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Controversial DFARS Proposed Business Systems Rule: "Case Closed"

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

On February 4, 2015, the DFARS proposed rule 2012-042 was closed (source: http://www.acq.osd.mil/dpap/dars/case_status.html). There was no explanation in terms of why this proposed rule was closed "with no further action"; however, one has to assume that DPAP (Defense Procurement and Acquisition Policy) was finally awakened by legitimate industry concerns which were stated in an August 2014 public meeting as well as in public comments submitted in response to the proposed rule. The proposed rule would have added requirements for contractor annual certifications and for independent CPA audits (initially and then triennially) of the three business systems audited by DCAA (Accounting, Estimating and MMAS).

Although the controversial proposed rule was closed, the fact remains that contractors with the DFARS Business Systems Clause (252.242-7005 and other clauses specific to one of six systems) are required to comply with the business systems criteria and are expected to demonstrate compliance should DCMA or DCAA initiate a review or an audit. DCMA is already actively engaged in reviewing contractor systems (Purchasing, EVMS, and Government Property); hence, nothing has changed with respect to the three systems which are reviewed by DCMA. For the other three systems which are under DCAA's cognizance, DCAA will now need to re-group and to determine if/how it will audit contractor business systems. In that context, DCAA has previously announced internal vacancies for auditors to be assigned to business systems audits and with respect to MMAS, DCAA's FY2015 Audit Planning document referenced a small number of MMAS audits at very large contractor's heavily engaged in manufacturing. One should assume that DCAA's FY2016 Program Planning Document (typically published in August each year) will answer the question in terms of future business systems audits. That said, contractors subject to the DFARS business systems regulations should already be compliant and should be positioned to demonstrate compliance if/when DCAA comes knocking.

THIS ISSUE:

GAO Reports of Interest to Government Contractors

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

We've identified two recent GAO (Government Accountability Reports) of interest to government contractors including the following:

- GAO-15-200, December 2014; *Further Actions Needed to Improve Oversight of Pass-through Contracts.* The report focused on pass-through contracts meeting certain criteria, specifically those where the prime contractors plan to subcontract 70 percent or more of the total cost of work to be performed. The GAO's review is a follow-up to Section 802 of the FY2013 NDAA (National Defense Appropriations Act) which requires DoD, State and USAID to issue guidance to ensure that contracting officers take additional steps prior to awarding pass-through contracts. Although required by Section 802 to issue guidance, the GAO reported that little or none had been developed (surprise, surprise). Perhaps DoD, State and USAID are "actively" ignoring Congress based upon the fact that FAR 52.215-23 defines unallowable excessive pass-through costs (something of a misnomer because the unallowable costs are the prime contractor add-ons such as G&A or material handling where the prime contractor adds "no or negligible value").

  In pressing for more than already exists in FAR, Congress suffers from the continuing belief (paranoia) that prime contractors are allowed to recover excessive indirect costs allocated to subcontract costs ignoring the fact that other regulations essentially compel the contractor to include subcontract costs within indirect cost allocation bases. Congress can't seem to grasp the fact that if the subcontract costs were removed from the base, the amount of indirect costs allocable to government contracts would likely be the same albeit at higher rates (having removed subcontract costs from the base). But this is the same Congress which never seems to grasp the fact that unit costs escalate when program funding reduces the quantities and/or changes product deliveries to later years. Even more disconcerting, Congress believes that the government should be displacing the prime contractor by contracting directly with the subcontractors. How soon we (they) forget the historical failures where the government displaced prime contractors by attempting to acquire key components (e.g. jet engines for fighters) directly from previous subcontractors; a theory which spun out of control when the government furnished materials were behind schedule and/or suffered from quality issues. It is equally alarming that Congress has apparently not read any of the abundance of literature suggesting that the United States Government has significant gaps in terms of qualified acquisition professionals; hence, difficulties managing existing prime contracts let alone the capacity to manage additional prime contracts. Perhaps most disturbing, the fact that Congress has added an abundance of new regulations imposing responsibilities on prime contractors because the Government has been unable to directly mitigate the risks of such issues as counterfeit IT parts/components and human trafficking. By implication, a Congressional mantra, if we can't do it, let's impose the requirement on government prime contractors.

- GAO-15-230, January 2015, *Insight into Subcontractor Selection Is Limited, but Agencies Use Oversight Tools to Monitor Performance*. The GAO was apparently asked (by Congress) to review the government's insight into subcontractor selection and oversight of subcontractor performance on federal construction projects (which involve 60-90 percent subcontracting). Although the GAO accurately reports that the prime contractor is ultimately responsible for project delivery at the agreed-to-price which means that the prime is ultimately responsible for the performance of its subcontractors, the GAO makes note of an "unethical" practice of the prime negotiating lower subcontract prices after agreement on price with the government. Apparently the GAO failed to read its own report, noting that it reported that these prime construction projects are "primarily competitive" fixed price contracts. Hence, if the successful contractor is competitively awarded the prime contract, that price is presumed to be fair and reasonable and the prime contractor's actual or projected costs have absolutely no relevance. Apparently in the eyes of the GAO, it's just not ethical for a prime construction contractor to successfully win a competitive bid and for that prime contractor to take actions to increase profits (or reduce losses) while being held to project delivery at the agreed-to-price.

Let's hope the GAO never looks at every other industry (government contracting) where the predominant practice is to negotiate the prime contract price with the Government, and then to negotiate the subcontract prices which might be lower than as originally proposed. Although the GAO has absolutely no regulatory basis for its views, apparently in their eyes a practice in play for decades and across multiple industries is now unethical. How distasteful!

DOD-IG Semi-Annual Reports Unintentionally Highlight the Risk of being a Government Contractor

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

In its semi-annual reports for government FY (Fiscal Year) 2014, the DoD-IG (Inspector General) includes a number of appendices which (perhaps) unintentionally highlight the risks of being a government contractor. In fact, these reports also unintentionally highlight the dysfunctionality of DoD in the context of untimely contract administration (DCMA) and contract audits (DCAA) as illustrated by Appendix E, Status of Action on Post-Award Contracts In its September 30, 2014 semi-annual report, the IG listed a total of 2,378 DCAA reports on incurred costs, defective pricing, equitable adjustment, business systems, and CAS noncompliances. Within these advisory reports issued to DCMA contracting officers, there were 437 open reports within guidelines (less than six months old), 1,254 reports are overage, and 687 were closed (with no information concerning the overage status of the closed reports). For the closed reports, the IG noted that the contracting officers dispositioned $1,814.6 billion (questioned by DCAA) and sustained $414.5 million (22.8 percent sustention rate assuming the amounts reported are accurate). It's noteworthy that the sustention rate implicates unsustainable costs questioned being generated by DCAA audits a fact which significantly contributes to the untimely issue resolution. Although one might assume or assert that perhaps contracting officers should be sustaining more, it should be noted that DCMA contracting officers cannot summarily dismiss DCAA questioned costs. There is a DCMA internal review process which simply does not permit the contracting officer to write-off the disallowance, a fact made more evident by DCAA's non-voting participation on the DCMA review boards. In other words, the alarmingly low sustention rate is not the result of cavalier actions by contracting officers; however, it is a reflection of DCAA audits which question costs with little or no basis for the audit exception (or as further discussed because DCAA summarily ignores case law/decisions which have previously considered and dismissed DCAA misinterpretations of the FAR).

The low sustention rate is also a likely indicator of the reasons for DCMA's untimely contract administration actions; in particular, that the 1,254 overaged actions are tainted with unsustainable DCAA questioned costs including those which are based upon highly subjective DCAA interpretations of FAR compounded by the fact that DCAA appears to ignore ASBCA or COFC (Court of Federal Claims) decisions which don't agree with DCAA's preferred interpretations. For a view into DCAA's highly subjective FAR interpretations, one only needs to read Appendix G of the IG Semi-annual report, "Audit Reports with Significant Findings". Examples of significant findings and our educated guess concerning the basis for DCAA's audit exceptions:

- $60.3 million of direct materials not adequately supported with purchase orders, vendor invoices, and proof of payment. DCAA is undoubtedly citing FAR 31.201-2(d) that the contractor is responsible for supporting costs claimed wherein DCAA is insisting that the contractor must support the costs with DCAA's pre-designated list of adequate documentation. DCAA is ignoring the FAR 4.705 records retention clause and equally ignoring decisions which have clearly rejected government assertions that a contractor must have certain types of records not prescribed in FAR.
- $18.3 million for unallowable consultant costs not adequately supported with statement or work, vendor invoices or proof of payment. DCAA is likely citing FAR 31.201-2(d) along with selective sections of FAR 31.205-33(f) and FAR 52.216-7 while ignoring the preponderance of evidence which supports the allowability of the consultant activity and also ignoring FAR 4.705 records retention clause. Again, DCAA seems to have self-created a theory that if DCAA requests five forms of documentation supporting "a" cost and the contractor only has three forms of documentation, the costs are unallowable. DCAA's strategy (pre-designating the specific types of records

which must be provided to support a cost) is conceptually inconsistent with FAR and with auditing standards which respectively implicate a contractor responsibility to support its assertions and an auditor responsibility to evaluate those assertions. Nothing like creating regulations outside the rulemaking process and ignoring a fundamental theorem of auditing.

- $70.4 million of unallowable Independent Research and Development (IR&D) costs with insufficient support of the nature and scope of the projects. Again, DCAA is likely citing FAR 31.201-2(d) as if that highly generic regulation is DCAA's wild card to be utilized whenever DCAA believes that the contractor should have documentation to satisfy the personal preference of the auditor. In terms of more specific regulations applicable to IR&D, nothing in FAR 31.205-18 or CAS 420 is prescriptive in terms of how a contractor should document IR&D project costs. Moreover, if the accounting data were insufficient, DCAA would need to request technical assistance who could, through inquiry, obtain additional information sufficient to demonstrate that the costs were IR&D differentiated from costs required by a contract (which would be unallowable IR&D). However, in its quest for independence from all others, DCAA rarely, if ever pursues competent technical assistance to evaluate a subject matter for which DCAA lacks the prerequisite competencies.
- $26.2 million of consultant, professional services and purchased labor due to lack of supporting data (i.e. FAR 31.201-2(d)). Doubtless that DCAA has once again imposed its list of required documentation and the contractor did not or could not provide everything required by DCAA although nothing in FAR prescribes all of the documents required by DCAA.
- $5.5 million of incentive compensation due to lack of an adequate bonus plan for which DCAA is likely citing FAR 31.201-2(d) and FAR 31.205-6(f)(1)(i); the latter requires either a plan or a policy consistently followed as to imply, in effect, an agreement to make such payments. In many cases, DCAA is now questioning the adequacy of a pre-existing incentive compensation plan in spite of prior audits which have reviewed and accepted the plan and the related costs. Typically DCAA is injecting its subjective requirements for a "sufficient incentive compensation plan" which do not exist in FAR or any other authoritative cite. Moreover, DCAA is ignoring the rather odd wording in FAR ("followed as to imply, in effect…") which is anything but precise and at odds with DCAA's pre-designated expectations for a bonus plan with very specific content and pay-out formulas.

For any contractor with DoD contracts subject to DCMA administration and DCAA contract audits, the DoD-IG semiannual reports are must reads, if for no other reason to gain an understanding of the current environment wherein DCAA's mantra is to maximize questioned costs with absolutely no regard for the ability of a contracting officer to sustain those audit exceptions. Thus the backlog of incurred costs awaiting audit, the backlog of audit reports awaiting contracting officer issue resolution, the backlog of issues in litigation, and the enormous backlog of physically complete contracts awaiting close-out.

DCAA Audit Policy on Billing System Oversight – Follow-up

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

In our January newsletter we reported on the subject of DCAA's pre-award voucher reviews and since that report, have become aware of some potential issues which could result in delayed approvals and delayed payments. Contractors need to recognize that these reviews are not considered audits (government auditing standards are discretionary, so to speak) which means that adequate supervision may be lacking and/or evaluation criteria may be highly subjective (i.e. auditor specific). This has recently surfaced with clients using unfamiliar (to the DCAA auditor) cost accounting systems' software, in particular systems which only accumulate and report direct job costs and use off-line spreadsheets to apply provisional indirect rates. In this context, the job cost status report only includes direct costs and indirect costs/rates are only applied during invoicing. Apparently some DCAA auditors are rejecting vouchers based upon this "issue" even though the voucher has been prepared consistent with FAR 52.216-7, the allowable cost and payment clause. Specifically the invoice includes allocable direct costs as supported by the job cost records and indirect costs based upon approved provisional billing rates applied to the appropriate cost base. The underlying issue, the DCAA auditor is familiar with other cost accounting software which applies indirect rates and displays the indirect costs on the job

cost report (self-contained, so to speak); hence, creating an auditor preferred method albeit far short of a requirement in FAR 52.216-7.

Additionally, DCAA auditors are free-lancing in terms of their request for contractor data to support the voucher review. Although DCAA's audit policies explicitly state that the auditor is to obtain certain information from WAWF (Wide Area Work-Flow), auditors appear to be requesting that information from the contractor. In particular, the SF1034 (the voucher) and the SF1035 (supporting data submitted with the voucher). Additionally, DCAA inquiries are asking the contractor for the basis for the indirect rates; a question which defies all logic given that DCAA should have established the contractor's provisional billing rates. Unfortunately the DCAA voucher review process is all too similar to every other DCAA audit, why obtain something (readily available to the auditor) when the auditor can impose that requirement on the contractor.

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Sterling, VA

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Instructors:

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- 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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