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DCMA Disposition of DCAA Incurred Cost Audit Reports – Not Quite up to Expectations per DoD-IG

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

The DOD-IG (Department of Defense—Inspector General) finally issued its report (DODIG-2017-055) covering Defense Contract Management Agency/DCMA (Contracting Officer) actions to disposition Defense Contract Audit Agency/DCAA Incurred Cost Audits. The DOD-IG initiated this review in October 2015 and it reviewed DCMA dispositions of 22 DCAA incurred cost audit reports between September 2013 and July 2016. As with virtually every other DoD-IG review, there were findings which require DCMA corrective actions and those corrective actions have implications to government contractors (with DOD contracts). The findings in the order presented by the DoD-IG:

- ACOs (Administrative Contracting Officers) failed to disposition $305 million in questioned direct costs (8 of 12 audits with questioned direct costs). The respective ACO dispositioned the indirect rates (i.e. negotiated final indirect cost rates), but failed to resolve contract direct costs because that action involves a different ACO. Per the DoD-IG, the ACO responsible for negotiating rates must coordinate with contract specific ACOs to concurrently resolve both direct and indirect costs/rates. Editor's comments: Our experience confirms that the ACO responsible for final indirect rates simply defers direct cost issue resolution to a contract specific ACO(s), with or without waiting for the contract specific ACO to disposition the issue. At the very least, the DoD-IG expectation will mean that there will be additional delays in obtaining final indirect cost rate letters which will be held-up pending direct cost issue resolution. The nominal advantage to impacted contractors is that direct cost issues will now be more timely addressed; not necessarily favorably resolved, but more timely.

THIS ISSUE:

- ACOs failed to comply with FAR 42.709-3 in assessing or adequately justifying a waiver of penalties on expressly unallowable indirect costs. This occurred with some frequency (7 of 22 audit reports), but it only amounted to $1.4 million. The DoD-IG asserts that this failure diminishes the incentive for DoD contractors to exclude expressly unallowable costs. Editor's comments: We doubt that the $1.4 million has any impact on the behavior of the seven government contractors; however, we are amazed that in 2 of 7 cases, the ACO failed to even address the penalties. In the other 5 of 7 cases, the DoD-IG subjectively challenged the adequacy of the waivers which all involved higher level DCMA management review and approval. As with any subjective, after-the-fact assessment, the gates are open to second-guess decisions made in the "heat of battle". Regardless, the impact on government contractors will be more predictable ACO demands for payments for penalties under FAR 42.709.
- ACOs failed to adequately prepare negotiation memorandums explaining why (2 of 22) did not sustain DCAA audit findings involving $5.6 million. In one case, the ACO inexplicably sustained $63,988 of $2,346,856 (2.7%). No one (DCMA cost analyst or management reviewers who had signed-off on sustaining the full amount) could explain why the ACO did not follow-through (the DoD-IG noted that the particular ACO has since resigned from DCMA). In the other case involving $3,299,456 (not sustained by the ACO), the ACO explained that she believed that the government action was beyond the six-year statute of limitations or SOL (FAR 33.206). However, this was at odds with internal legal advice that the questioned costs should be pursued regardless of the potential SOL issue. Editor's comment: The good news embedded in this issue is that DCMA ACOs sustain far less than 50% of DCAA cost questioned and apparently, the basis for not fully sustaining DCAA was generally adequate (on 20 of 22 dispositions). Although unstated, the most likely reason for legitimate rejections of DCAA assertions is that contractor rebuttals are well written and ultimately form the basis for the ACO action. Regardless of the validity or lack of validity in DCAA assertions, this confirms the importance of well-researched, well-documented, and well-written contractor rebuttals. Even if DCAA tends to ignore them, DCMA ACOs do not ignore them.
- ACOs sustained $16,746,279 in 3 actions (per negotiation memorandums), but only excluded $12,444,402 from the negotiated final indirect cost rates. Noting that the final rate agreement letters are contractually binding, the DoD-IG reported that the government "may be" prevented from recovering the difference. Editor's comment: "May be" prevented; where is the "may" when the agreement is contractually binding?
- ACO's failed to retain documentation showing that the final rates' negotiation memorandum was appropriately distributed to DCAA and other affected agencies. Although ACO's maintained that the negotiation memorandums were distributed, per the DoD-IG, without a record of distribution, the ACOs could not demonstrate that the documents were actually sent to DCAA. Editor's comment: Apparently, the DoD-IG is incapable of third party verifications to determine that DCAA did receive a copy of the document as likely shown on the document distribution list. At the very least, instead of completing the job (third party verification), the DoD-IG failed to answer (the easily answerable question) did DCAA receive copies of the documents…but I guess that it's not their (DoD-IG) job.

- If there is a summation to the DoD-IG report and its indirect impact on government contractors, safe to assume that DCMA ACOs will adhere to the regulatory and/or internal DOD instructions…at least for now. Final indirect cost rate letters will be held-up pending resolution of direct costs questioned, penalties will be assessed, and ACOs will be more closely monitored in terms of final rate agreement letters (or direct cost issue resolution) when not fully sustaining DCAA. Not sure who is going to check the math for those ACOs who weren't able to exclude dollars in the final rates which replicate dollars excluded (sustained) in the negotiation memorandum, but taxpayers can now sleep at night knowing that ACOs will keep a paper trail that proves that documents were actually sent to DCAA (as indicated on the document distribution list).

DCAA Audit Alert on Final Voucher Services

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

DCAA issued an audit alert (17-PIC-001, dated January 18, 2017) which ultimately provides DCAA, DCMA and government contractors with a well-documented process for final vouchers and contract close-out. On page one of this audit alert, DCAA makes note of the FAR 52.216-7(d)(2)(v) requirement for contractors to update Schedule I, Cumulative Direct and Indirect Costs claimed and billed to reflect final rates and cumulative (direct and indirect) within 60 days of rate settlement. In the context of final vouchers, Schedule I is the point of reference for ACOs in terms of providing the total allowable costs which should match the total claimed by a contractor on a final voucher. By design, for physically complete cost-type contracts, once Schedule I is updated for the last year of those contracts, the contractor should be able to submit the final voucher within 120 days of the rate agreement letter.

To its credit, DCAA correctly notes that the Schedule I requirement only applies to contracts executed after June 1, 2011 (the requirement was published in the Federal Register on May 31, 2011); hence, "older" contracts may not have the same information (i.e. lacking a Schedule I because it was not a contractual requirement). In those cases, the ACO may require additional information in the context of an updated Schedule I or equivalent information. In terms of alternatives, DCAA notes that assisting the ACO should only involve compiling existing facts (no additional auditing), but for final vouchers on contracts executed after June 2011, the ACO should obtain updated information, i.e. Schedule I, from the contractor (not from DCAA).

DCAA also mentions contracts which were not "addressed" in previous audits, in which case DCAA can perform (undefined) audit effort at the time of final voucher. DCAA's use of the word "addressed" is a tacit acknowledgment that thousands of contracts have not been audited, but have been addressed and costs accepted because the contractor was considered low risk. DCAA also notes that an ACO may be requesting DCAA assistance for contracts/contractors whose costs were the subject of an audit disclaimer (e.g. unauditable incurred costs typically attributed to the condition of or absence of accounting records). In these cases, DCAA will discuss the circumstances which led to the disclaimer to determine whether the condition still exists in which case the alternative may be an agreed-upon-procures (AUP) engagement.

In terms of what this means to contractors, DCAA might be performing "last minute" audit tests to assist an ACO in determining allowable costs (direct and/or indirect) on a contract (or contracts) where DCAA had previously attempted to perform an audit, but terminated the audit without accepting or rejecting the contractor's claimed costs. However, it is highly unlikely that the condition (for the original disclaimer) has changed; hence, the most likely audit assistance will be an AUP wherein DCAA assists the ACO in determining a decrement (to be applied to contractor claimed costs) to protect the Government's interests. Absent any contractor specific information, DCAA will presumably recommend approximately 16% decrement factor applied to all direct and indirect cost on cost-type contracts (the same decrement as DCAA would recommend for contractors who fail to submit an adequate indirect cost rate). One might ask why an agreed-upon procedures alternative wasn't considered at the time of the initial (attempted) audit and the answer is quite simple, that would have delayed the audit and it would have adversely impacted DCAA's quest to (nominally) eliminate its incurred cost backlog.

DCAA's audit alert includes a 41 page "Final Cost Voucher Training" which is an extremely useful tool and reference for auditors, ACOs and government contractors. It provides narratives and illustrations which define expectations, roles and responsibilities and easy to follow examples of schedules relevant to contract close-out. Hopefully, this will assist ACOs with some aspects of contract close-out; however, the unanswered question remains if and how DCAA will help ACOs in closing contracts which were previously deemed unauditable (included in a DCAA audit disclaimer for a contractor fiscal year incurred cost submission).

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Retroactive Disallowance and Miscellaneous Cost Allowability Issues in ASBCA No. 59577

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

As is often the case, a published ASBCA decision provides a secondary "educational" benefit to government contractors subjected to FAR 52.216-7, Allowable Cost and Payment clause, and its incorporation of the FAR Part 31 Cost Principles. At issue in the ASBCA decision:

- $159,303 in unallowable costs including direct and indirect costs
- FAR 33.206 Six Year Statute of Limitations
- Retroactive disallowance (types of costs were previously claimed and at least tacitly accepted by prior auditors)
- Dissenting opinion (generally supporting the contractor's appeal of the CFD/Contracting Officer Final Decision)

The majority decision provides the following interpretations of the more significant issues:

- FAR 33.206 Six Year Statute of Limitations. The "start (accrual) date" does not begin with the date of the annual indirect cost rate submission. Per ASBCA Nos. 58945, 58946, the Government claim starts when the Government has sufficient supporting data to establish Government knowledge of the claim.
- Auditor independence. Although the contractor had valid concerns (based upon the auditor's behavior) that the auditor was not objective, it wasn't enough to justify sustaining the contractor's appeal. Translated, even though the auditor might have been biased, if his/her audit assertions are consistent with the facts and the regulations, it may have been a frustration, but it's not a reason to convert unallowable costs into allowable costs.
- Retroactive disallowance. Discussed in great detail (particularly in the dissenting opinion) included references to prior decisions and the connection to equitable estoppel. The majority decision noted "that DCAA's failure to question in prior audits, certain costs, without more, does not establish a common basis of understanding. It could mean that the (current) auditor chose to more carefully investigate certain issues in some years, than in others."
- Marketing Costs (Consultant Costs). In sustaining the contractor appeal, the ASBCA succinctly noted "The government labors under the false impression that the FAR requires a consultant to create work product. Although FAR 31.205-33(f) refers to consultant work product, the government's insistence on "work product" fails to consider the case in which documents were never created by the consultant". The ASBCA determined that the consultant services were allowable based upon invoices provided and testimony at the hearing. The implications to contractors, although the ASBCA did consider corroborating data (testimony), consultant costs will still be an issue in DCAA audits when there is no consultant work product (report, notes, etc.). Although during an audit, DCAA could or should request additional explanations (the nature of the work performed), DCAA auditors tend to rely solely on the written record contemporaneously prepared, thus discounting verbal explanations as unreliable. Not the right answer, but it yields cost questioned.
- Travel costs. Costs in excess of the regulatory per diems are unallowable. It does not matter that the ACO incorrectly referenced the JTR (it should have been the FTR), nor did it matter that the company offered unsupported assertions that a company policy generally saved money/costs.
- Executive bonuses. FAR 31.205-6(f) includes requirements for a consistently followed policy or plan and basis for the award is supported. In the ASBCA decision, the executive bonuses were associated with a plan which "gives to much leeway in making bonus awards to those who would benefit from them. The contractor bonus plan was "fatally flawed" because it effectively left decision-making to the unfettered discretion of the very same three individuals who were to be the recipients of the bonuses." Translated, a bonus plan can have a discretionary component to the plan, but in execution it can't be 100% discretionary to the sole benefit of these exercising total discretion. Equally important, the determination of bonus payouts should involve a "committee" including those who have little or no vested interest in the payouts.
- Legal fees. FAR 31.205-47(g) pertains to legal fees related to a government investigation; that such fees (whose allowability is dependent on the future outcome) should not be reimbursed while the investigation is proceeding. In this case, the

company was notified in 2006 that the government investigation was complete (no findings), but the company waited until 2007 to claim the legal costs. DCAA and the CFD asserted that the costs could only be claimed in 2006 (a closed-year; hence, unrecoverable as such); however, the ASBCA rejected the Government assertions noting that the contractor appropriately waited until 2007 because it was only then that the company received it documents back from the investigators. Even though the contractor prevailed on the issue, they were only allowed to claim 80% of the legal costs (FAR 31.205-47(e)(3)).

- Subcontract costs. FAR 52.244-2(c) required the contractor to obtain ACO consent before subcontracting; otherwise, the costs may-be disallowed. The clause was in the contracts and the requirement is clear; hence, the ASBCA rejected the contractor assertions that the COTR (Contracting Officer Technical Representative) had determined after-the-fact that the subcontractors performed in support of the statement of work. As noted by the ASBCA, the fact that the COTR agreed that the subcontractors performed in support of the statement of work fails to address the question of price reasonableness (subcontract prices).

In summary, this ASBCA decision should help contractors in navigating FAR Part 31 as well as certain other contractual clauses which impact cost recovery. Unfortunately, the decision may answer the mail in terms of facts which yielded unallowable costs; however, the decision doesn't always explain what should have been documented to yield allowable costs. In some cases, we know what not to do, but not necessarily what to do (i.e. no precise allowability interpretation related to executive bonuses and FAR 31.205-6(f)). And we have the somewhat interesting (but moot) discussion within the dissenting opinion.

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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. The next meeting is TBA. 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.

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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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