REDSTONE Government Consulting

Government Contract INSIGHTS

A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 73

MARCH 2017

Are Final Indirect Cost Rates Really Final?

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

FAR 52.216-7, Allowable Cost and Payment Clause and the corresponding clause in FAR 42.705 refer to a contractor certified indirect cost rate proposal, establishment of final indirect cost rates, adjustment or true-up vouchers and ultimately contract close-out. Although the timeline for certified indirect cost rate proposals is explicit (six-months after the end of the respective contractor fiscal year, in most cases, June 30 of the following year), there are no timelines for the subsequent actions with the reasoning stated in a May 31, 2011 Federal Register: imposing due dates or timelines on subsequent Government audits or rate resolution could adversely impact the quality of these Government actions. Oddly enough, DOD, through its CAFU (Contract Audit Follow-up) process doesn't have a problem with imposing due dates on contracting officers; specifically, Contracting Officers are to resolve DCAA incurred cost issues within 6 months and disposition them within 12 months (of the audit report date). The fact that CAFU due dates are frequently missed is of little or no consolation to contractors because CAFU is purely a Government internal operating procedure.

Although government contractors subject to FAR 52.216-7 may not be able to control (or influence) the timing of subsequent audits or issue resolution, recent events suggest that even when audits have been completed and rate agreement letters co-signed (by the contractor and the auditor or contracting officer), issue resolution may be far from over. In fact, there may be new issues as a result of i) Government attempts to revise the rate agreement letter(s) or ii) additional audits of direct costs.

THIS ISSUE:

Government Attempt to Rescind a Rate Agreement Letter.

In the case of rate agreement letters and revisions, a recent ASBCA Case (No. 57558) involved a rate agreement letter (18 April 2006) followed by a letter confirming the contractor's acceptance of the rates (12 July 2006). In a letter (18 February 2007), the contractor advised the contracting officer that the agreed to rates included a duplicate amount for deferred incentive compensation, a home office allocation that should have been uncovered with a timely review of corporate allocations. The 18 February 2007 letter also indicated that the subject rates are negotiated and final; thus, the letter was merely to provide information as requested by the contracting officer. The contracting officer (8 May 2008) notified the contractor that the final rates cannot be used; the contracting officer "cannot authorize payment based upon the rates which contain costs which were not actually incurred".

The contractor subsequently submitted an invoice based upon the final rates, that invoice was rejected by the contracting officer, and the contractor submitted a certified claim for the amount of the invoice, interest, "plus future costs to be incurred using the FY2003 indirect rates at issue". In this particular decision, the ASBCA determined that the reference to the "future costs to be incurred" did not invalidate the claim under the definition of a claim in FAR 2.101 (for a sum certain). Unfortunately, the ASBCA decision did nothing more than to reject the Government's motion to dismiss (for lack of a valid claim by the contractor). The decision leaves unanswered the question of rescinding the final rate agreement letter because of a mutual mistake (failure to exclude duplicated costs).

Exactly what constitutes a mutual mistake is subject to interpretation although a different published decision (ASBCA No. 55626) did allow a contractor to re-open and to revise its claimed rates for a "mutual mistake" which involved the failure to use the correct value for capital assets and depreciation. Specifically, the contractor had mistakenly omitted allowable cost because the contractor had erred in using a later FAR Part 31 cost principle which prohibited increased asset values as a result of a merger or acquisition. It remains to be seen if mistakenly including unallowable costs has the same result.

Additional Audit of Direct Costs

If and when DCAA audits a contractor final indirect cost rate proposal (or when DCAA accepts it without audit based upon a low risk assessment), DCAA includes both indirect costs/rates and direct costs in its audit opinion and audit results. In the case of an audit, the record shows that as many issues and audit disallowances are for direct costs as for indirect costs; however, any final rate agreement letter specifically states that it only applies to the "indirect rates" (notwithstanding the fact that many rate agreement letters also include a CACW (Cumulative Allowable Cost Worksheet) including direct and indirect costs).

Once the contractor has a rate agreement letter, most assume that there will be no further audits involving indirect or direct costs for the applicable fiscal year. Although there is the potential (but rare) issue of a mutual mistake (impacting indirect rates), there is a risk of a subsequent DCAA audit of direct costs (regardless of the audit coverage during the audit of the final indirect cost rate proposal). This could occur if any of the following apply:

DCAA Internal Quality Review

If an internal quality review determines that the audit scope was inadequate, the field auditor might be compelled to supplement the audit with transaction testing for direct costs (cost-type contracts or time and material (T&M) contracts). This scenario played-out with some degree of frequency in the 2011-2013 time-frame, but it now appears that DCAA completes internal quality reviews before issuing the final audit report. That said, there remains the possibility that a different source may insist that DCAA supplement audit testing (e.g. a DoD-IG post-audit review which concludes that DCAA's audit scope was insufficient).

Prime Contractor audit triggers assist audit of subcontract costs.

As clearly stated in DCAA's audit program for incurred cost audits, the DCAA auditor cognizant of a prime contractor incurred cost audit has the discretion to request an assist audit at the subcontractor regardless of the open or closed status of the subcontract. Per DCAA's audit program, as long as the prime contract has not been administratively closed, any subcontract under that prime contract is still subject to audit.

The obvious question, what is the subcontractor responsibilities for a subcontract which has been administratively closed (between the prime contractor and the subcontractor). Done properly, the subcontract closeout will

include subcontractor releases and assignment of rebates (similar to prime contract close-out involving a Government ACO). The subcontractor release will invariably state that the subcontractor has no further claims for cost reimbursement because the subcontract (and the deliverables) are complete. In the case of an after-the-fact DCAA self-initiated assist audit, is there anything in the subcontract which compels the subcontractor to be responsive to the DCAA audit inquiries? The subcontract presumably has the access to records clause (FAR 52.215-2) which along with the Records Retention clause (FAR 4.7) could be interpreted as compelling the subcontractor to support an audit up to three years after final payment (from the prime contractor). To the extent that the subcontractor incurs costs to respond to the DCAA audit inquiries, how does the subcontractor recover those costs given that the subcontractor has released the prime from further claims for reimbursement? In most cases, subcontractors (who re-open their books to DCAA) will simply absorb the costs as; however, these are not G&A costs (costs related to a specific and previously closed subcontract are direct costs of that subcontract). At the very least, the subcontractor needs to approach the prime contractor to discuss funding for the untimely DCAA assist audit (there are rarely easy answers when the activity is caused by untimely actions by the Government).

ACO Request for DCAA Audit Assistance on Contract Close-out.

As discussed in the February Government Insights Newsletter, 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. In that audit alert, DCAA advises its field auditors and its customers (ACOs) of DCAA's availability to provide additional audit support to facilitate contract close-out. Those audit services could involve anything required by the ACO which could translate into audit testing of direct costs (although that should be the exception and not the rule).

In summary, DCAA by design, fully intends to audit indirect and direct costs during the audit of a contractor's final indirect cost rate proposal. Unfortunately, DCAA "reserves the right" to audit subcontract (direct and indirect costs) regardless of subcontract closure (between the prime and the subcontractor). Prime contractor direct costs are fair game up to administrative close out of the prime contract. Lastly, it isn't obvious as to its intent, but the access to records clause (52.215-2) and records retention clause (4.7) seemingly extend this audit process to three years after final payment. We suspect that this "might" be in play should there be a mutual mistake.

Beware of 350 Pound Malaysian Bearing Gifts

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

The reference to a 350 pound Malaysian is Leonard Francis, also known as "Fat Leonard" whose name will be forever linked with a scandal which has directly impacted the lives and careers of at least twenty Naval Officers and Civilian employees of the Navy or Department of Defense. In addition, five executives or employees of GDMA (Glenn Defense Marine Asia) have been indicted. Those impacted now include three Navy Admirals along with five Navy Captains and one NCIS Special Agent. The reference to "bearing gifts" includes upscale travel, dinners, cash, electronics and the services of prostitutes in exchange for information and favors which facilitated contract awards and overpayments to Glenn Defense Marine Asia (GDMA). Leonard Glenn Francis was the CEO for GDMA and he and two Navy officials were the three initially indicted (September 2013). Mr. Francis pleaded guilty in 2014 to three charges and is awaiting sentencing in this case (based on the charges, the maximum sentence could be 35 years and supervised release for the remainder of his life). Since 2013, there has been an almost continuous series of Department of Justice media releases, the latest March 15, 2017 which disclosed eight additional indictments including a retired US Navy Rear Admiral and five retired US Navy Captains.

In recent history, the GDMA bribes and contract fraud is unprecedented as is the fact that so many Navy officers were susceptible to bribes. As with all too many fraud schemes, it is disconcerting that it happened, but equally disconcerting that the schemes go back to at least 2004 when GDMA first bribed Navy officials to provide GDMA with sensitive information permitting GDMA to secure US Government contracts. In 2011, GDMA began to bribe a Supervisory Agent with NCIS and that agent served a critical (and malicious) role of impeding the initial investigation (for which neither DOJ or NCIS have disclosed what triggered the investigation). The

NCIS agent accessed NCIS databases (with information on the GDMA investigation), shared that information with Leonard Francis and worked behind the scenes to assist Francis in responding to NCIS inquiries. Having plead guilty, the NCIS agent was sentenced to 12 years' imprisonment and required to pay $20 million in restitution (which will never be paid, but at least it sounds good).

Based upon the charges, GDMA began to defraud the US Government in 2009 (inflated claims); hence, the first five years were only abusive in the context of bribes to facilitate contract awards to GDMA. Apparently, once that was working without detection, the next step was to submit false invoices to the tune of $35 million (perhaps to pay for the bribes, etc.).

According to a recently released indictment, GDMA, along with Navy officials (initially involved in the conspiracy), expanded the net by seeking out Navy personnel who were i) susceptible to gratuities and ii) disinclined to "blow the whistle". Per this indictment, seeking new participants was a "shaping operation", which included GDMA sponsored meals (if a Navy Officer appeared to be "uncomfortable" with a defense contractor picking up the tab, that Navy Officer was ironically described as "poisoned" and exclude from any future shaping operations.

The shaping operations weren't limited to US Navy Officers, in one case the operation involved social activities (and gifts) between spouses (with no indication that any of the spouses knew that their respective spouses were involved in a conspiracy of epic proportions).

The "Fat Leonard" fiasco has been and will continue to be the topic of discussion and interest for anyone dealing with contractor business ethics and compliance. A reminder that US Government contracts include clauses related to business ethics and compliance, including a number of requirements in FAR 52.203-03 through 52.203-17. None of these mean much in an organization which is poisoned at the top unless there happens to be a fully independent compliance officer who is aware of the illegal activity and willing to notify an NCIS, DOJ or DoD-IG hotline. It is impossible to gauge the impact of this case on government contractors other than the expectation that there may be a resurrection of audit inquiries into a contractor's business ethics and standards of conduct policies and practices (and not just "check the box" superficial approach as often the case in responding to a pre-defined list of questions on a DCAA questionnaire). There may be very little initial impact on government contractors as the first order of business has to be some soul-searching on the part of the US Navy.

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Hilton Head, SC

July 18-20, 2017 – The Masters Institute in Government Contract Costs
Hilton Head, SC

August 21-22, 2017 – Life Cycle of an Indirect Rate Cost Proposal
Arlington, VA

August 22-24, 2017 – The Masters Institute in Government Contract Costs
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August 24-25, 2017 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk
Arlington, VA

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

December 6-7, 2017 – Accounting Compliance for Government Contractors
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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. The next meeting is on April 27, 2017 at Redstone Government Consulting, Inc. located at 4240 Balmoral Drive SW, Suite 400 Huntsville, AL 35801. Sign up for the April 27th CFO Roundtable here.

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 Upcoming CFO Roundtable Notifications here.

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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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