which simply ignores the facts; in particular that it is prohibitively expensive to evaluate every healthcare claim to eliminate absolutely every ineligible claim. For what it's worth the United States Government has been totally ineffective at accomplishing this for healthcare costs under Government programs and is also ineffective at limiting all forms of improper payments (estimated improper payments by Government agencies have been estimated to exceed $100 billion). Obviously it is much easier for the Government, DOD/DDP in this case, to impose unrealistic and expensive administrative expectations on defense contractors, than it is for the Government to get its own house in order. These actions by DOD/DDP will do nothing to entice commercial companies to pursue DOD contracts---the US Government; DOD in particular, unfortunately continues to make itself the customer of last resort.

Where Contractor Executive Compensation Ceilings Stands in Senate DOD Authorization Bill

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

Key Congressional legislators and the White House continue to posture in reaching a compromise in establishing allowable government contractor executive salary ceilings, primarily to get an approved National Defense Authorization Act in place for 2014. An overwhelming number of amendments to the current U.S. Senate version of the 2014 defense authorization bill continue to cloud any clear outcome redefining ceilings on allowable government contractor executive annual salaries. Moreover, the legislative process of sorting through so many amendments is likely to inhibit the finalization of an authorization bill that will be sent to the White House for

signature this calendar year even if a compromise on salary caps is reached.

The annual compensation cap in the 2014 NDAA (National Defense Authorization Act) is $625,000), the bi-partisan compromise (negotiated by Senator Murray and Representative Ryan) is $487,000, although an amendment introduced by Senator Joe Manchin would lower the annual cap to $230,700, a benchmark frequently discussed over the past two years that mirrors the salary paid to the Vice-President and/or Cabinet executives. However, the Manchin amendment broadens exemptions to the cap to include certain medical professionals, security experts, scientists and engineers (inexplicably these functions are worth more than are other management functions; by inference a CEO function is worth less than a scientist or engineer).

Government contractor community leaders see the proposal as setting an undesired compensation level for contractor employees significantly lower than annual wages commanded by employees/executives in the private sector market place. Alan Chvotkin representing the Professional Services Council (PSC) prefers that the existing regulatory annual compensation cap of $763,029 become the benchmark for future adjustments for inflation. True to their watchdog mantra, the Project on Government Oversight (POGO) had previously noted that the cap will eventually exceed an unreasonable cap of $950,000 if Congress does not agree to a new (lower) cap and/or a revised methodology for annual updates, and consequently the government will share in "excessive and unreasonable" contractor wages.

And while the debate continues for lowering 2014 ceiling benchmarks to as low as $230,700, the Office of Management and Budget (OMB) finally established the FY 2012 regulatory contractor executive annual wage ceiling at $952,308 in its December 4, 2013 Federal Register notification, a 24% increase over the ceiling established for FY 2011. As a clarification, these caps represent those annual contractor employee salaries/wages up to which the federal government will reimburse contractors in connection with performing certain types of government contracts which include FAR Part 31 cost principles. Along with the OMB FY 2012 compensation cap determination, the White House announced that it proposes to replace the current government contractor salary caps with a $400,000 cap, an amount equal to the President's annual salary, ostensibly beginning with a signed 2014 defense authorization bill, and that realigned cap would cover all contracts awarded by all government agencies. The close timing of the OMB's publication of a $952K FY 2012 government contractor compensation cap and the Obama announced goal of dropping the FY 2014 compensation ceiling to $400,000 is seen as a bargaining tool to move Congress closer to a contractor compensation benchmark more in line with public sector executive compensation. Unfortunately there is bi-partisan support for lowering the statutory cap albeit support which simply ignores the history, facts and logic which have been used to establish and to annually update the cap.

Discussion as to a new baseline is still up in the air, which may mean establishing a new wage salary survey source and methodology other than the one currently used to benchmark average executive salaries for purposes of establishing contractor employee regulatory caps. It could also mean the utilization of new annual escalation source data which, should proponents of lowering the ceiling caps to those of government executives have their way, would likely reduce annual salary cap adjustments to annual ceilings of government employees (e.g., annual wage increases arbitrarily set by Congress and based more on government spending constraints than actual wage inflationary trends experienced within the private sector labor force).

Grassley Staff Oversight Report States DFAS Financial Statements Flawed, Enabled by DOD IG

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

A staff oversight report released by the office of Senator Charles Grassley asserts that financial statements issued by the Department of Defense's (DOD) accounting agency, the Defense Finance and Accounting Services (DFAS), were not worthy of "clean opinions" provided by an external CPA firm whose auditors performed the financial statement audits and issued those opinions. The report states that the outside audit firm "rubber stamped DFAS' accounting practices using defective audit methods", and the DFAS financial statements

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are unreliable and do not balance because the agency has "lost control of the money at the transaction level".

Even more alarming, the report accuses the DOD Office of Inspector General's (IG) of being complicit in allowing unqualified audit opinions, based on flawed audit work, to go unchallenged thereby perpetuating a potentially long-term inaccurate and unreliable representation of the DFAS financial position. The DOD IG, the report states, independently reviewed the CPA audits to determine if the external auditors employed professional auditing standards in rendering clean opinions; instead of producing a report that should have clearly identified poor auditing methods that could not support unqualified opinions, the DOD IG "seems to have turned a blind-eye" to sub-standard audit work after purportedly being "steam rolled by DFAS" into covering for the agency and the external audit firm. The report states that the IG actually never completed its reviews of those "clean opinions" because of a series of ethical and legal blunders. The inability of DFAS to produce credible financial reports and the IG to perform responsible and independent audits, the staff oversight report says, places the DOD audit readiness initiative in jeopardy which is designed to bring the agency in compliance with the CFO Act by 2017.

Grassley's office initiated a review in 2012 of the DFAS financial statement audits, as well as the IG reports which were supposed to confirm the CPA firm's use of valid financial audit methods, after having received numerous emails from whistleblowers asserting "gross misconduct' in connection with two of the CPA DFAS financial statement audits (2008-2009). The Grassley report states that the IG endorsed the CPA DFAS financial statement audit opinion for FY 2008 when no such affirmation should have been made; however, for FY 2009, the IG planned to "non-endorse" the CPA audit opinion but did not formally report that intention.

The Grassley staff oversight report leaves little to the reader's imagination in discerning its investigation outcome and its impact on the integrity of the DOD accounting process, not to mention the competence of the DOD IG in its ability to serve as a viable watch-dog, one responsibility of which is to protect the financial posture of the DOD (with just as much diligence as the IG would in examining private sector government contractors for flagrant misuse of taxpayer funds). The report terms the DFAS accounting work as "substandard", the IG staff "weak and ineffective", and the DFAS financial statements without credibility.

The DOD IG is no stranger to accusations of audit misconduct and ineffectual methods for achieving its assigned mission. The Grassley camp has issued three oversight reports between 2010 and 2012 finding that IG audits are wasteful and ineffective. DOD IG attributes much of its inability to conduct timely and quality audits to reductions in IG auditor resources. Should Grassley refer allegations of misconduct to relevant integrity committees as Grassley has threatened, the DOD IG will likely remain a continuing target for overhaul of its mission and audit approach.

Six Common Myths in Application of FAR Part 31 Cost Principles

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

The FAR Part 31 Cost Principles is the single most comprehensive regulatory source that defines cost accounting, cost allowability, and other contract cost guidelines with which government contractors must comply for contracts that include provisions requiring the disclosure of costs as a condition of bidding, reporting, or billing contract costs. Although other FAR parts bring in peripheral accounting qualifications that must be in place before subject to cost type contract awards (FAR Part 9), or pertain to unique events causing special consideration in recovery of costs (FAR Part 49, Terminations), FAR Part 31 is the only regulatory source that identifies the core foundation for contract cost accounting requirements.

However, both contractor and government officials often misconstrue the applicability and execution of the cost principles to individual contractor cost and accounting practices, largely because the cost principles were written to be open-ended and adaptable to individual contractor business environments, rather than inflexible and rigid which would impair contractor judgment in determining individual company best practices for following those principles and allowing contracting officers to exercise prudent judgment in evaluating contractor compliance to these regulations. In fact, a number of myths persist among government and contractor

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officials as to the intent and applicability of the cost principles, and consequently much administrative bickering among contractors and contracting officers occurs in defending those myths and delaying settlement of disagreements between the government and contractor.

Some of the most common misinterpretations of the cost principles we frequently observe include the following:

1. **FAR Part 31 covers ALL government contracts**---FAR Part 31 cost principles are only applicable to contracts and subcontracts where solicitation instructions or contract clauses require the disclosure of detailed cost estimates in the bidding phase or the monitoring, reporting, or billing of actual costs incurred. (See FAR 31.102 through -108). Where government contract arrangements, such as commercial fixed-price commercial-off-the-shelf (COTS) or sealed bids, are executed, no cost information is ordinarily required to support the pre-award bid price, nor are there requirements for tracking actual costs after award.

2. **Cost principles were intended for all contractors, operating in same industries, to utilize same cost accounting practices**—not what the cost principles intended. Although FAR 31.101 states that an objective is for companies of "similar types doing similar work will follow the same cost principles and procedures", this does not translate to mandating those entities maintaining identical accounting practices. No expectation that two companies performing sheet metal shop fabrication operations, for example, have a total cost input base for G&A allocation, maintain the same valuation of inventoried materials released to production, or charge direct labor utilizing the same categories, is embedded in FAR Part 31.

3. **Specific direct and indirect cost allocation guidelines are provided**—all one has to do is read FAR 31.202 and 31.203 to learn that the cost principles establish an open-ended framework for contractors to select and implement its practices for categorizing and allocating direct and indirect costs. Cost principles do not prescribe cost elements that should be direct, indirect cost centers that must be in place, allocation bases for specific types of indirect costs, methods for valuation of labor, etc.

4. **Cost principles discourage changes in cost accounting practices once established--If changes in cost accounting practices are made, all changes must be disclosed to the government**--the regulations do not discourage changes in cost accounting practices; on the contrary, FAR Part 31 recognizes that changes in business conditions and operations will necessitate accounting system changes to maintain compliance with the regulations and improve the precision in allocation of direct and indirect costs. One example of this flexibility is found in FAR 31.203(e) where the regulations clearly recognize that revisions in indirect allocation methods may be required due to changing contractor operations and events. Further, there is no requirement within FAR Part 31 to submit to the contracting officer prospective cost accounting practice changes for approval, nor a calculation presentation of the cost impact, as a condition for making the change. That requirement stems only from the Cost Accounting Standards, a separate statute outside the FAR, which does require these administrative procedures if a change is made, but a change notification and cost impact analysis is only required when a contractor is performing CAS covered contracts.

5. **Cost principles specify cost accounting internal controls and subsidiary systems criteria**—no specific accounting systems criteria for satisfactory internal controls are presented within the cost principles, nor are there specific requirements or processes for compliant timekeeping & labor charging, project ledger, materials management, billing, or other systems procedures within FAR Part 31. The requirements for a contractor to maintain satisfactory timekeeping and project cost groupings of costs by contract, for example, are found in the form SF 1408, "Pre-award Survey of Prospective Contractor Accounting System", and more explicit (although still vague) regulatory accounting system criteria is embedded within the DFARS Business System contract clauses. However FAR Part 31 contains no internal control or procedures criteria for establishing procedures to maintain compliant internal controls, although some government agencies insist the cost principles "implicitly" embrace these requirements. In fact DCAA audit policies state that DFARS Business System criteria should be applied in evaluating contractor internal controls even

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though the contractor may not have any contracts with the Business Systems clause.

6. **Government contractors are held to the same government policies and cost constraints applicable to government employees** —the most common examples of these myths held by contractors pertain to employee business travel, severance pay, relocation and business meetings, and contractor misperceptions are frequently forged by misguided government auditor assertions that contractors should mirror the government employee limitations. Not true, except for certain travel costs (e.g., per diem) where limitations of the government's FTR are included with FAR 31.205-46. Contractors should resist the notion that the company's failure to follow a government agency's internal cost parameters and practices in these areas will produce unallowable costs (often incorrectly characterized as expressly unallowable), and before accepting a government practice or auditor assertion of limiting costs incurred to those government employees are held, contractors should read the relevant cost principles**.**

The vast majority of government procurement cost accounting and pricing regulations are not finite in application, but subject to interpretation; however, both contractor and government personnel often read more into the regulations than actually stated, often times as a matter of supporting what they would like the regulations to mean. FAR 31.205 identifies numerous costs that are explicitly unallowable, without qualification, thus further interpretation is not required (e.g., alcoholic beverages are unallowable regardless of business purpose or benefit). However, other costs may be expressly unallowable depending on underlying events giving rise to those costs; that determination however requires an open-minded assessment of events and documentation supporting those costs before deeming those costs unallowable, and the evaluation requires assessing the unique contract environment and contractor business activities while avoiding pre-conceived ideas that such costs are always unallowable regardless of purpose. A good example of frequently challenged cost as unallowable regardless of what the regulations say: cost of any food at a company business event equals entertainment, regardless of the purpose or nature of the event or the contractor documentation justifying the requirement and/or the purpose.

A message to government contractors: read FAR Part 31 with an unbiased mind-set before finalizing decisions in prospective changes to company accounting practices or in analyzing government cost related challenges, and utilize common sense in application of the broadly defined cost regulations (e.g., reasonableness) to your company's unique contracting activities and company business culture.

DOD IG Cites Contracting Agencies for Not Complying with Rules in Awarding Cost Reimbursement Contracts

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

In what seems to be a never-ending whipping of government contracting agencies for issuing cost reimbursement contracts to contractors, the Department of Defense Inspector General (DODIG) issued a report citing the Missile Defense Agency (MDA) and the Defense Microelectronics Activity (DMEA) for circumventing regulations requiring documentation supporting the award of cost reimbursable contracts. The IG reported findings only identify contracting agency documentation lapses and do not, similar to previous IG reports on this subject, set forth any factual information or examples that connect the documentation deficiencies to actual government contractor cost overruns or misuse of contract funds.

The November 22, 2013 report asserts that the MDA and DMEA inconsistently applied the interim FAR regulations which require agencies to support awards of cost reimbursement contracts by documenting that those awards were justified, properly approved, suitable for transition to firm-fixed-price contracts in the future, evaluated to ensure Government resources were available for administration, and awarded to contractors with adequate accounting systems. Conclusions are supported by the IG's finding that 72 out of 88 reimbursable contracts reviewed (contracts valued at $528 million) were not adequately documented.

Consistent with the preconceived legislative and executive government departments' assumption that cost reimbursable contracts automatically open the door for government

contractor overruns, the IG report concludes that government procurement agencies' failure to document these awards "may inappropriately increase DOD's contracting risks because cost reimbursement contracts provide less incentive for contractors to control costs".

The report is the third the DOD IG has released in 2013, the first two of which also found that the Army and Air Force procurement commands neglected to follow documentation rules for awarding reimbursable contracts (DODIG-2013-120, August 23, 2013 & DODIG-2013-059, March 21, 2013). DOD procurement activities are not alone in being castigated for non-compliance with these FAR provisions—example, the Department of Transportation IG issued an August 2013 report noting that "high risk" reimbursable contracts were being awarded without adequate justification, thereby subjecting the government to waste and misuse of taxpayer funds.

Amazingly, all of these IG reports ignore a fact-based DOD report on Major Defense Programs which cited empirical evidence in concluding that "contract type" is not relevant to cost control" (refer to our article in the July Government Contract Insights). Ignoring reality, the cascade of government watchdog agency reports bashing government agencies for documentation deficiencies associated with the use of cost type contract will continue as long as government contracting officers are allowed the luxury of judgment in choosing the level of documentation for awarding reimbursable contracts, and may in fact never cease as long as cost reimbursable contracts are an acceptable vehicle for procuring services and supplies from the private sector.

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May 20-21, 2014 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Las Vegas, NV

July 14-15, 2014 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Hilton Head Island, SC

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July 15-17, 2014 – The Masters Institute in Government Contract Costs

Hilton Head Island, SC

October 20-21, 2014 – Accounting Compliance for Government Contractors

Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
- Cyndi Dunn
- Wayne Murdock
- Cheryl Anderson
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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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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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