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New FAR and DFARS Rules Enhance Whistle Protections & Constrain Allowability of Contractor Legal Costs

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

The Federal Acquisitions Regulations (FAR) Council and Department of Defense (DOD) each issued interim rules that revise the FAR and Defense Federal Acquisition Regulations Supplement (DFARS) to strengthen existing contractor employee whistleblower protection measures, as required by Sections 827 and 828 of the FY 2013 National Defense Authorization Act (NDAA). The new rules not only create added whistleblower rights for insulating employees from contractor reprisals, they also address the allowabilty of contractor legal fees arising from whistleblower legal proceedings initiated by employees who submit a complaint of reprisal. As one might guess, the costs are unallowable when there is a determination that the contractor is culpable in punishing the employee for disclosing suspected contractor mismanagement of government funds, violation of laws or contract terms and conditions, or other activities detrimental to the government.

The Interim rules effected by DOD (DFARS) and the FAR Council (FAR) are largely the same, except that FAR changes are subject to a four year pilot time test period, while DFARS changes are permanent. Changes to FAR to bolster protection of a whistleblower are incorporated into FAR 3.908 (Pilot Program for enhancement of contractor employee whistleblower protections); FAR 31.205-47(b) (Allowability of legal costs), and; FAR 52.203-17 & 52.212-4 (implementing contract clauses). Companion DOD interim provisions for whistleblower protection and rights are largely found within DFARS 203.90 (Whistleblower protection for contractor employees).

THIS ISSUE:

Highlights of the changes in the FAR and DFARS whistleblower regulations include:

- Extends protection to subcontractor employees (previous rule confined protection only to prime contractor employees), and allows those employees "compensatory damages" assuming employee has been the target of a reprisal event;
- Expands type of misconduct disclosures that are protected to include violations of a rule or regulation, or abuse of authority, which goes beyond the previous protective disclosure scenarios such as gross mismanagement of government funds and violation of statutes & expands definition of "abuse of authority" in DFARS 203-901;
- Expands protected disclosures to include those not only made to a government official, legislator, Inspector General (IG), or Department of Justice, but also disclosures made to appropriate contractor (or subcontractor) authorities;
- Prohibits reprisal against an employee even if it is undertaken at the request of a government official;
- Requires contractors and subcontractors to notify in writing all employees of their protective rights as a whistleblower, and;
- Amends DFARS 203.905 to identify specific situations in which the DOD IG could justify averting an investigation of a whistleblower complaint.

The provisions of FAR 31.205-47(b) were amended to explicitly address the allowability of contractor legal fees associated with a proceeding brought by a contractor or subcontractor employee submitting a whistleblower complaint of reprisal (where a disclosure of a violation of, or a failure to comply with, law or regulation by the contractor is asserted). The -47(b) opening paragraph adds as one of the types of "proceedings" addressed in this section, *(and therefore potentially unallowable if one of five outcomes result from the proceeding (FAR 31.205-47(b)(1) through (5)),* a reprisal complaint filed by a contractor or subcontractor employee. Formerly only proceedings brought by the government, or a third party action brought in the name of the United States under the False Claims Act (a.k.a., "qui tam"), were addressed in this paragraph.

The second of the five outcomes of any proceedings covered in -47(b) (-47(b)(2) and relevant only to civil or administrative proceedings was also amended to include a new condition in which contractor incurred legal fees pertinent to a Whistleblower Proceeding would be unallowable—that condition--if an order is issued by an agency head to the contractor or subcontractor ***to take corrective action*** pursuant to the whistleblower protection statutes.

This added Whistleblower Proceeding allowability criteria placed in FAR 31.205-47(b)(2) is not specific as to the nature and contents of an "order issued" by an agency head" or the authoritative level at which an agency head decision can be considered final. For example, it does not address delegation, e.g. "Could an agency head decision of this nature be delegated to a local ACO, with only limited facts having been provided to an agency head for coordination"? Moreover, the added language defers to the government the criteria or circumstances surrounding a specific Whistleblower Proceeding that would necessitate an agency order for corrective action, thus rendering the associated contractor fees unallowable.

Government Contractors: Media and Social Media Disclosing Too Much Information to Government Regulators/Auditors?

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

Everyone is familiar with social media in terms of individuals freely disclosing too much information and then losing control of that information; one example, an insurance company advertisement where a traveler posts her plans to vacation in Hawaii followed by a "bad guy" posting words to the effect of "thanks for the tip". Recently a news article had similar implications for a government contractor, a very successful entrepreneur who fully utilized small business set asides to create a company which was eventually sold to a large business for $120 million (Editor's note: our article has changed specific amounts/facts to protect the identity of the government contractor although the other news article fully identifies the contractor name, the timeframes and the sale price).

There is absolutely nothing wrong with creating and selling a successful company/government contractor; however there

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are some unallowable contract cost implications for any company which goes through a sale, merger, or acquisition. Unallowable costs under FAR 31.205-27, *Organization costs*, include those in connection with "planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions". This particular regulation does not define the point in time at which point "planning" a reorganization begins (in this case a sale), but it does provide a long list of types of costs which are unallowable including those "sale related" functions performed by third parties (e.g. consultants) or by employees of the company. Additionally, FAR 31.205-14, *Entertainment costs*, makes unallowable costs of entertainment for which a fairly recent ASBCA Case 57795, Thomas Associates, Inc., makes it clear that office Christmas/Holiday parties or similar outings involving boat cruises are expressly unallowable costs as are gifts to employees under FAR 31.205-13, *Employee morale, health, welfare, food service, and dormitory costs and credits*.

In terms of the news article and its unintended disclosures of unallowable costs, the article discusses the success of the company including that the owner took his workers on annual boat cruises and paid for the formal Christmas party in a hotel ballroom where he passed out $1,000 gift certificates as prizes. Further, the news article speaks to the contracts won by the company and the fact that in 2012, after a big win, the company began fielding calls from potential suitors (Editor's note: although specific details are included in the referenced news article, some of those details have been changed in our newsletter to avoid identifying the company).

Although the other news article is focused on the success and new wealth created by Federal Government spending, it contains information which may also be an unintentional "audit lead" to the more astute government contract auditors (i.e. DCAA auditors, at least those who understand that auditing is more than merely following a checklist or standard audit program). At the very least, any auditor with his/her eyes open and brain engaged should take note of the fact that a company was sold and that should mean that there are unallowable organization costs. Although this should be obvious without the details divulged in the news article, the fact is that the news article highlights the sale and the fact that the successful company began considering its market value and potential sale for a period of time before actually executing the sale. Less obvious, but perhaps more damaging is the news article effectively boasting of the annual Christmas parties, entertainment and gifts; all expressly unallowable costs to the extent the company had any government contracts with FAR 52.216-7, *Allowable cost and payment clause*.

We know nothing about the company/contractor other than the disclosures in the news article; hence, it is entirely possible that the successful company was also fully compliant with its government contracts and that any expressly unallowable costs were identified and not claimed/billed to any government contract. Similarly, if the company had fixed price contracts, the unallowable incurred costs may not have been an issue because FAR 52.216-7 would not be applicable. Nonetheless, the news article and its disclosures are a reminder that media, social media and emails can be the source of unintentional disclosures leading to potential issues. We are not suggesting that any contractor incur unallowable costs and attempt to hide those costs, but we are suggesting that there is no reason to unintentionally publicize potentially unallowable costs.

Idle Time: Allowable or Unallowable and Worst Case Scenario Contract Fraud

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

Recently we've observed a new cost allowability or even a False Claims Act (FCA) challenge, that of idle time on the part of government contractor employees; more specifically, idle time that was not caused by government actions or inactions (such as the October 2013 Shutdown). Government actions may trigger contractor entitlement to a delay claim and equitable adjustment to increase the contract price whereas the consequences of contractor actions or inactions causing employee idle time yield potential contractor liabilities.

Unlike idle facilities (unallowable per FAR 31.205-17), there is no corollary cost principle which specifically addresses idle time. However, there is FAR 31.201-3, *Determining reasonableness*, which can always be used by a government auditor to force the contractor to satisfy the "burden of proof" requirement: "If an initial review of the facts results in a

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challenge of a specific cost by the contracting officer or contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable". This clause is something of a "wildcard", but "it is what it is" as reinforced by a US Court of Federal Claims decision involving KBR (Nos. 09-428C & 09-578C) wherein the amount considered reasonable appeared to start at $0, ended up at about $11 million even though the costs incurred were between $40-$50 million.

In application to a contractor incurred cost proposal, a DCAA auditor asserted that the amount of idle time recorded by contractor employees was excessive, thus unreasonable. In this situation, the contractor used a specific idle time work authorization code to better identify and manage idle time, particularly for employees who were awaiting new work. Although this may seem to be a good management tool and a sound internal control, unfortunately, this cost visibility made it easy for a DCAA auditor to quantify and to challenge idle time as unreasonable (analogous to the cliché' "no good deed goes unpunished"). The DCAA auditor asserted that it is unreasonable to have any idle time for a specific employee exceeding more than 80 hours in a fiscal year which would seem to make it easy for the contractor to challenge the auditor's benchmark of 80 hours (which has no authoritative basis); however, that will not solve the "burden of proof" issue (on the contractor) in terms of how much is reasonable. This particular issue has not yet been resolved, but it is a lesson in terms of the unintended consequences of having too much detail within a contractor's indirect labor charge codes.

In terms of idle time becoming the focus of an FCA investigation and settlement, the Department of Justice (DOJ) recently issued a press release highlighting a $1.2 million FCA settlement with a company in Holland, Michigan which charged employee non-productive time/labor costs (watching movies, playing games and volunteer work) to an ARRA (American Recovery and Reinvestment Act) grant. The ARRA funding was for $150 million under what appears to be a cost sharing arrangement for LC Chemical (LGCMI) to build and operate a $300 million lithium-ion battery facility in Michigan. The alleged FCA violation occurred during 2012 when LGCMI claimed costs for domestic workers who were engaged in non-work activities which apparently resulted from hiring employees who were temporarily idle due to the delayed construction and/or delayed production start-up. To the extent the production employees could not be "productively employed", they watched movies, played games and volunteered in the local community while being compensated and the labor charges went to the ARRA funded project. DOJ alleged that the company did not cooperate during the investigation and that the "manner in which LGCMI handled the unallowable costs shortly after those costs were identified factored into the Government's settlement position. Those who receive federal grant funds must deal openly and honestly with the federal government". (Editor's comment: contractors must "do as they say" and not necessarily "do as they do" when dealing with the federal government).

It remains to be seen if this matter would have resulted in an FCA investigation but for the manner in which idle employees utilized their idle time or if there would have been any settlement but for the alleged lack of cooperation with the DOJ. The DOJ (and most Inspector Generals) are very unforgiving when dealing with allegedly uncooperative contractors because it triggers a retaliatory reaction which becomes the primary motivating factor, often overshadowing the question of a legitimate basis for the FCA investigation.

The moral to the story, idle time, rarely thought to be an issue, has now become an issue and under certain circumstances, what employees do while idle goes beyond merely a cost allowability issue. The second moral to the story, cooperate with the federal government or plan to do battle with agencies and their employees who may not exactly "fight fair".

DCAA Releases Updated Procedures for Sample Auditing Low Risk Incurred Cost Proposals

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

The Defense Contract Audit Agency (DCAA) has issued a October 29, 2013 guidance memorandum (13-PPD-021(R)) which sets forth updated policies and procedures for identifying low-risk vs. high risk incurred cost proposals (ICPs) during government fiscal year 2014, and subsequently selecting samples of low-risk proposals for audit.

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The new guidance changes certain previous metrics and criteria (prior year memo September 6, 2012) in separating low risk from high risk proposals, the most notable of which are altering Auditable Dollar Volume (ADV) strata and level of questioned costs disclosed in previous ICPs, and expanding and clarifying the "Significant Relevant Risk" criteria. (The new guidance better defines ADV as being the cost incurred and claimed which are allocable to government contracts and subcontracts subject to payment provisions necessitating final indirect rate determination; guidance makes clear that these amounts include corporate or shared service allocations to those contracts or subcontracts, but exclude any subcontract costs which would be audited by another DCAA Field Audit Office).

Several basic premises for determining low risk ICPs remain the same as prior policy. All incurred cost proposals of $250 mil or higher in ADV are automatically deemed high risk and therefore subject to audit. Conversely, all ICP proposals with ADV below $250 mil are subject to pre-audit analysis for qualification as low risk, and then further subjected to random selection for audit. The basic risk criteria for identifying low risk proposals remain much the same (with exceptions described below). And all low risk proposals included within the individual strata pools not selected for audit will be closed out with a memo to the contracting officer, meaning final rate settlement without further administrative hurdles. There is no mention that DCAA will have the option, when submitting a final letter rate agreement to a contractor, of unilaterally decrementing final rates for a low-risk ICP that is not audited.

For an ICP (below $250 mil ADV) to be deemed low risk, and therefore subject to sampling techniques, the following criteria as stipulated in the updated DCAA policy memo must be met:

- ICPs must be deemed "adequate", with DCAA continuing to take the lead in performing the necessary analysis and providing the results of the review to the ACO; should a proposal not be considered adequate after the first government pass, it is possible, although not stated in the guidance memo, that the ICP may be rendered high risk and not subject to a sampling process

- Questioned costs reported in the last completed ICP audit for a contractor must not exceed certain thresholds. The ADV strata categories and the determining of significant questioned cost thresholds have changed from the prior year guidance. Current guidance for assessing if questioned costs are significant:

    - ICPs with ADV under $1 million—Questioned cost is equal to or greater than 10% of last completed ICP audit's ADV
    - ICPs with ADV between $1 mil and $5 mil—Questioned cost for prior year is equal to or greater than 5% of last completed ICP audit's ADV, or $100K, whichever is greater
    - ICPs with ADV between $5 mil and $250 mi—Questioned cost for prior year is greater than $250K in last completed ICP audit

- ICPs are subjected to a "Significant Relevant Risk" analysis to determine if risks material to the ICP exist. The prior year's guidance memo provided limited instructions for assessing risk and only abbreviated examples of such risks, but the current policy significantly elaborates certain types of risks auditors must consider before taking a leap of faith in giving an ICP a "low risk" rating. For purposes of gauging significant risk, the policy separates the risk evaluation process between those for ICPs less than $5 mil ADV, and those between $5 mil and $250 mil. The risk considerations delineated in the new memo for both ADV strata are largely the same, and include known significant risks (such as fraud referrals), unacceptable pre-award accounting system audit opinion, lack of previous experience with contractor (voucher processing, forward pricing, etc.), and an ambiguous risk factor stated as "significant risk with contractor that has material impact on ICP being assessed".

The primary difference between the application of risk assessments for the two strata above is an apparent expected higher level of audit scrutiny expectation for the $5 mil to $250 mil stratum ostensibly because of the larger dollar value exposure to undetected cost overcharges to the government. The memo states that if the last incurred cost audit for a contractor's ICP which is less than $5 mil in ADV found no significant questioned costs, all other ICPs of the same contractor within that stratum should be considered low risk, unless the auditor or contracting officer is aware of specific known risks. The memo's verbiage for the $5 mil to $250 strata, however, suggests a more cautious and pro-active analysis in determining significant risks before rendering all ICPs for a specific contractor as low-risk, notwithstanding that the most recent ICP audited for that contractor yielded no questioned costs above the established thresholds for low-risk categorization. To accomplish the distinctions auditors should make when evaluating significant relevant risk, DCAA includes as Enclosures 2 and 3 to its memo, separate risk determination tools for each of the strata, whereas there was only a single checklist in the prior year policy.

The inclusion of more expansive "significant relevant risk" criteria as well as extended cautionary guidance to auditors in assessing risk before naming an ICP as low-risk will likely have the consequence of placing more pressure on auditors to absolutely document that significant risks are not evident leading a risk-averse auditor to potentially determine ICPs as high risk based on nominal observations or loosely substantiated notions that there exists a relevant risk "potentially" material to the ICP. Moreover, auditors will most likely lean toward deeming an ICP as high risk, for example, if during that fiscal year there was an audit/ACO pre-award accounting system determination of inadequacy even though accounting system deficiencies highlighted cannot be linked to increased risk of overcharging the government.

Other notable features of the guidance memo of use to government contractors:

- If no low risk ICPs for a contractor are selected in the annual sampling pool for audit, the auditor will close out all adequate incurred cost proposals that were in the sampling pool for that contractor; if however one or more ICP included in the pool is selected for audit, prior year low risk ICPs may be closed out, but ICPs for years subsequent to those selected for audit will not be closed until the selected audits are completed.
- Low-risk sampling percentages and the ADV strata have not changed, with one major exception. No low-risk ICPs less than $1 million in ADV will be selected for audit; those ICPS will simply be closed out without any audit review. In the prior DCAA policy, the low-risk sampling percentage was one percent.

A mandatory incurred cost audit will be performed once every three years for all ICPs greater than $100 million up to $250 million in ADV. If a contractor ICP is not randomly selected for audit in a three-year cycle where the ICP ADV is within this range, the auditor will select the third year ICP after the last audit was completed.

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Hilton Head Island, SC

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Las Vegas, NV

Instructors

- Mike Steen
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