Redstone Government Consulting

Government Contract INSIGHTS

A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 91 April 2020

Coronavirus and Government Contractors

By Michael Steen, Senior Advisor

In lieu of repeating many suggestions and opinions stated in numerous postings/blogs by private attorneys and others, we believe it is appropriate to provide the following link to the Government website which has a multitude of interrelated links. https://www.acquisition.gov/coronavirus

The link contains advice and direction to Government agencies, but some of the references (links to agency memorandums, etc.) are relevant to Government contractors, particularly:

- OMB M-20-18: Managing Federal Contract Performance Issues Impacted by COVID-19
- DHS March 5, 2020 Letter to DHS Contracting Community

The DHS letter is a one-page letter of encouragement whereas the OMB memo includes five pages of "Q&A"; thus, it provides some information which should be considered by government contractors. Government contractors should routinely check the link above for further information, but note that at least for now, most of it is directed to Government acquisition officials and procedures and a recurring suggestion for "for maximum flexibility within the constraints of the laws". There are few answers to specific situations because the majority are addressed in a recurring reference for the need to evaluate on a "case-by-case" basis. OMB's memorandum does make a specific reference to FAR 31.201-3, Cost Reasonableness, including OMB's suggestion that contractor communications with contracting officers (or representatives of the contracting officer) could be one factor in determining if a contractor action and related cost is reasonable (a non-specific conceptual framework).

THIS ISSUE:

Although the overall tone of the OMB Memorandum is clearly focused on maximizing flexibilities, OMB is clearly not providing many answers but deferring to the contracting officers in dealing with "case-by-case" situations which could include schedule slippages as well as REAs (Requests for Equitable Adjustments). That said, contractors impacted should:

- initiate communications with their contracting officer(s),
- identify and accumulate relevant data which could support a potential REA, and
- ensure that existing contractor policies are timely revised as necessary to accommodate changing circumstances and also to avoid after-the-fact audit issues (i.e. cost reasonableness challenges because a contractor's actions/costs were inconsistent with that contractor's policies). If nothing else, an internal MFR which universally suspends policies which pose health and safety risks related to COVID-19 (examples could include time clocks or similar equipment which typically involve physical contact by many employees).

Although the OMB memorandum mentions "contractor communications with contracting officers (CO)" (which is not actually a criteria stated in FAR 31.201-3), OMB does not address what if a the contractor takes the initiative, but hears nothing from the CO and/or nothing even approaching CO approval. Given the urgency of addressing COVID-19, we suggest that a contractor cannot wait for contracting officer reaction or approval before changing policies or practices as needed to protect the safety and health of contractor personnel. As many experienced with other uncontrollable situations impacting contract performance (such as Government shutdowns caused by political impasse), notifying the contracting officer is one thing, but receiving any kind of contracting officer approval or feedback is something else and completely unpredictable. That said, create and retain documentation supporting whatever actions are taken because history (e.g. contingency contracts in Iraq) has shown that subsequent audits hold contractors to the FAR 31.201-3 reasonableness criteria, disregarding contractor short-cuts caused by operational urgencies

COVID-19 might be on a much larger scale, but it is similar to other events and situations wherein contractors focus on day-to-day operations without recognizing the secondary need to consider contract cost recovery. In the context of cost recovery (or price adjustments), all such events and situations compel contractors to recognize that in contemplation of pursuing any contractual remedy or relief, there are two factors, entitlement and quantum. If a contractor is fully and irrefutably entitled to a REA, they might recover nothing if that contractor does not begin (early in the process) to segregate and accumulate data in support of the quantum.

And one other tip, if a contractor obtains assistance on a potential REA by engaging a consultant or attorney, do not make the consultant or attorney's compensation contingent on specifically recovering that compensation from the Government (in the REA or similar action) because the cost "contingent on recovering it from the Government" is expressly unallowable per FAR 31.205-33(b).

Incurred Cost Submissions and Incurred Cost Audits

By Michael Steen, Senior Advisor

Contracts subject to the Allowable Cost and Payment clause, FAR 52.216-7, include subparagraph (d) which includes the subsections (schedules) for an adequate indirect cost rate proposal (aka Incurred Cost Submission/Proposal/Electronic or ICS, ICP or ICE). This annual submission is due within six months after the end of a contractor fiscal year (i.e. June 30 2020 for a contractor fiscal year ending December 31,2019) and to the best of our knowledge, this due date has not been extended due to COVID-19.

Once submitted, these are subject to an adequacy review and for those subject to DCAA audit cognizance, the adequacy checklist can be found here. As a by-product of the 2018 NDAA (National Defense Authorization Act) DCAA now has 60 days to perform the adequacy review (and notify the contractor of the results) and 365 days to complete the audit fieldwork of an adequate ICS/ICP/ICE. Of passing interest, the current DCAA ICS adequacy checklist is dated December 2019 and DCAA has routinely revised and reissued this checklist notwithstanding the fact that the details contained within the underlying regulation have not changed since May 31, 2011. In other words, the precise requirements for an adequate ICS are a function of DCAA's checklist which has been DCAA's interpretation and reinterpretations of a "static" contractual requirement. Although DCAA is arguably stepping into an

inappropriate role of rewriting the regulations, contractors have learned to "live with it" or accept that "it is what it is" in part because DCAA has seemingly become more flexible in accepting less than perfect contractor ICS submissions.

A case in point, a contractor FY 2018 ICS which had some rather obvious reconciliation issues (easy to identify by simply using all of the internal reconciliation references in DCAA's ICS adequacy checklist) and perhaps most notable, an obviously incomplete Schedule I (cumulative allowable direct and indirect costs for flexibly priced contracts such as cost-type and Time & Material). The ICS was determined adequate, deemed low-risk, and final indirect rates and implicitly direct costs were determined to be allowable (as submitted) without any audit. Only at the time of preparing the final rate agreement letter did a different auditor realize that there were obvious reconciliation problems with the ICS and correcting these held up the final rate agreement letter. Oddly enough, the second DCAA auditor still failed to recognize the issue of an incomplete Schedule I which might be considered "no harm, no foul" by the contractor; however, any contractor submitting an ICS needs to recognize the importance of a complete and accurate Schedule I. Not only is it contractually required, but it will ultimately serve as the Government's point of reference in determining the total allowable direct and indirect costs for a contract or task order being administratively closed. There are far too many examples of non-value added and costly actions attempting to support contract close-out when it is virtually impossible to determine and document (long after the fact) cumulative allowable costs because there was no Schedule I (or equivalent).

Other more common examples of DCAA's flexibility in accepting less than perfect incurred cost submission are the DCAA ICS adequacy letter along with a short list identifying schedules requiring corrections before DCAA will issue a final rate agreement letter (with or without an audit)

In terms of trends in audit issues (if and when DCAA or an Independent Public Accountant (IPA) performs an incurred cost audit), we've experienced the following (or more accurately, clients have experienced the following):

- Compensation reasonableness (FAR 31,205-6(b) remains on DCAA's "hit list" wherein DCAA requests contractors to complete a DCAA template (five most highly compensated employees and their respective annual compensation by type of compensation). In some cases, the field auditor summarily accepts the cost as reasonable, in others the field auditor obtains benchmarking assistance from DCAA's Compensation Team. DCAA's benchmarking is unchanged in spite of some embarrassing losses in published ASBCA decisions. A side note related to the 31.205-6(p) compensation cap which was last published by OMB for FY2018 at $525,000. Although OMB has the BLS data to calculate and to publish a slightly higher amount for FY2019, OMB apparently can't find the four to eight hours to accomplish this apparently insurmountable task. Although anyone can easily do this, the wording in 31.205-6(p)(4) gives OMB the exclusive authority to publish annual updates. Translated, at least for purposes of preparing an ICS for FY2019, contractors should avoid substituting anything more than $525,000, else risk an issue of having expressly unallowable costs subject to FAR 42.709 penalty.

  One unique "twist" on the reasonableness of a contractor's executive compensation bubbled-up in an audit performed by an "IPA". That CPA firm requested a schedule listing the contractor executives who were also officers of the corporation, in turn the total compensation for the listed executives/officers was compared to a data source which represented that on average, officer compensation was 2% of revenues. Thus, aggregate officer compensation exceeding that number was questioned as unreasonable. The good news, this approach was void of any regulatory basis; in fact, it was completely at odds with FAR 31.205-6(b). Nonetheless, an issue which required contractor time and effort to resolve.

- Subcontract costs on cost-type prime contracts are rarely audited, in particular, there are few, if any, government performed "assist audits". Recently, an IPA (aka a Qualified Public Accountant per the wording in the 2018 NDAA), issued its audit results in a "clean report" with the exception of qualifications for two unaudited subcontracts. One of the two was a "low risk" contractor, thus, costs were accepted without audit by DCAA. The fact that DCAA accepts, without audit, hundreds of millions (in the aggregate) and thousands of contracts are ultimately closed without any incurred cost audits did not influence the IPA in terms of "why bother" to issue a qualification

because approximately $350,000 in subcontractor costs had not been audited. But was nonetheless deemed allowable. The other subcontractor involved a similar amount but was for a very large contractor whose total incurred costs are the subject of an ongoing DCAA audit. Based upon history, DCAA will likely have audit exceptions (cost questioned) for this particular contractor, but it is highly unlikely that the audit exceptions will be timely resolved. Thus, the IPAs qualification that the assist audit has not been completed will be unresolved for the foreseeable future.

The good news as it relates to DCAA or IPA audits of subcontractor costs included in the incurred cost audit of a prime contractor, no one questions 100% of these costs because that DCAA tactic was destroyed in a late 2016 ASBCA case. DCAA and perhaps IPAs which follow DCAA audit policies, still have expectations that prime contractors "manage their subcontracts", but only as a procurement or billing (business system) practice (reference DCAA MRD 19-PIC-001, dated January 11, 2019) differentiated from a basis for questioning the subcontract costs (the DCAA assertion which was destroyed in the ASBCA case).

The bad news, apparently none of the entities performing these incurred cost audits have ever read FAR 52.216-7(d)(5) as it pertains to the administrative responsibility for subcontracts. That subpart makes clear that the prime contractor is responsible for settling subcontractor amounts and rates included in the (prime contract) completion voucher. To fully understand this statement, it was inserted into FAR in the final rule published in the Federal Register date May 31, 2011 in response to public comments suggesting that government assist audits should have due dates (included in the regulation) to which the FAR Councils made it crystal clear that there are no requirements for or expectations of government assist audits because the responsibility resides with the prime contractor.

- Accounting systems and incurred cost audits. Although many of the "old dogs" (old incurred cost years awaiting audit) are now behind us, there are still old dogs awaiting audit and/or dispositioned with an audit disclaimer because contractor records were in no condition to audit (years after the fact). These apply to audits attempted by DCAA as well as those attempted by IPAs. DCAA's most recent reference to these has been in the context of contractor incurred cost submissions that were not audited within the 365 days prescribed in the 2018 NDAA. In DCAA's 2018 Annual Report to Congress (dated March 31, 2019 and the latest annual report available) the data included a surprisingly large number of "unauditable" contractor submissions for which DCAA presumably issued "audit disclaimers" (an audit was attempted, could not be performed and DCAA had no basis to deem any cost allowable or unallowable).

  In one case, an IPA took a different approach in terms of questioning 100% of the contractor's claimed direct and indirect costs for one or more years where accounting records were "unauditable" because the contractor had changed accounting systems (software), but failed to retain any capability to access/use the prior system. Assuming there were public vouchers submitted and government payments, there is evidence that the contractor performed the services and on an interim basis, the government accepted and paid for the invoiced costs. Under the circumstances, it is an unsustainable audit position (disallowing 100% of the claimed costs), because the government cannot pay nothing for services received.

  New and "untested" audit interpretations will come and go as new accounting firms perform (or attempt to perform) government contract audits. Unless the amount(s) at issue are inconsequential, contractors should balk at concurring with audit results which will in some cases be based upon creative and potentially unsustainable interpretations of the regulations. These will likely include wholesale disallowance of "unsupported" costs because of DCAA or IPA imposed response dates (unrealistic because of the volume of records requested and the allotted response time) as well as highly creative (thus untested) audit assertions.

With or without a consulting engagement, Redstone Government Consulting, Inc. and the author of the newsletter (msteen@redstonegci.com) is interested in obtaining draft audit results related to after-the-fact (incurred cost) audits. Contractor experience (clients or non-clients) are a source of information and ideas for future newsletters as well as webinars and other training.

DCAA's Post-Award Audits for TINA Compliance

By Michael Steen, Senior Advisor

As we (and others) have noted in blogs, newsletters and webinars, DCAA has significantly expanded its audits of contractors for compliance with TINA (Truth in Negotiations Act, ask Truthful Cost or Pricing Data). If one wants to gain an understanding of the scope (or potential scope) of these audits, the point of reference is DCAA's website and the audit program for DCAA activity code 42000. This 24-page audit program is actually a very unique audit program because it contains several pages of risk assessment steps (not unique), but followed by a "go or no-go" decision to perform the audit ("no-go" is not an option in virtually any other scheduled audit).

As with every other DCAA audit, the audit program, thus the auditor(s)' inquiries in support of a risk assessment, are a continuum of questions, contractor responses, follow-up questions, etc. The initial questions are predictable, they are those listed on page 5 of 24 of the 42000 audit program. In all too many cases, many of the questions, particularly the follow-on questions, have no direct connection to the objective of the audit, but they will be asked because they are in the audit program, DCAA's Contract Audit Manual or DCAA's auditor training on Government Auditing Standards. DCAA auditors face an uphill battle if they try to remove prescribed, standardized audit steps/questions for contractors, after all, individual auditors are not expected to engage in critical thinking involving professional judgment because that results in variation in audits which is more difficult to explain and defend with the Monday-morning quarterbacks, e.g. Office of Inspector General or the Government Accountability Office).

For any contractor notified of a planned DCAA "post-award audit" (for TINA compliance), they should anticipate a barrage of questions and DCAA expectations for timely responses and one or more "walkthroughs", Any contractor dealing with these audits should recognize that a post-award audit is a "no net gain" situation for the contractor because it will cost hundreds of hours (internal and in discussions with DCAA) and the best possible outcome is a DCAA decision to fold-up-shop and stop the audit at the end of the risk assessment ("no-go" decision on the part of DCAA). The second-best outcome is a more time consuming audit ("go" decision), but with no RPA (Recommended Price Adjustment) and the third best (or more accurately the worst) outcome is an audit with an RPA (which will likely only be reported if the amount of the RPA exceeds $50,000). Unlike an accounting system audit where "no findings" equates to an adequate (approved) accounting system which is a definitive advantage to the auditee because it opens the door to bidding on cost-type Government contracts, a post-award TINA compliance audit without any findings keeps the auditee on the competitive level as a contractor who has never undergone a TINA compliance audit. In relative terms, no net gain for the contractor subjected to the TINA compliance audit.

As more contractors have the (undesirable) opportunity of experiencing a DCAA post-award (TINA compliance) audit, a few closing observations:

- The access to records contractual clause (52.215-2) compels a contractor to provide records (with some limitations such as internal audits), but in no context to create, filter or edit records in response to an audit. A recent example: "Explain in detail your procurement and subcontracting practices including how you manage subcontracts" and if these practices are not contained in one or more company policy, create a fully detailed written description of your practices". Obviously, the contractor response should be consistent with the philosophy of Management Team (e.g. "we want to appear 100% cooperative" versus "we want to push back when appropriate"), but no contractor is contractually required to create any document which does not currently exist as a contractor record.
- DCAA will predictably ask about internal audits, management reviews, and third-party audits or reviews (not specifically related to the TINA compliance audit) as well as management awareness of fraud risks (in general and specifically related to TINA compliance). DCAA will ask and re-ask for access to internal audits and management reviews, particularly if any part of the description is "fraud risks". Recent experience has shown that DCAA will ask these questions in one set of questions (initial notification) and include the same question(s) in a later set of questions (if the contractor has not provided the internal audits or reports). Although

DCAA auditor routinely mention that denying access is the almost unmentionable "contractor denial of access to records", as an Agency, DCAA knows from past-experience that it cannot compel a contractor to provide internal audit reports, working papers or access to the internal auditors.

- DCAA questions are frequently in terminology which has no common contractual definition, such as "provide a list of significant events by cost element related to this pricing action". In the absence of any regulatory definition of "significant events", the obvious answer is "none". In any case, "less is more" in terms of providing a response beyond "none".

We could "write a book" about DCAA's questionable practice of expecting (requiring) contractors to provide a written response to DCAA's long list of questions which commonly accompany an audit notification letter, However, the key take-away is for contractors to anticipate these "opportunities" and to recognize that DCAA is out on a limb when requesting "document creation" versus providing existing documents. Also, to proceed with caution in terms of devoting hundreds of hours to be fully responsive because all too many questions have no direct relevance to a specific topic. In other words, much of this contractor effort merely "papers a file".

One last parting comment or focused discussion on contractor costs to comply with DCAA's bloated risk assessments inclusive of DCAA requests which involve the creation of documentation (far more than existing documents, policies and procedures). Most contractors absorb all of their DCAA audit support as an element of contractor G&A which is absorbed against a very broad G&A base. Not a significant cost recovery issue if the G&A base includes a significant amount of cost-type Government contracts, but a significant cost recovery issue if the G&A base is primarily fixed price or commercial. If/when these pertain to a post-award audit, almost all TINA compliance audits involve fixed price contracts which will contain the required TINA clause (FAR 52.215-10, -11, -12 and -13), however, there will be nothing in the contract statement of work or specific pricing which will cover the contractor's cost of supporting a DCAA TINA compliance audit which will be contract specific (in other words, this activity is not G&A). One suggestion, contractors facing this situation should propose an amount to cover contractor costs to support a DCAA audit which is contingent on DCAA performing the audit. Effectively an exercisable contract option which self-deletes if there never is a TINA post-award audit. Will this be readily accepted by a contracting officer…probably not but remember that almost all TINA compliance audits are related to fixed-price non-competitively awarded (sole source) contracts which means that a contractor isn't risking a source selection faux pax.

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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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