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Department of Justice: 2016 FCA Recoveries

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

The US DOJ (Department of Justice) recently announced its 2016 recoveries from alleged FCA (False Claims Act) violations. The DOJ press release noted that the $4.7 billion in settlements and judgments was the third highest on record with other highlights including:

- The DOJ has recovered $31.3 billion since 2009; a highly political reference to the year when Obama took office as if a President has any direct involvement and ignoring that many cases span many years; thus, numerous collections involve investigation which predate the Obama Administration.
- Healthcare continues to lead the pack, evidenced by $2.5 billion in recoveries; however, this is surprisingly only 53 percent of the total 2016 recoveries (unlike other recent years when healthcare FCA recoveries approached 90 percent of the total).
- The financial industry was responsible for $1.7 billion in FCA recoveries generally attributable to the housing and mortgage fraud which was a significant factor in the 2008 economic meltdown (the FCA applies to banks and lending institutions because these involved "federally" insured residential mortgages)
- Procurement fraud isn't mentioned other than in a DOJ statement that from 2009 to 2016, the recoveries were $3.6 billion or 11.5 percent of the overall civil FCA recoveries. Apparently lacking any 2016 procurement fraud recoveries worth noting, the DOJ mentions a 2015 recovery and a 2009 recovery, $434 million and $325 million, respectively. In reference to the $325 million recovery in 2009, the DOJ stated that action ended 12 years of litigation; an unintended confession that settlements involve years of investigation and litigation (by implication, acknowledging that it is misleading to attribute FCA recoveries from 2009-2016 to the current Administration).

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One observation, the relative absence of fraud recoveries from traditional government contractors (in particular defense contractors) is never acknowledged by the DOJ, nor is this recognized by Congress. Notably with each fiscal year NDAA (National Defense Appropriations Act), Congress introduces new regulations imposed on DOD contractors. One recent example, a DFARS (252.203-7996) prohibition on DOD from contracting with companies which require employees to sign internal confidentiality agreements…apparently, Congress believes that such agreements have caused employees not to report fraud, waste and abuse even though employees could recover up to 30 percent of the Government FCA recovery (If the employee files a Qui Tam through an attorney rather than directly contacting the Government using a Government agency hotline). In fact, the DOJ media release repetitively highlights the "commissions" paid to Qui Tam Relators, tacitly encouraging potential relators to come forward with their "inside information" (non-public information) and win a prize. Congress also believes that the Government should not contract with companies which have unpaid federal taxes or who have been convicted of a felony in the past two years (final rule published September 30, 2016, Fed Reg 67728-67731). The same Congress which continues to block a proposed regulation which would terminate Government employees with federal income tax delinquencies; apparently, it's no problem to continue to employee persons who effectively steal from their employer (the federal government) by failing to pay federal income taxes.

As mentioned, the DOJ media release is clearly meant to convince the reader that FCA recoveries have flourished under the current Administration; hence, the numerous references to fraud recoveries since 2009. FCA data is shown beginning with 1987, which recognizes that the Act was significantly changed in 1986, making it far more-costly, thus risky, for those who allegedly violate the FCA. More recently, the potential cost to FCA violators increased significantly as of August 1, 2016, when the FCA civil penalties essentially doubled; hence, one can expect FCA settlements will continue to increase given the potential liability of approximately $21,000 for each false claim (not to mention the prospect of significant, non-recoverable legal costs to respond to an FCA allegation). As the liability (for FCA violations) increase, so does DOJ's leverage to persuade one to settle. We will never know how many FCA settlements truly involved violations of the Act because a significant majority contain the following statement (at the end of each DOJ media release): "allegations only, and there has been no determination of liability".

Lessons from an ASBCA Decision involving CAS and FAR

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

As those who have experienced a DCAA audit may know, alleged cost accounting non-compliances are frequently based upon parallel regulations, CAS (Cost Accounting Standards) and FAR (Federal Acquisition Regulations). This scenario was evident in ASBCA No. 60131 involving CAS 404 (Capitalization of Tangible Assets) and FAR 31.205-11(m) (cost allowability for Capital Leases).

At issue was $3,821,534 due to increased costs purportedly paid by the government on the contractor's CAS covered contracts from 2003 through June 2015 (final decision). The amount, which linked an alleged FAR 31.205-11(m) noncompliance with CAS 404, included increased costs (cost type contracts) as well as increased prices (fixed-price contracts). Although FAR rarely extends an after-the-fact cost impact to fixed price contracts, CAS does provide a broader definition of cost impacts including price reductions for CAS covered contracts which were priced based upon non-compliant cost accounting practices (reflected in the cost estimate). In this ASBCA case, which involves the classification of a lease (capital versus operating) but for the CAS administrative provisions applicable to fixed price contracts, about 85 percent of the alleged cost-impact would vanish. Stated differently, only 15 percent of the alleged cost impact applies to costs incurred on cost-type contracts.

In the published decision, the contractor prevailed on its assertion that CAS 404, Capitalization of Tangible Assets, did not apply because the issue involved an intangible asset, the building lease, rather than the actual building which is a tangible asset. Thus, the "plain language" of CAS 404 did not apply to a building lease in which case the administrative provisions of CAS did not apply. As stated by the contractor, at the very most the mischaracterization of a capital lease as an operating lease would create a FAR allowability issue (only impacting actual allowable costs on cost-type contracts). The

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government (unsuccessfully) argued that properly interpreted, CAS 404 applies to the building lease at issue.

The "plain language" at issue was the distinction between a building and a building lease; the latter an intangible rather than a tangible asset because the lease itself is a right to use and occupy the building and does not have physical substance. The government focused on the CAS 404-40(a) fundamental requirement that "the acquisition cost of tangible assets shall be capitalized". As noted by the ASBCA, "the government interpreted the word "acquisition" in isolation, which would create a nonsensical interpretation of the regulation as a whole". Further, the ASBCA noted that the government's proposed interpretation does not recognize a distinction between capital leases and operating leases, thus if the government's interpretation were correct, contractors would need to capitalize all long-term leases, not only building leases, but also leases of vehicles and equipment.

The government also made an assertion concerning the hierarchy of CAS and GAAP; however, the ASBCA made note of the fact that the government attempted to use the lowest level of the hierarchy (GAAP) to interpret the top level of the hierarchy (CAS).

Although ASBCA 60131 appears apply to a relatively narrow issue of government contract cost accounting for leases and even more narrowly, capital versus operating leases, there are several universal lessons for any contractor subject to both CAS and FAR:

- DCAA and DCMA will misread, misinterpret or selectively apply the regulation(s) to yield the desired objective of maximizing the amount at issue. In this case, to incorrectly read-in CAS 404 to increase and overstate the cost at issue by $2.6 million or 85 percent.
- Even if a contractor has a compelling rebuttal to DCAA's flawed assertions, contracting officers defer to DCAA's cost accounting "expertise". Based upon the ASBCA decision (that the government assertions were at odds with the plain language of CAS 404), DCAA's advice may fall short of "expertise".
- DCAA issues audit reports which will link CAS and FAR, but the linkage may not be appropriate. In the ASBCA decision, it was clearly established that CAS did not apply; however, the FAR allowability issue was not addressed by the ASBCA. The importance of de-linking the two regulations pertains to the vastly different measure of cost impact, CAS versus FAR.

Cost allowability issues may take on a life of their own; in this case, a 2016 decision only partially resolved a cost issue which first surfaced in a 2007 DCAA audit of a contractors 2004 final indirect cost rate proposal. The underlying lease dates to 1997 and the lease was acquired by an acquisition (predecessor in interest); a reminder that the acquiring company assumes the government contract compliance contingent liabilities of the acquired entity.

DOD-IG Semiannual Report to Congress

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

In its report for the period April 1 – September 30, 2016, the DOD-IG provides some insights into cost allowability and cost recovery issues for defense contracts (or any contractor audited by DCAA). In particular, Appendix F, Status of Action on Post-Award Contracts, and Appendix H, Section 845 Annex Audit Reports with Significant Findings. Appendix F pertains to significant post-award audits which are tracked in accordance with DOD Instruction 7640.2; during the six-month reporting period 458 audit reports were closed with costs (questioned) sustained of $468.9 million for which DCAA had reported $2,140.2 costs questioned. The sustention rate was 22% (compared to 26% for the previous six months). Appendix H is indirectly related to Appendix F because H provides a list of audits issued by DCAA along with a very high-level synopsis of the audit findings (questioned costs or recommended price reductions in the case of defective pricing). Of passing interest, two of the reports included in "H" were issued in March 2016; hence, outside the six months reporting period. However, the DOD-IG states that these "are being reported now for full transparency and disclosure" (which reads much better than "to correct omissions from the previous six- month report").

Of more than passing interest, although Appendix F is based upon the data reported by DCMA in the CAFU (Contract Audit Follow-up) process, the DOD-IG doesn't make any attempt to caution the reader in terms of the validity of the CAFU. Why might the DOD-IG caution the reader? Because the DOD-IG

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issued a separate report, DODIG-2016-078, wherein the IG reported an 82 percent record inaccuracy rate (data in the DOD CAFU). In 2016-078, the DOD-IG reported that there were 15 (of 50) instances where DCMA overstated cost questioned sustained and reported that the IG had detected errors in the CAFU information while compiling that data. One startling example, the IG detected an error, which could have caused a $1.97 billion overstatement of questioned cost sustained in March 2014 (that semi-annual report stated that questioned cost sustained was $463 million; approximately 23% of what might have been inaccurately reported but for the IG's intervention).

Appendix H of the semi-annual report does provide a summary-level perspective of the significant findings (cost questioned) reported by DCAA. Some of the hot-spots:

- DCAA frequently disclaims an opinion on contractor indirect cost rate proposals; however, DCAA provides specific findings to the extent DCAA could come to a cost allowability conclusion on specific costs. In some cases, the basis for the audit exception appears to be inextricably interrelated to the audit disclaimer (e.g. inadequate documentation supporting claimed subcontractor costs). At any rate, DCAA appears to have found a new means of isolating itself from any peer reviewer criticisms, simply disclaim an audit opinion and disengage from the audit.
- IR&D (Independent Research and Development) costs questioned because of inadequate project descriptions or in one case, alleged failure to report IR&D and B&P to DTIC (Defense Technical Information Center) as required for major contractors. Although the failure to report to DTIC is a condition of allowability for major contractors, it remains to be seen if that DFARS clause was in the contracts for the years included in DCAA's audits (DCAA auditors have been known to use current FAR or DFARS in application to prior years' incurred costs).
- Recommended price reductions for alleged non-compliance with 10 USC 2306a, Truth in Negotiation Act (aka Defective Pricing). Appendix H lists three audit reports with a combined recommended price adjustment (reduction) of $108.2 million. We are provided with very little detail other than allegations that cost or pricing data was not current, accurate, or complete including failure to disclose subcontractor quotations, updated bill of material and exchange rate analysis for foreign subcontract costs. The fact that DCAA is performing some post-award (TINA compliance) audits is significant because these audits are budgeted for 1,200 hours, which implicates expectations for findings (no competent auditor would spend 1,200 hours only to come up dry). The other significant but undisclosed fact, we can assume that at least two of the three defective pricing audits were also referred to an investigative agency as a potential violation of the FCA (False Claims Act). A reminder that all audits, but particularly post-award TINA compliance audits, could lead to a DCAA referral to an investigative agency.

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CFO Roundtable

Redstone Government Consulting, Inc., Radiance Technologies, Inc., & Warren Averett will be sponsoring a CFO/Controller roundtable for Government Contractors.

All Government contractor CFO's or Controllers are invited to participate. The meetings will be held quarterly and will include lunch and networking from 11:30am – 1:00pm. Participants will be notified via email announcements for all future locations and seminar topics.

The CFO Roundtable is **free** to attend. All participants will be invited to share topics of interest and the group will be interactive. Redstone GCI, Radiance Technologies, and Warren Averett will strive to provide speakers on topics that are of interest to the group each quarter. Please provide us your email address and we will notify you 30 days in advance of each meeting. RSVP's are required.

MORE DATES COMING SOON

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About Redstone Government Consulting, Inc.

Our Company's Mission Statement: RGCI enables contractors doing business with the U.S. government to comply with the complex and challenging procurement regulatory provisions and contract requirements by providing superior cost, pricing, accounting, and contracts administration consulting expertise to clients expeditiously, efficiently, and within customer expectations. Our consulting expertise and experience is unparalleled in understanding unique challenges of government contractors, our operating procedures are crafted and monitored to ensure rock-solid compliance, and our company's charter and implementing policies are designed to continuously meet needs of clients while fostering a long-term partnership with each client through pro-active communication with our clients

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.

Specialized Training

Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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