REDSTONE
Government Consulting
Formerly Beason & Nalley Government Compliance Group

Government Contract
INSIGHTS
A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 40 June 2014

FAR Interim Rule June 24, 2014 Contractor Compensation Cap falls from $952,038 to $487,000

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

As required by Section 702 of the 2014 Bipartisan Budget Act (BBA) signed by President Obama on December 26, 2013, the June 24, 2014 Federal Register includes an interim rule setting the FAR 31.205-6(p) executive compensation statutory cap at $487K (coincidentally a 49% reduction from the most recent, 2012-June 23, 2014, statutory cap of $952,308). Although the statutory cap has typically been referred to in the context of executive compensation, effective in contracts executed on or after June 24, 2014, it now applies to the costs for all contractor and subcontractor employees for costs incurred on or after June 24, 2014. The June 2014 rule notes that it also implements a possible "narrowly targeted" exception to this cost limit for scientists, engineers or other specialists upon an agency determination that such exceptions are needed to ensure that the executive agency has continued access to needed skills and capabilities. The interim rule also includes a comment period which is for 60 days after the Federal Register publication date (June 24 to August 23, 2014).

In terms of how to implement the new $487,000 cap, it will only apply once a contractor receives a government contract (or subcontract under a covered prime contract) after June 24, 2014 and only that contract and subsequent contracts will be subject to the $487,000 cap. However, as discussed in this newsletter article, *Impact of Compensation Limitations On Forward Pricing Actions—14-PPD-004, April 7, 2014,* DCAA has defined its expectations in terms of contractor forward pricing (bid) rates including the use of $487,000 as a compensation cap (most likely embedded in indirect or G&A rates proposed in response to solicitations to be negotiated after June 24). By far, the most important question for any given contractor is "does the $487,000 cap have any effect?" which is determinable by comparing the $487,000 cap to an employee's total compensation (wages, salary, bonus, deferred compensation, and company contribution to a defined contribution pension plan).

THIS ISSUE:

In terms of what to expect in the context of the significance of this new lower cap to the contracting community, based upon a GAO report in 2013, the lower cap will only apply to .4% of contractor employees and the GAO noted they are all executives, as if that has any particular significance other than the President and certain Congresspersons who were publicly outraged with "excessive" executive compensation. The lower cap will have minimal, if any impact on small businesses, but not for the reasons noted in the Federal Register interim rule that "most contracts awarded to small entities are awarded on a fixed-price basis, and do not require application of the cost principle contained in this rule". Apparently the authors (The FAR Councils) of this statement are incorrectly assuming that all fixed price contracts are exempt from cost or pricing data (FAR Par 15); ignoring the fact that fixed price contracts subject to FAR Part 15 must be priced consistent with the cost principles in FAR Part 31. Although the FAR Council maybe off-base in terms of its statement, the fact is that the only relevance of the $487,000 cap is for those government contractors who have one or more employees who exceed this significantly lower cap.

For those contractors who are actually impacted by this cap, they will potentially be facing a Fiscal Year 2014 which has multiple indirect or G&A rates (assuming compensation exceeding $487,000 applies to employees who are indirect or more likely G&A). Contracts executed after June 24, 2014 will be subject to slightly lower rates by virtue of the lower cap; conversely, contracts executed on or before June 23, 2014 will be subject to the $952,308 cap.

Perhaps the only favorable component of the new cap is that it will be increased annually based upon the overall employment cost index (published by the Department of Labor) which will allow contractors to project/propose escalation for out-year pricing. Unfortunately, but obviously by design, the new index will result in markedly lower annual increases because the employment index has been increasing by 2-3 percent whereas the 2011 to 2012 increase (under the now replaced formula) was approximately 25 percent.

One reminder, the FAR 31.205-6(p) statutory cap is an absolute maximum for allowable compensation; however, contractor compensation is also limited to reasonable amounts as defined in FAR 31.205-6(b). Hence, an employee may be compensated at an amount below the cap, but that compensation may not be reasonable (reasonableness is a more subjective criterion measured against compensation paid by comparable sized firms in the same industry and the same geographic area).

A parting comment with respect to the 60 day comment period, don't bother other than perhaps to point out that the cost principle can apply in pricing fixed price contracts. Otherwise the $487,000 cap maybe arbitrary, it may be unfair; but "it is what it is".

DCAA Memos Address T&M Labor, Budgeted Compensation Ceilings, & DTIC IR&D Reporting Requirements

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

Over the past several weeks, DCAA has made public several guidance memorandums issued to its field auditors addressing several topics, three of which we consider worthy of a briefing for our newsletter readers. A brief summary of each of these memos is presented below.

IR&D Reporting—14-PAC-005, April 24, 2014

As a condition for determining if Independent Research & Development (IR&D) costs are allowable, auditors are to consider the January 2012 implemented changes to DFARS 231.205-18(c)(iii)(C) which requires certain contractors to report IR&D information to the Defense Technical Information Center (DTIC).

DTIC IR&D reporting requirements apply to IR&D costs incurred and allocated to contracts awarded on or after January 30, 2012, and costs incurred at major contractors whose "covered segments" charged $11 million or more in IR&D and B&P to covered contracts in the preceding fiscal year. Because of confusion as to time frames in which contractors were to begin recording this data, the DPAP (Defense Procurement and Acquisition Policy) in a February 2014 memorandum extended the initial reporting requirement to the end of contractor fiscal year 2014.

Under the new Department of Defense regulation, contractors are required to: (a) record IR&D project information in a DTIC data base no later than three months after the end of the fiscal year in which such costs are initially incurred; (b) annually update this information for projects in progress, and; (c) revise the DTIC data based upon completion of the project.

DCAA will utilize the contractor recorded IR&D information in the DTIC data base in its assessment of IR&D cost allowability when reviewing bid proposals and incurred cost submissions. If contractors have not adequately recorded IR&D expenditure data in the DTIC data base, notwithstanding having met all other criteria as to allowability of the IR&D costs, auditors are nevertheless directed to reduce forward pricing rate estimates proportionately, and question incurred IR&D costs for those contractor fiscal years in which IR&D information was not included within the DTIC. Moreover, IR&D costs included within incurred cost proposals (final indirect rates) for the year in which the contractor failed to report IR&D project data will be considered expressly unallowable and subject to penalties.

A more daunting action which may arise from failure to record IR&D data is a DCAA accounting system deficiency report; although connecting the omission of project data within a government data base to an accounting system deficiency is a stretch, DCAA field auditors are nonetheless given the option of opining that the contractor's accounting system is inadequate through a formal report to the ACO.

The memo notes that there is no expectation that IR&D expenditures recorded in the DTIC data base will reflect actual expenditures recorded in a contractor's accounting records or displayed within the incurred cost proposal. Additionally, the DCAA memo explicitly states that there is no requirement for any reconciliation of the amounts reported in DTIC (approximations) with the actual amounts recorded and claimed in the incurred cost proposal.

T&M Labor Verification—14-PPD-008, May 22, 2014

The memo provides additional guidance to auditors in evaluating qualifications of contractor employees who charge direct labor to Time and Material (T&M) contracts, to ensure that employees assigned to billable labor categories meet technical, experience, and educational requirements stipulated within the government contract for each of those categories. Under the provisions of FAR 52.232-7(a)(3), labor hours incurred by employees who do not meet the qualifications specified within the contract for the labor categories to which the employee is assigned will not be paid unless approved by the Contracting Officer.

When auditors determine that hours have been billed to T&M contracts by unqualified employees, ordinarily during an incurred cost proposal audit, auditors are to coordinate with the contracting officer before questioning costs to ascertain if authorization to bill those hours has or will be made, notwithstanding that labor effort performed by technically unqualified personnel (for a specific labor category) was otherwise considered by the contracting officer to be adequate (qualified) and within the scope of the contract. If the contracting officer has or will authorize the billing of those labor hours, the hours will not be questioned nor will system deficiency reports be issued. If, however, specific contracting office authorization to bill those hours is not forthcoming, DCAA will question all hours charged by those employees not meeting contract labor category specifications.

The memo acknowledges that where work is successfully completed, albeit some hours billed were charged by personnel not meeting all contract labor category qualifications, it would be impractical to question all labor costs incurred by those personnel. Instead, contracting officers may consider downward adjusting the fixed hourly rates to a level commensurate with the capabilities and technical qualifications of employees performing/billing the work. Auditors are to assist the contracting officer in deriving an acceptable hourly rate, and it is DCAA's expectation that a modification to the contract will be executed to implement those new rates.

The memo does not expressly state that DCAA auditors should involve technical specialists (e.g., government technical personnel) in comparing contract stipulated labor category requirements to specific employee qualifications before making potentially overly simplistic assumptions that employees are not qualified for the category to which their hours are billed, and too quickly advising the contractor that labor hours are therefore questioned (subject to CO interface).

Determining if an employee functioning within a specific labor category meets the solicitation or contract required minimum educational criteria is sometimes relatively simple for an auditor to assess—level and type of degree (e.g., Master's Degree in Mechanical Engineering); but comparing the contract stipulations for employee past experience, which is often vague and open ended, to a specific employee's background frequently requires an in-depth knowledge of the technical responsibilities of an employee's work history, going beyond a simple determination of prior job titles. DCAA auditors are not technically qualified to make these determinations, but apparently are encouraged to nevertheless

make broad assumptions before (implicitly) seeking technically qualified analyses by government experts.

Impact of Compensation Limitations On Forward Pricing Actions—14-PPD-004, April 7, 2014

DCAA should determine the impact of recent legislative and regulatory changes to contractor compensation ceilings when conducting forward pricing proposal or rate audits. The 2012 National Defense Authorization Act (NDAA) expanded the executive annual compensation caps to all contractor employees and will affect awards by the DOD, NAS and GSA after January 1, 2012, and the FY 2014 Bipartisan Budget Act (BBA) establishes an annual compensation cap of $487,000 for contractor employees applicable to all government contracts awarded on or after June 24, 2014 (Note that the BBA was implemented as an interim rule published in the Federal Register on June 24, 2014; see the first article in this newsletter).

Although final rules had not yet filtered into the FAR Cost Principles when DCAA published 14-PPD-004, DCAA instructed its auditors to ensure that contractors utilize these caps when auditors perform forward pricing bid proposal audits.

Where existing Forward Pricing Rate Proposals (FPRPs) or Forward Pricing Rate Agreements (FPRAs) have been submitted and/or executed and those agreements/proposals have not included the impact the impact of the compensation regulation changes, auditors are to coordinate with ACOs to ensure that existing rate agreements or proposals are decremented for the effect of the $487,000 cap due to take effect this year. Exception to adjusting rates would be if DCAA is notified that a contract award to which the regulations and rates would apply would take place prior to the June 24th effective date (again, this is overtaken by events, because a contract execution date before, on, or after June 24, 2014 would now be a matter of fact).

The DCAA memo is silent as to how auditors should handle the impact on incurred cost audits. Once the DAR Council has issued appropriate regulatory FAR Cases to implement the statutory compensation changes, DCAA will issue guidance related to incurred cost proposals and future incurred cost audits.

DOD Proposes Rule to Track Services Contracts

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

The Department of Defense (DOD) issued a proposed rule on June 5, 2014 the purpose of which is to improve tracking of DOD services contract activity by requiring government contractors to prepare and submit contract labor hour and cost statistical data to the DOD annually using an online DOD database. The implementation of the proposed rule requiring contractors to electronically report labor hour and cost data for services contracts fulfills a FY 2008 National Defense Authorization Act (NDAA) commitment to enable the DOD to provide Congress an annual inventory of DOD contract services.

As proposed, the service contracting reporting requirement applies to both prime contractors and subcontractors and requires disclosure of information for all service contracts and orders with a total estimated value exceeding the simplified acquisition threshold (SAT) and also applies to separate services line items or orders under *supply* contracts where the total of those orders/line items exceed the SAT. Exceptions to the reporting requirement are contracts for construction, equipment or facilities rental, utilities, freight/shipping, and classified services. Contractors will be required to enter services contract labor data annually into the "Enterprise-wide Contractor Manpower Reporting Application" (ECMRA) database annually, no later than October 31st each year, or at the end of the contract period whichever comes first.

The proposed rule is vague as to how the reported services contractor data will be used, and the objectives of the proposed rule are also ambiguous. The rule states in part that the information "will support DOD's total force management and in making strategic workforce planning decisions". Our interpretation—the government needs empirical data which will support a pre-conceived desire to reduce the level of services contracts awarded to the private sector.

It is no secret that a primary catalyst of this reporting requirement is a long-standing perception by both the Legislative and Executive branches that too much money is being spent on services contacted with the private sector,

when many of those contract activities represent "inherently governmental" functions which could be performed at less expense. The General Accountability Office (GAO) has issued three reports over the past few years (January 2011, April 2012, May 2013) with recommendations for improving DOD's ability to collect services contract inventory data with a primary goal of lowering service contract expenditures by targeting and shifting government contractor functions which are inherently governmental (or close to being inherently governmental) to the federal employment ranks.

It remains to be seen if the contractor services contract labor data will improve the government's ability to more efficiently procure those services; however, one known outcome of the contracting reporting requirement is an added layer of administrative headaches to the contractor, with the added costs for administering the reporting requirement likely passed on to the government and taxpayers. In typical regulator fashion, the proposed rule states that the rule will not have an administrative impact on effected contractors who "should already have the required information readily available" as if inputting data into a government database never takes any time/cost on the part of the contractor.

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Sterling, VA

August 13-14, 2014 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Sterling, VA

August 13-15, 2014 – The Masters Institute in Government Contract Costs
Sterling, VA

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

- Mike Steen
- Darryl Walker
- Scott Butler
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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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