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DCAA's Post Award Accounting System Audits---Small Businesses held to Non-Applicable DFARS Clause

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

DCAA has a number of audits (or reviews) which have implications concerning the adequacy of a contractor's accounting system. Among others, those audits include the pre-award (accounting system design), the post-award accounting system audit and the comprehensive DFARS 252-242-7006 accounting system audit. Because of the cost (7,500 hours each) for FY2017, DCAA only planned four of the comprehensive accounting system audits (audit code 11070 for "Major" contractors); however, DCAA's less comprehensive and more commonly deployed post-award accounting system audit (audit code 17741 for "Non-Major" contractors) is premised upon the exact same regulatory criteria as the 11070 audits. Specifically, both audits are to determine if a contractor complies with the 18 accounting system criteria in DFARS 252.242-7006(c) and of more than passing interest, the 17741-audit activity involves contractors who may not have a contract with DFARS 252.242-7006.

As stated in the 17741-audit program, for contractors which do not have the DFARS contract clause and "are not contractually required to comply with the DFARS criteria" (i.e. 100% reimbursable as in 100% non-DOD contracts), "nevertheless the criteria are suitable standards to use in determining the acceptability of any Government contractor accounting system for accumulation and billing of cost under Government contracts".

Although DCAA's audit program differentiates the DFARS applicability as a function of DOD versus non-DOD contracts, DCAA seems to be oblivious to the "other inapplicability" which is the explicit exemption for small businesses (which are exempt from CAS/Cost Accounting Standards which is linked to the exemption from DFARS 252.242-7006). In other words, DCAA summarily applies the criteria from 252.242-7006(c) to small businesses which are exempt from that DFARS clause. In many cases, when DCAA applies these criteria, they reach into their vault (analogous to "tales from the crypt") of historical audit issues with a particular contractor; hence, the predictable end result is a long list

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of conditions drawn from prior audits with any given deficiency linked to 1 of 18 criteria in DFARS 252.242-7006. In almost any case, a deficiency could be linked to (c)(1) which is the highly generic and all-encompassing requirement for a system of internal controls.

Focused on the contractors without the DFARS clause, what's the big deal, after all "suitable standards or criteria" should be universally applied even if there is no contractual requirement (per DCAA). The big deal, DCAA has used the same logic (or illogic) to question hundreds of millions in costs (subcontract costs flowing up to cost type prime contracts) and that DCAA tactic has been described (by an ASBCA Administrative Judge) as a non-contractual "legal theory originated by an auditor" (See Redstone Government Consulting Blog "ASBCA Repudiates DCAA Legal Theory for Prime Contractor Management of Subcontracts", posted January 18, 2017). In the ASBCA case, the suspect legal theory involved FAR 42.202(e)(2) which is not a contractual clause, at least conceptually the same fundamental issue as with DCAA's theory for using DFARS 252.242-7006 even though the contractor is "not contractually required to comply with the criteria".

It seems rather basic, but if a contractor is not contractually required to comply with the stated criteria (explicitly stated but unfortunately within the not-applicable DFARS clause); why would DCAA believe that a contracting officer should issue a determination of non-compliance. Equally, why would a contracting officer waste his or her time issuing notifications and determinations for requirements which don't contractually apply. Perhaps a classic A conundrum (i.e. there is no answer and perhaps DCAA needs to change its name from Defense Contract Audit Agency to Defense Contract and Miscellaneous Non-Contract Audit Agency (DCMNCAA).

Fair and Reasonable Prices (Prime or Subcontractor) Interpretations

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

Bid Protest—Agency Improperly Excludes a Bidder based upon One Line Item (not a fair and reasonable price).

A recent GAO decision sustained a bid protest wherein the government agency had disqualified (excluded) the bidder because 1 of 24 line items was deemed not a fair and reasonable price (for each line item using a formula based upon the mean of unit prices from all bidders). However, 23 other line items were fair and reasonable, including several which were below the agency measure of a fair and reasonable price (the mean price of other bidders). The protestor successfully asserted that there were a number of interrelationships across the line items and that many were lower which implicated offsets and more importantly that certain common costs were included in the "over-priced" line item. In other words, the one line item may have included costs/prices for activities which benefitted other line items (an example could be overall project management). Of passing interest, the protester also asserted that its line item price was in line with the GSA schedule pricing for that task for similar vendors and the GAO stated that it would not have found that argument to be a basis for sustaining the protest. In its published decision, the GAO recommended that the agency re-evaluate the reasonableness of the protestors price and reconsider whether the protestor should be awarded a BPA (Blanket Purchase Agreement). Additionally, the protestor should consider a certified claim for bid protest costs (reasonable attorney fees, etc.) and although not stated, other published decisions suggest that costs to support the assertion that the price was reasonable compared to the GSA schedule are not recoverable. If the successful protestor recovers bid protest costs, it will only be those related to the successful assertion(s).

Contingency Contracts and Fair and Reasonable Prime or Subcontract Prices

Contingency contracts occur in war zones and also in the wake of natural disasters, notably hurricanes such as the very recent Hurricane Harvey which has unfortunately impacted millions along the Gulf Coast. History shows that contingency contracts may have urgent requirements; however, those urgencies do not necessarily eliminate contractual clauses including FAR 31.201-3 which defines cost reasonableness criteria. In many cases, the prime contract is cost reimbursable (which include FAR Part 31) which means that both prime and subcontract costs must be allowable, allocable and reasonable; otherwise, FAR 52.216-7 (the contract clause which invokes FAR Part 31 cost principles) provides for cost disallowance.

In two notable cases involving war zone contingency contracting, a prime contractor (cost-type prime) incurred significant subcontract costs (sole source fixed price subcontracts for dining facilities and services in Iraq) which were subsequently challenged as unreasonable, first through DCAA audits, second through contracting officer final decisions disallowing the costs. In both cases, the contractor procurement files were unpersuasive in convincing a Judge that the subcontract costs were fair and reasonable. The obvious message for prime contractors, your procurement files are critical in establishing and documenting that a subcontract price is fair and reasonable. If those (contemporaneously created) files don't measure up, it's almost impossible to retroactively remediate. In application to any after-the-fact challenge to the reasonableness of the subcontract costs, prime contractor procurement files are critical in satisfying the burden of proof standards in 31.201-3 (if bases upon an initial review of the facts, the government challenges the reasonableness of a cost, the burden of proof is on the contractor to establish reasonableness).

In a more recent case involving a contract dispute concerning the reasonableness of contract costs (subcontract costs flowing into a prime contract), the contingency was for post-Hurricane recovery efforts (including Katrina and Ivan) and the cost allowability issue involved $14.7 million. The contingent and urgent nature of the contract was evident in the history of the initial award and subsequent task orders; initial award of $150,000 (no specific scope) and ultimate value of $85 million (21 modifications and 47 technical directives, and many verbal directives and clarifications). The contractor has an approved purchasing system (noted, but in and of itself, not sufficient to derail the reasonableness challenge). The contractor also received high ratings and award fees for its contract performance, also noted but not decisive. As early as June 2007, DCAA was involved and questioned $1.7 million and in July 2009, DCAA questioned an additional $24.3 million (resulting in a series of DCAA Form 1s disallowing $26 million and ultimately an ACO final decision February 27, 2012, disallowing $14.7 million.

A significant component of the subcontract cost reasonableness issue involved a subcontractor mark-up of 21% (for overhead and profit) applied to the direct labor and equipment costs. Undoubtedly, the mark-up was a lump sum and DCAA expected an overhead (pool-base-rate) separated from the profit. In-spite of the numerous assertions by the Government, the contractor prevailed, largely on the basis of the oral testimony by the contractor's program manager (who provided corroborating evidence to supplement the limited documentation during a time when the government also failed to "document" many directives and clarifications). This case also involves other subcontracts (similar issues) and one issue involving the contract requirement for subcontractor "certified payrolls" (prescribed statement and format). Although the subcontractor clearly provided the services (acknowledged by the Government), the Government disallowed 100% of the subcontractor labor. The ASBCA determined that 100% disallowance is unreasonable, but that there could be a withholding which is reasonable in amount (remanded the parties to determine that proper withholding).

There are numerous other issues within this ASBCA case (58081) including those where subcontract pricing was challenged because the subcontractor had "over-provided" for meals. As specified by the prime contractor, a subcontractor provided facilities (tents), utilities and food service for 7,500 meals per day when actual meals were less. With classic 20-20 hindsight, DCAA questioned the excess and the ACO cost disallowance ($1.5 million) was consistent with DCAA's assertion. There were other issues, the government second-guessed the prime contractor determination that the subcontract was for commercial items/services and that per diems for meals were for normal market conditions, not post-hurricane conditions. A number of the government contentions also involved strict adherence to prime contractor policies or terms in a subcontract such as time limits on subcontractor claims for unit price adjustments. In its decision, the ASBCA considered all relevant facts, not just the fact that a subcontract included a time limit for a subcontractor claim for a price adjustment. Good news for the prime contractor who was allowed to "supplement the record" to satisfy a number of reasonableness challenges by the Government. That said, for anyone operating outside of contingency contracting, it remains to be seen if/how/why a decision might forgive a prime contractor for deviations from its explicit terms and conditions with subcontractors. Rest assured, that DCAA will continue to audit subcontract costs based upon very literal application of terms and conditions giving no consideration to extenuating circumstances. As in the case of the issue involving a prescribed format for payroll certification, if the administrative requirement is overlooked, DCAA will interpret that as 100% disallowance. In the case of the issue of "over-providing" or excess capacity for meals (versus actual

requirements), there would have been no issue whatsoever had DCAA sought the input from government contract personnel who were directly involved in planning and who testified that they actually provided higher estimates. Multiple examples of over-stated audit exceptions which can't withstand scrutiny or challenge in court….which might explain why DCAA's cost questioned sustained is between 20 and 25 percent.

Training Opportunities

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COMING SOON

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October 23-24, 2017 – Accounting Compliance for Government Contractors
Sterling, VA

December 6-7, 2017 – Accounting Compliance for Government Contractors
DC Metro Area

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CFO Roundtable

Redstone Government Consulting, Inc., Radiance Technologies, Inc., and Warren Averett are sponsoring a CFO/Controller roundtable for Government Contractors.

All Government contractor CFO's or Controllers are invited to participate. The meetings are held quarterly and will include lunch and networking from 11:30am – 1:00pm. The next meeting is TBD. 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.

Sign up for CFO Roundtable updates here.

Redstone Edge Conference 2017

We have an exciting slate of speakers, panels and networking sessions planned where you will earn 8-hours of NASBA CPE. We are also happy to help with accommodations for other CPE types.

Limited seating is available for this event, so we hope you will register soon! We are continually adding highlights of the day's sessions, topics and speakers. Since the focus of the Redstone Edge is on emerging industry concerns the sessions will largely be driven by the changing regulatory landscape and challenges as they arise during 2017.

Click here to view the schedule or register today!

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.