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Professional & Consulting Costs – High on List of Audit Questioned Costs

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Contractor claimed professional and consulting services costs has climbed to one of the most common categories of costs frequently questioned by government auditors during evaluation of cost claims under reimbursable contracts submitted within incurred cost proposals (ICPs), based on our experience in serving government contractor clients over past year. And the government audit agencies pouncing on claimed professional fees include Department of Defense (DOD) as well as non-DOD (civilian). The reason for significant questioned costs—failure to satisfactorily support consulting and professional fees with adequate documentation under the provisions of FAR 31.205-33 (e) and (f).

Auditors consider professional fees low hanging fruit, easy pickings, etc. because the allowability verbiage and parameters stipulated in FAR 31.205-33 are ultimately highly subjective, thus affording auditors a wide open door for interjecting judgment, sometimes to the point of individual auditor/ personal expectations, in benchmarking contractor incurred/claimed professional and consulting costs to the cost principle. There are two "adequate documentation" provisions of this cost principle that allow a huge amount of audit latitude in potentially determining professional and consulting fees unallowable, and both documentation provisions are deemed by the DCAA to render costs as "expressly unallowable" (subject to FAR 42.709 penalties) if sufficient evidential data (in the auditor's opinion) is lacking. Those include (1) 31.205-33(e), specific to "retainer fees", and (2) 31.205-33(f), inclusive of any and all professional and consulting costs including fees generated by retainer arrangements.

THIS ISSUE:

Documentation standards for retainer agreement costs (31.205-33(e)) include proving that services are necessary and customary; level of past services justifies retainer fees (if applicable); fees are reasonable when compared to maintaining in-house resources for same services, and; actual services meet the -33(f) requirements.

Evidential requirements for ***all*** costs covered by 31.205-33(f) include details of agreement with professionals providing services; invoices/billings that identify an expression of time expended and services provided, and; work product.

Neither provision of these two subparagraphs discussing supporting evidence are specific as to type and level of detailed procurement and accounting data contractors must maintain that would necessarily allow auditors to override contractor judgment in meeting evidential data regulations, as long as contractor data in its totality supports the underlying intent of the requirement—that is, actual services were performed consistent with agreement terms and conditions and due diligence was exercised in ensuring that costs are reasonable and exclude costs for unallowable activities. The retainer guidelines are at best vague leaving it to reasonable parties to select sufficient data to support allowability. The -33(f) standards are more specific; however, they are nonetheless open-ended.

Auditors are more frequently using the 31.205-33(f) provisions in justifying questioned professional and consulting services costs, sometimes including the entire amount billed by a consultant under a single engagement agreement. Contractors are at the mercy of audit judgment in interpreting and applying the regulatory documentation requirements to actual data maintained by the contractor. Costs are questioned if actual consultant "hours" (interpretation of "time expended") are not clearly stated in the invoice—in some cases even though consultant's time records or other information is separately produced outside of the invoice. Moreover, auditors inexplicably question all invoiced fees because, in their judgment, invoice verbiage describing services provided is too short or only refers to the consulting agreement (where, if the auditor were to review, they would find a connection to services provided). Auditors are more prolific in challenging fixed price retainer costs because often times the "consumption" of a fixed monthly invoiced amount (without "time expended" shown) is not evident on the invoice; and, cost incurred via retainer agreements (fixed monthly amounts) are viewed as higher at risk of including costs for "unallowable" activities (e.g. lobbying). Auditors are overlooking the intent of the "time expended" documentation requirement which is inextricably interrelated with the description of the activities; specifically, if the activities listed on the invoice and the agreement are allowable activities, there is no significance to the time expended because the activities/costs are 100%. Only if the activities are partially allowable and partially unallowable is there any significance to detailed recording of time expended.

The absence of what auditors envision as a satisfactory "work product" has become more problematic to contractors, with the entire consulting fees being questioned, even though services performed, consistent with the engagement agreement, are demonstrated with other data. The DCAA's contract audit manual expressly states that auditors should not insist on a work product if other evidence is available to nature and scope of actual work performed (DCAAM 7-2105.2c)—when a work product is not relevant, invoices that describe the services provided should suffice as having met the intent of evidentiary data required to support consulting costs. However, recent experience with several clients shows that auditors sometimes ignore their Agency guidance and insist on a work product.

Companies that are all too frequently subject to questioned consulting and professional services costs are small businesses and/or those new to government contracting. However, we encourage all contractors to review existing practices in meeting the documentation requirements discussed in this article and to consider re-evaluating existing documentation which supports historical consulting fees included within incurred cost proposals not yet audited. Be aware that consulting and professional services costs not adequately supported per the cost principle documentation provisions will be reported by DCAA as "expressly unallowable" and subject to FAR 42.709 penalties.

DCAA Audit Program for Contractor Accounting Systems Why Limit a DOD (DFARS) Regulation Just to DOD Contracts?

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

It should come as no surprise that DCAA's latest revision (March 2013) to its Accounting System Audit Program (DCAA internal code 11070) is full of DCAA embellishments and misinterpretations not the least of which is a DCAA statement that "contractors without DOD contracts are not contractually required to comply with the DFARS (business systems) criteria. Nevertheless, the DFARS criteria are suitable standards to use in determining the acceptability of any Government contractor's system for the accumulation and billing of cost under Government contracts". Apparently "not contractually required" has absolutely no significance to DCAA which will unilaterally impose the "not contractually required criteria" as DCAA sees fit. It should not go unnoticed that during the Commission on Wartime Contracting hearings (which ultimately led to the DFARS Business Systems Rule) DCAA publicly stated that the DFARS Business Systems Rule should be extended to all contractors and the fact that the government rule-makers have not extended the rule has not stopped DCAA from exercising DCAA's unofficial motto: "We prefer to believe what we prefer to be true".

Perhaps the one saving grace is that DCAA cannot unilaterally decide to audit a non-DOD contract/contractor because the non-DOD (civilian) agency must first agree to fund DCAA. Trends suggest that civilian agencies are balking at funding DCAA (reimbursable) audits because these audits tend to be very long, drawn-out and expensive with little predictability of any "value-added" by DCAA's involvement. As further discussed within this article, DCAA has a very muddled and subjective interpretation of reportable system deficiencies; hence, the agency receiving a DCAA business systems audit report (using "not contractually required criteria") will first have to resolve contractor challenges to DCAA's use of "not contractually required criteria".

In addition, the DCAA audit program can be used at major or non-major contractors, which is an internal DCAA designation which seems to build upon DCAA's decision to impose the DFARS criteria regardless of it not being contractually required; specifically, that many non-major contractors do not have any CAS covered contracts in which case the DFARS criteria is clearly not applicable. When the DFARS regulation was published, the DAR Council intentionally linked CAS applicability to the applicability of the DFARS rule knowing that small businesses are exempt from CAS. The obvious intent was to not subject these small businesses to the DFARS regulation. However, DCAA is apparently oblivious to the obvious intent of the DAR Council which begs the question; at what point will someone in authority "help" DCAA in adhering to the contractually required contract terms and conditions?"

DCAA's audit program also makes reference to auditing standards and auditing terminology including DCAA's unilateral assertion that "significant deficiency", specifically used in the DFARS Business Systems Rule, is identical to "material weakness" (derived from government auditing standards, but not incorporated into the business systems rule). Unfortunately, the DCAA reference to "material weakness" provides absolutely no additional clarity or objective criteria which will assist anyone in defining what is or is not a significant deficiency. On the same lines, DCAA also adds a reporting requirement for the auditor to report deficiencies which are "less than a material weakness"; hence, less than a significant deficiency. Such deficiencies will probably never be reported by DCAA who considers any deficiency to meet the "significant deficiency" standard and reporting less than material weaknesses would be of absolutely no interest or value to a contracting officer dealing with the specifics of the DFARS Business Systems Rule unless that reporting would assist the contracting officer in understanding the difference between a significant deficiency and less than a significant deficiency (it won't because it will never happen and if you ask a DCAA auditor to explain the difference, they can't). It should be apparent to anyone reading this article and trying to understand the distinctions that nothing in DCAA's audit program helps in any context in terms of the ill-defined distinction between a significant deficiency and less than a significant deficiency; a distinction which could be the difference between system failure and system approval.

DCAA appears to tacitly or implicitly acknowledge that it does not timely complete any comprehensive accounting system audit because DCAA's audit program has a requirement that the auditor consider reporting a significant deficiency

(identified during the audit) before completing the accounting system audit. DCAA's audit program does make the point of deferring to the auditor's judgment in terms of a decision to issue a "deficiency report" during the audit or to complete the entire audit and then report any deficiencies noted during the audit. Recent experience has shown that DCAA just can't wait to report a significant deficiency as soon as possible by drafting, internally coordinating, obtaining contractor rebuttals, and issuing a spontaneous deficiency report during the audit notwithstanding the fact that DCAA then diverts hundreds of hours to the deficiency report when those same hours could have been applied to more timely completion of the overall accounting system audit. Assuming there is more than one alleged significant deficiency identified at different times, most likely by different auditors during the audit, the process of deficiency reporting can (and has) easily overtaken the comprehensive accounting system audit in terms of utilization of DCAA, contractor and contracting officer resources.

Apparently no one at DCAA sees any need to encourage auditors to consolidate the audit results into a single comprehensive audit report, infusing significant efficiencies into the process for all concerned; in particular for contracting officers who are already overwhelmed with audit issues because of DCAA's quest to protect the taxpayer (translated: DCAA is flooding the system with audit issues including all too many which are not consistent with the actual contract regulations which is self-evident in DCAA's publicly reporting cost questioned statistics, but not reporting cost questioned sustained). DCAA has yet to show any real concern for efficiencies as exemplified by DCAA's exhaustive use of adequacy checklists to continuously reject (for inane reasons) contractor bid proposals, forward pricing rate proposals and indirect cost rate proposals rather than timely initiating and completing the associated audit. DCAA's preference is to delay the audit and to attribute those delays to contractors' inadequate submissions although most of those allegedly inadequate submissions are auditable/easily corrected during the early phases of the audit.

The DCAA audit program has an interesting section which pertains to the need for the audit team to consider and to discuss the risk of fraud and other non-compliances with applicable laws and regulations. This team exercise is oddly enough based upon relevant prior audit experience (which may or may not be current—very little is current due to DCAA's inability to timely audit) and this fraud risk assessment is documented before the audit commences. The auditor (or team) should then "consider audit procedures" to address the risk of fraud and other non-compliances" and provide reasonable assurance of detecting fraud and other non-compliances with applicable laws and regulations". Oddly enough there is no requirement to actually design and perform audit procedures, but they must be considered. Equally odd, the fact that DCAA's audit program combines "fraud" with "other non-compliances with applicable laws and regulations"; however, there are vastly different ramifications with fraud juxtaposed to other regulatory non-compliances. Finally, DCAA's audit program inserts this consideration of fraud as an initial step based upon other relevant audits when fraud is rarely discernible until the instant audit is well underway and there are current, relevant observations which could be indicative of fraud. In other words, effective consideration of fraud is more a function of critical and reactive thinking by the auditor during the audit which perhaps explains why the vast majority of contract frauds are identified through Qui Tams (or internal whistle-blowers working for a contractor) and not by DCAA audits---DCAA auditors are trained to expect standardized, one-size fits all contractor submissions and to blindly follow standardized audit programs as opposed to being trained to critically think.

One final comment about the DCAA Accounting System audit program, DCAA has publicly stated that it will be deferring to contractors to demonstrate to DCAA (and to DCMA) how the contractor complies with the business systems criteria (e.g. the 18 accounting system criteria in DFARS 252.242-7006). This should involve a "walk-through" and a system demonstration deferring specifics to the contractor and its system of controls. However, anyone reading the DCAA audit program and/or encountering a DCAA audit or an accounting system will likely discover that DCAA is unwilling to simply "defer to the contractor". DCAA's audit program and its stated expectations (during these audits) are indicative of an agency who is quite willing to "fill in the blanks" in terms of embellishing the somewhat generic systems criteria with DCAA's interpretations of specific requirements. One audit program example, DCAA's insistence that the accounting system criteria of "providing for a timekeeping system that identifies labor by intermediate or final cost objectives" also includes requirements that timesheets are completed by employees and approved by the employees' supervisors" and that "the contractor has segregation of duties in its timekeeping system". A second recent example, with respect to the criteria

that a contractor system "provides for billings that can be reconciled with the cost accounts", DCAA is asserting that each billing (invoice/public voucher) must include that reconciliation ("can be" reconciled is significantly different than "must be reconciled and documented on each invoice"). DCAA's insistence that contractors document billed to booked reconciliations on each invoice is non-value added, administratively expensive and one more example of DCAA's disinterest in considering cost efficiencies.

DCAA remains its own worst enemy by embellishing the actual regulatory requirements which in turn unnecessarily expands the audit scope, unnecessarily burdens the contractor with supporting that audit scope, and yields audit results (significant deficiencies) which are at best a loose translation of the actual regulatory requirement leaving contracting officers to wrestle with the contractually correct interpretation (typically provided by the contractor in rebutting DCAA draft audit reports). This grossly inefficient process will not improve unless and until DCAA (the agency) receives qualified, competent adult supervision. Any volunteers?

Major Defense Acquisition Programs (MDPAs) Report: Contract Type Irrelevant to Cost Control

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

The Department of Defense (DOD) June 28, 2013 "Performance of the Defense Acquisition System" annual report states that little difference exists between fixed price and cost-plus contracts when it comes to predicting or controlling costs.

The first annual study focused on Major Defense Acquisition Programs (MDPAs) and concluded that no individual contract type was found to be better than others in controlling costs, particularly for development or early production contracts. The report stated in part, "relying on contract type alone to achieve better affordability outcomes will not likely be successful".

The report contradicts the long-standing belief by the White House and certain legislators that cost reimbursable contracts foster government contractor irresponsibility in controlling costs, thus creating unnecessary cost overruns. Moving from the award of cost plus to fixed price contracts has been a center piece in the Obama Administration's government acquisition reform program based upon the presumption that contractors would be forced to better manage contract costs. To be clear, this presumption is not limited to the Executive Branch; notably Senator McCain has repeatedly proposed legislation which would place extreme limitations on the use of cost-type contracts.

The DOD Under-Secretary of Defense for Acquisition, Technology, and Logistics, Frank Kendall, stated that fixed price contracts are not in themselves the answer to improving the procurement system. He stated, "The finding that fixed price contracts are not a magic bullet to controlling costs has reinforced my experience that we need to consider and select the most appropriate contract type given the maturity, system type and business strategy for each system." Translated, there are valid circumstances when cost reimbursable contracts are practical; reimbursable contract types cannot be avoided, for example, when program development requirements and scope of effort are ill-defined in the early stages of a new program.

It remains to be seen whether the report will impact the Administration and certain Legislator's never-ending persistence in achieving a goal of all but eliminating cost reimbursable contracts. The reported finding that no one contract type can ensure better control of contract costs, albeit limited to major acquisition programs, should at least "incentivize" the government acquisition reform advocates to moderate their position on killing off cost reimbursable contract types.

OMB Announces Extension for Accelerated Payment to Small Business Subcontractors

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

In a July 11, 2003 memorandum to Executive Departments and agencies, the Office of Management and Budget (OMB)

announced it would extend its 2012 policy for improving cash flow to small businesses who are subcontractors by accelerating payment of invoices to the applicable prime contractors. The memorandum extends the temporary policy until July 11, 2014.

The policy originally established in September 2011 with follow-up guidance issued in July 2012 required agencies to pay prime contractors a promptly as possible with a goal of not later than 15 days after receipt of adequate prime contractor invoices. That memorandum also "encouraged" prime contractors to expedite payment to its small business subcontractors, and suggested that such prime contractors modify subcontractor payment terms to identify an accelerated payment commitment.

The memorandum also states that the updated policy does not negate the application of the Prompt Payment Act's late-payment interest penalty provisions (which only applies to government "non-prompt" payments to the prime contractor).

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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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