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Executive Compensation Statutory "Cap" Lowered to $487,000: Politically-charged Emotions Prevail Over Logic

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

It appears that the political skirmishes over the statutory cap on executive compensation (FAR 31.205-6(p)) have been successful if success is measured by accomplishing an objective void of fact and logic; but one which plays well to the naïve and uninformed. On December 26,2013, President Obama signed the Bipartisan Budget Act (2014) which included a statutory cap of $487,000 and it appears that amount will become the new FAR 31.205-6(p) cap within 180 days (the Act requires the "cap" to be implemented in 180 days which is approximately June 25, 2014). Of passing interest and now something of a moot point, the Executive Branch had proposed lowering the cap to $230,700 (Vice-President salary), the 2014 National Defense Authorization Act (NDAA) included a cap of $625,000, and as recent as December 4, 2013, FAR had been changed to reflect a cap of $952,308 (applicable to contractor fiscal years 2012 and beyond for costs incurred after January 1, 2012).

A number of our prior newsletters (Government Contract Insights) have followed the trends and proposals related to the emotional issue of executive compensation as a cost allocated (charged directly or more likely indirectly) to Government contracts; most recently in the December 2013 newsletter ("Where Contractor Executive Compensation Ceilings Stands in Senate DOD Authorization Bill") and previously in the June 2013 newsletter ("GAO Report on Capping DOD Contractor Salaries: Huge Increases in Unallowable Wages and DOD Cost Savings"). Suffice to say that the incentives for lowering the executive compensation cap were all about lowering Government contract costs by placing arbitrary limits on allowable executive compensation. Arbitrary in the context of ignoring the logic embedded within the existing statutory cap (which resulted in a cap of $952,308) as explained in the highly political Federal Register notice on December 4, 2013. As previously required by Section 39 of the OFPP (Office of Federal Procurement Policy) Act, the cap amount had been set at the median (50th percentile) based on the amount of the compensation provided over the most recent year (2011 in the case of computing the 2012 cap) for the five most highly compensated managers/executives of all publicly traded US companies

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with annual sales over $50 million.

As has been obvious in other Legislative actions, certain members of the US Congress simply can't accept the fact that the level of executive compensation for publicly traded US Companies (filing SEC reports) is what it is. In reference to the other Legislative actions, in particular the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010, that Act included Section E, Accountability and Executive Compensation, which imposed a number of additional requirements concerning executive compensation including the requirement for shareholder votes on executive compensation (at least every three years). Further, those shareholders must be provided with data concerning the relationship of the executive compensation with the company's financial performance and data concerning the CEO compensation as a ratio of median compensation to all employees of the company. The objective of Section E of the Dodd-Frank Act is to cause executive compensation to decline (or at least to publicly shame the CEOs).

It is ironic that with the Dodd-Frank Act, Congress has imposed downward pressures on executive compensation; however, in imposing an arbitrary cap of $487,000 on government contractors, Congress obviously has no faith in the effectiveness of the Dodd-Frank Act. It is further ironic and wholly disingenuous on the part of those proposing arbitrary and artificially low executive compensation caps that they make the point that a company/government contractor can pay higher salaries to its employees than the cap, but will restrict the amount reimbursable by the government to $487,000. In other words, Congress is ignoring compensation which fully complies with their-own Dodd-Frank Act.

In terms of implementing the new caps, contractors will now reflect in their cost accounting $952,308 for two fiscal years (2012-2013) and potentially for part of fiscal year 2014. At some point during 2014, the Federal Register will post the new cap ($487,000) and its applicability (effective date and the agencies to which it applies, noting that at various times, DOD contracts have been subjected to specific caps not necessarily applicable to civilian agency contracts). For forward pricing and cost estimating purposes in preparing proposals subject to FAR Part 15 which invoked cost principles in FAR Part 31, contractors should be using the annual cap of $487,000. Although one could assert that the cap won't apply until the Federal Register Notice is published, rest assured that Government auditors will challenge anything above $487,000 for years 2014 and beyond.

As has been shown by previous Government actions, the effective date of the $487,000 cap may trigger breach of contract legal actions (by contractors) if the cap is made retroactive to January 1, 2014 and/or made retroactive to existing contracts which had been executed with the prior regulatory cap and OFPP methodology for annual updates. In discussions with industry groups, such as NDIA (National Defense Industrial Association), some representatives have suggested that the latest statutory cap could result in three sets of books (indirect rates) to reflect statutory caps of different amounts and different applicability dates.

Congress is oblivious to the operational inconveniences caused by their petulant and illogical actions; however, those who have promoted the lowering of the statutory cap are undoubtedly savoring the victory and the millions which will be saved as a result. Unfortunately, as we reported in our December newsletter, the "millions saved" is but a façade because of the dilution effected by the cost allocation structure. In some cases, a few million in unallowable corporate salaries has almost no impact on indirect or G&A rates ultimately applied at the business segments. That said, as with every other aspect of this emotional issue, there is no point in bothering Congress with the facts.

DCAA Moderates Its Position on Documentation Requirements for Professional & Consulting Fees

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

In a December 2013 memorandum to its field auditors, the Defense Contract Audit Agency (DCAA) has implicitly mandated that its auditors take a more practical business approach in demanding documentation from contractors to support contractors' claimed professional and consulting services costs within the FAR 31.205-33(f) boundaries. Those documentation requirements include (1) an agreement

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explaining services to be provided; (2) invoices identifying time expended and services provided, and; (3) work products or other data showing outcome of services. Auditors have historically applied the three documentation provisions literally, often independent of each other, and so rigidly to the point of bypassing the practical audit approach of determining if the totality of information provides a reasonable basis to support the nature and type of work provided and the associated expenses incurred.

The DCAA guidance encourages auditors to evaluate evidential data in total, rather than separately; dispels the myopic thinking that a defined work product must be available; clarifies the definition of services to which this cost principle is applicable, and; opens the door to accepting data other than that which was generated at the time costs were incurred. The memo states "the audit team is looking for evidence to satisfy these three areas (three documentation criteria) and not a specific set of documents", and states that auditors should not demand the creation of documentation if the information provided by the contractor is not exactly what the auditor expected.

Specific details as to evidential data auditors must take into consideration include:

- Types of evidence will vary significantly based on consulting services and each contractor's contracting environment; hidden message to auditors—stop asking for the same standard documents for every contractor, and curtail your preconceived notions of what types of data are mandatory and how the data must be presented;
- A stand-alone work product is not necessary if other evidence demonstrates work actually performed; the memo states "the audit team should not insist on a work product if other evidence provided is sufficient to determine the nature and scope of actual work performed". Example provided in the memo of substitute evidence for a work product includes "information on the invoice"
- Invoices need not have all information shown on the face of that document, as literally required by FAR 31.205-33(f)(2)—information such as "time expended" need not be included on the actual invoice if other data can be submitted showing services provided, and time incurred (example, separate progress reports, time entry documents, etc.)
- Auditors may accept documentation created after the consulting services were performed; for example the contractor may ask the consultant to produce evidence of work performed during the incurred cost audit (which is probably performed several years after those services were delivered). Contemporaneous evidential data is considered more reliable, and testimonial data obtained after services were performed may not be acceptable without other corroborating data

The guidance memo also cautions auditors that the 31.205-33 cost principle, and its documentation parameters, applies only to professional services/fees—these include external personnel with a specific profession or skill to enhance a contractor's legal, economic, financial, or technical position. Personnel who do not maintain such skills are exempt from this cost principle, and auditors should discontinue subjecting such external service providers to the 31.205-33(f) documentation requirements. Examples of service providers not subject to the cost principle include clerical accounting (accounts payable, filing.), or "purchased labor" such as janitorial or security. More importantly, the guidance excludes from applicability to 31.205-33 any consultants who work directly with contractor employees and managers (equivalent to a contractor employee) particularly in a direct contract services role.

The memorandum is likely a result of ubiquitous contractor complaints, which include contractors who represent small business professional consortiums, the members of which have been subjected to significant questioned consulting costs during DCAA incurred cost proposal audits, the results of which were based on limited data analysis and unrealistic documentation expectations. Clients we have served where DCAA has questioned incurred consulting fees have noted that the audit approach is one of an individual analysis for compliance with each of the three documentation criteria without consideration of the data collectively, the very type of audit approach that the DCAA memo now seeks to dismantle.

DCAA's guidance still leaves it to auditor judgment in determining the correct mix of evidential data to satisfy 31.205-33(f). Work product is one area where ambiguity persists leaving it to auditors to nonetheless request a separate document, although other data sufficiently supports work performed. Exactly how auditors transform the December

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2013 guidance into an audit approach when reviewing claimed incurred professional fees remains to be seen.

DOE Guidance Renders Third-Party Civil Action Legal Costs Unallowable

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

The Department of Energy (DOE) has issued guidance stating that it considers certain claimed contractor legal and related damages costs associated with a specific third-party type of civil action as unallowable even though the FAR 31.205-47 cost principle for legal costs does not specifically address third party civil suits other than False Claims Act actions.

In a January 6, 2014 Acquisition Letter memo, DOE declared as unallowable any claimed legal or related settlement costs related to allegations of discrimination under a third party Title VII discrimination civil action where contract clauses are incorporated into government contracts prohibiting discrimination (e.g. 52.222-26) if one of the two conditions exists; (1) the conclusion of a trial or hearing resulted in an judgment against the contractor, or; (2) a compromise was reached between contractor and plaintiff, and there is sufficient evidence that the plaintiff's claim "would have had more than very little likelihood of success on the merits".

The DOE's decision is based on the outcome of a Court of Appeals for the Federal Circuit decision handed down in 2009, which determined legal and settlement costs incurred by Tecom, Inc. as unallowable, reversing an earlier ASBCA ruling that found such costs were allowable under FAR 31.205-47. The action giving rise to Tecom's claimed legal and settlement costs was a sexual harassment Title VII civil action brought by a former employee. Tecom entered into a compromise with the former employee to avoid a protracted legal battle, and claimed its legal fees as well as the settlement cost paid to the plaintiff as allowable expenses; the Federal Circuit, however, rendered those costs unallowable.

The Federal Court held that contractor costs associated with a violation of federal discrimination laws is also a violation of contract terms (since contract clauses are implemented enforcing discrimination statutes). The Court noted that any trial verdict in favor of the plaintiff would affirm a contractor violation of contract terms in which case contractor legal costs would be unallowable. Because a compromise between Tecom and the plaintiff was reached before a trial ensued, however, the Federal Circuit determined associated legal and settlement costs as unallowable because Tecom could not demonstrate that there was very little likelihood of the plaintiff's success in the action.

The FAR 31.205-47 cost principle does not stipulate any specific conditions for determining allowability or unallowability of costs related to third party civil actions leaving costs for such action to the "reasonableness" criteria. The Federal Court's standard for demonstrating "very little likelihood" of success for recovering legal costs is a provision of cost allowability related to third party actions (FAR 31.205-33(c)(2)) where compromise is achieved, but *only* applies to third party *False Claims Act* civil actions.

Notwithstanding the absence of defined verbiage within FAR 31.205-47 addressing the allowability of legal costs associated with a civil action of this nature, DOE has decided to hold its contractors to the same allowability standard as the Federal Circuit did with Tecom. A verdict where the plaintiff wins renders the costs unallowable if DOE contracts contain clauses prohibiting discrimination. When a compromise is reached with a third party under a Title VII discrimination civil action and the terms of the contract prohibit discrimination, contractors must be able to persuade the respective DOE contracting officer with sufficient evidential data that the plaintiff had a bad case. Otherwise, the contractor is implicitly guilty of violating discrimination statutes and cannot claim its legal fees under government contracts.

Has DCAA Unreasonably Determined Your Final Indirect Cost Rate Proposal Inadequate? Consider an "End Run"

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

The seeds for the all-too-frequent problem of DCAA unreasonably rejecting final indirect cost rate proposals (FICRPs) were sown several years ago when DCAA began re-

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prioritizing its resources away from audits necessary to close out contracts. DCAA instead focused on other priorities to alleviate wide-spread criticism. This shortsighted reaction to criticism has created its own problem. At the end of 2011, DCAA had a backlog of approximately $560 billion in contracts needing incurred cost audits.

Now DCAA is under intense pressure to reduce the backlog. In response to the pressure, DCAA is performing adequacy reviews of FICRPs. Many of the FICRPs being reviewed have languished with DCAA for years. These adequacy reviews have frequently resulted in FICRPs being rejected for unreasonable reasons. Sometimes the inadequacies are for trivial matters. At other times, the inadequacies are based on unreasonable DCAA demands for more data. After finding a FICPR as "inadequate," DCAA no longer counts the FICPR towards the approximate $560 billion in backlog.

DCAA's ploy of finding an FICPR inadequate can have dire consequences for a contractor. First, because years may have passed between the submission of the FICPR and the rejection, the ACO is likely to regard the re-submitted FICRP as late.[1] According to FAR § 52.216-7(d)(i), an extension is necessary after the six month deadline for submitting the FICRP. Moreover, FAR § 52.216-7(d)(i) requires "exceptional circumstances" before an extension is authorized.

Usually, ACOs grant the extension. However, a minority of ACOs enforce the literal requirement for exceptional circumstances. These ACOs are insensitive to the inequity arising from DCAA allowing the original FICRPs to languish for years. Compounding the problem is the fact that many ACOs lack the accounting background to ascertain if DCAA's findings of inadequacy are either (1) trivial or (2) place unreasonable demands on the contractor. Instead, these ACO generally defer to the DCAA auditor's judgment. Unfortunately, many ACOs are unaware of the DCAA's self-serving motive to reject FICRPs.

The minority of ACOs that enforce the literal requirement for "exceptional circumstances" are rarely convinced such circumstances exist. In those circumstances, the best the contractor can hope for is that the ACO will accept some amount of consideration for an extension. However, if the ACO perceives that he or she has no discretion to grant the extension absent exceptional circumstances, the consequences can be severe. For example, FAR § 42.705(c) expressly allows the ACO to unilaterally set the indirect rate without further input from the contractor. The following are some other possible adverse actions that an ACO could take if the FICRP is deemed late:

- Determine the contractor's accounting system is inadequate and withdraw direct billing authority.
- Apply a decrement to provisional billing rates for unsupported costs. FAR § 31.201-2(d).
- Implement withholding based on an inadequate accounting system under the provisions of DFARS § 242.7000(b)

Let's consider a situation where DCAA has found a FICRP to be inadequate. In addition, DCAA seeks voluminous additional data that the contractor perceives as onerous and unreasonable. Is there another alternative available to the contractor other than to comply with the DCAA demand? Yes, the contractor could attempt an "end run." As further explained below, the "end run" invokes the Disputes clause. Of course, before invoking a strategy as described below that may require going to disputes, contractors are urged to overcome DCAA's obstructions to FICPR adequacy determinations through informal appeals to the ACO, and possible elevation of the problems to the respective DCAA Regional Offices.

FICRPs are required by FAR § 52.216-7(d)(2)(1). From Dec. 2002 until June 2011, the FAR § 52.216-7 clause merely stated: "The Contractor shall support its proposal with adequate support data." In June 2011, the clause was expanded to provide a detailed outline of what was required for adequate support data.

Let's assume the FICRP that DCAA rejected was submitted pursuant to a contract with the Dec. 2002 clause. If the DCAA adequacy review concluded the FICRP is inadequate and places onerous demands for more data, the following is a possible "end run:"

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[1] Under FAR § 52.216-7(d)(i), a FICPR is late if it has not been submitted within six months of the end of the fiscal year that the FICRP addresses.

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First, prepare a thorough explanation to the ACO why the demand for more data is unreasonable.

- The letter to the contracting officer should ask the ACO to rule in favor of the contractor as to the adequacy of the FICRP. The letter should further request that, if the ACO nevertheless agrees with DCAA on inadequacy, please issue a final decision on adequacy under FAR § 33.211.

- Furthermore, the letter should request that, if the ACO agrees with the DCAA as to inadequacy, please proceed under FAR § 42.705(c). This FAR provision states:

> (1) If the contractor fails to submit a completion invoice or voucher within time specified in paragraph (b) of this section, the contracting officer may—
>
> (i) Determine the amount due to the contractor under the contract; and
> (ii) Record this determination in a unilateral modification to the contract.
>
> (2) The contracting officer determination must be issued as a final decision in accordance with 33.211.

Second, submit a routine request for payment pursuant to FAR § 52.216-7(h) seeking the amount that the contractor believes is the correct amount that the ACO should determine pursuant to FAR § 42.705(c)(1)(i). Provide ample support information justifying the rates advocated by the contractor. Hopefully, the ACO will use the information to reach a favorable decision.[2]
In Smith v. Dalton, 49 F.3d 1563 (Fed. Cir. 1995, the United States Court of Appeals for the Federal Circuit decided a case that is conceptually analogous to predicament facing some vendors concerning FICRPs. Both the Smith law suit and the present facts involve contractors being frustrated about not getting paid. In Smith v. Dalton, Smith, Inc. requested an equitable adjustment to a Navy contract to repair a bridge. Smith's claim did not provide invoices, cost breakdowns, or other documentation explaining how Smith arrived at the sum requested. The contracting officer refused to issue a final decision because the claim had not been documented to the satisfaction of the contracting officer.

The similarity between the facts in Smith v. Dalton and the problem facing contractors over FICRPs is striking. In both instances, the contracting officer refuses to pay a claim unless more documentation is provided. In Smith v. Dalton, the Federal Circuit held that a contractor can by-pass the contracting officer and obtain a *de novo* review at a Board of Contract Appeals where an ALJ will independently decide how much is owed based on the record.[3] Specifically, the Court in Smith v. Dalton held:

> A contractor must submit in writing "a clear and unequivocal statement that gives the contracting officer adequate notice of the basis and amount of the claim." Contract Cleaning Maintenance, Inc. v. United States, 811 F.2d 586, 592 (Fed.Cir.1987). But the contractor need not include a detailed breakdown of costs. The contractor may supply adequate notice of the basis and amount of the claim without accounting for each cost component.

Id.

In summary, the above "end run" is confrontational and should be avoided if working cooperatively with DCAA has a reasonable possibility of being productive. In essence, the contractor is invoking the right to have the matter resolved by a Board of Contract Appeals through an Administrative Law Judge (ALJ). The good news is that the Contract Disputes Act of 1978 gives no deference to the DCAA or ACO but instead the ALJ reviews the matter "*de novo"* which means without any preference for the government's position. However, litigation

[2] After a month, the contractor should make inquiries when the routine request for payment will be paid. Invariably, the ACO will indicate that the underlying controversy precludes any payment in the near future. Once a controversy is acknowledged by the ACO, convert the routine request for payment into a claim that seeks a final decision. Appeal the final decision to the appropriate board of contract appeals. The appeal will be docketed with the related final decisions [e.g., the adequacy of the FICRP and the indirect cost rates unilaterally determined pursuant to FAR § 42.705(c).]

[3] It should not be overlooked that, if the indirect costs are not adequately documented, the ALJ is unlikely to make a finding that the contractor should be paid the claimed indirect rates.

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brings its own frustration, risks, and expenses. As a practical matter, if the DCAA's position truly is unreasonable, the government attorney will probably settle the law suit without the need for protracted litigation. Nevertheless, there is no assurance of early settlement. Hence, the "end run" should not be undertaken without first performing a thorough risk/reward analysis.

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Redstone Government Consulting, Inc.

Huntsville, AL
101 Monroe Street
Huntsville, AL 35801
T: 256.704.9800

Email: info@redstonegci.com
On the web: www.redstonegci.com

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