



Government Procurement & Audit Challenges for Government Contractors Calendar Year 2012

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Our annual newsletter outlines our forecast of government contract procurement and oversight trends and issues that we believe will have a significant impact on government contractors in calendar year 2012. Our dialogue also includes corresponding risks contractors face in light of these trends and issues, and hopefully provides insight as to how contractors can better prepare in anticipating and preparing for forthcoming procurement and audit challenges. The 2012 newsletter addresses a wide range of topics impacted by legislative and executive government department initiatives, DOD policy and procurement regulation changes, a continued pursuit of acquisition reform and realignment of procurement responsibilities, and current Defense Contract Audit Agency (DCAA) audit policies and priorities. We have carefully analyzed data and information gleaned from a broad range of sources and filtered that data to identify issues and audit related “hot topics” which will likely test the resolve of both large and small government contractors in meeting the increasingly competitive and regulated environment of government contracting in 2012. As with each annual newsletter, there is no certainty in terms of guaranteeing that a topic/issue will evolve into, or continue to attract a high level of Government interest or oversight. However, we have been substantially accurate in prior year predictions, especially those related to contract audit oversight; hence, we recommend that all government contractors give consideration to the contractor financial, management, and other functional areas that are affected by the topics/issues discussed herein.

Contractor Reporting & Business Ethics

There have been continuing changes to contractor reporting (by the contractor as well as by government contracting agencies) in pursuit of the overused concept of transparency. In terms of contractor reporting, we have FAPIIS (Federal Awardee Performance and Integrity Information System) which requires government contractors to report their “bad deeds” such as OSHA, EPA or DOL violations which could include administrative agreements, adverse administrative proceedings, contractor self-reporting, defective pricing and terminations for default. Although FAPIIS was

originally intended for internal government use, it has been modified (by Congress) to require public disclosure except for past performance reporting. As of January 3, 2012, the FAPIIS rule incorporated a provision allowing contractors seven days to review and identify information protected by a FOIA exemption (Freedom of Information Act), but ultimately the decision to remove or not remove this data belongs to the contracting officer. If the contracting officer does nothing, the data will be released to the public within 14 days.

In addition to FAPIIS, there is the internal government past performance reporting which now requires all

agencies to use the DOD CPARS system to use a five-point scale to report:

- Technical quality
- Cost control (as applicable)
- Schedule/timeliness
- Management or business relations
- Small business subcontracting

Although at least one government entity proposed that contractors not have any opportunity to comment and potentially have this data corrected, the regulation does permit contractors to coordinate with the government to assure the accuracy of this past performance data which can be critical in future contract awards (source selection).

In terms of combining contractor reporting with business ethics, a number of contractors have expressed concerns with contractor certifications required by the FAPIIS regulations and with respect to those concerns the FAR Councils basically responded, “it is what it is” or welcome to the world of government contracting and the inherent risks of being a government contractor. Also related to contractor reporting, the somewhat dormant “Stimulus” funds (which require certain contractor reports) are anything but dormant in terms of the coming tsunami of fraud investigations involving the alleged misuse of stimulus funds including the alleged misreporting by recipients of the stimulus funds. An example is a DOE (Department of Energy) IG report in early 2011 citing more than 100 active investigations involving stimulus funds and we suspect this is but the tip of the iceberg considering that stimulus funds were shoved out the door with only superficial promises of sufficient oversight and management. In fact the DOE IG report has made the observation, that no one was ready for the influx of funds (dwarfing normal funding levels) and the concept of “shovel-ready” projects was grossly exaggerated. Suffice to say, more to come as government investigations take time as most investigations originate with Qui Tams or hotline referrals which are most likely in the works but are sealed from public disclosure.

As it relates to the most specific business ethics requirements for a government contractor, FAR 52.203-13 and -14 are the most salient points of reference. FAR 52.203-14, Posting of agency hotline posters, was modified with little fanfare in 2011 to now require the posting of the DOD-IG hotline poster (previously the only required agency hotline poster was DHS (Homeland Security)). Based upon the proposed rule and discussions within the final rule, apparently the DOD-IG believes that allowing contractors to post their own internal hotline poster without posting a DOD-IG hotline poster is not as effective as “it could be”. We surmise that DOD-IG and virtually all other IGs are not getting the hoped-for influx of egregious contractor misdeeds through the hotline process; instead, the preponderance of hotline referrals are inconsequential “in-the-weeds” referrals because anyone with any referral of any value will most likely pursue it through the Qui Tam process wherein the relator may ultimately share in the government recovery (for anyone unfamiliar with the Qui Tam process, simply do an internet search on the phrase). As noted by DOJ (Department of Justice) in each annual announcement of fraud recoveries, Qui Tams account for the lion’s share of government fraud recoveries; by implication, hotline referrals directly to government IGs are a distant second. In fact, during a recent seminar, a spokesperson for the DOD-IG indicated that they are going to wait for at least another year before publicizing their hotline data or other data resulting from the mandatory disclosure provision of FAR 52.203-13 (by implication, they have nothing to report or they would be reporting it now).

In anticipation of DCAA audits, a government contractor should be familiar with its contractual requirements under FAR 52.203-13 and -14 which could include a mandatory disclosure of certain reportable events and should there be a reportable event, that disclosure is to an agency IG with a copy to the cognizant contracting officer. Although DCAA has an audit program wherein DCAA field auditors are told to ask contractors for this data, DCAA is clearly not in this reporting process. Contractors, particularly large contractors with DCAA auditors in residence, should familiarize themselves with DCAA’s audit program (Control Environment,

activity code 11070) and be contemplating in advance if and how to respond to a number of very invasive requests from DCAA.

Contractor Business Systems

On May 18, 2011, the interim DFARS Business Systems Rule was published defining six business systems and the criteria for determining the adequacy of each system. The rule only applies to CAS covered contractors and by design the rule does not apply to small businesses which are statutorily exempt from CAS. However, pending the precise wording within the final rule, the DFARS rule could be applicable to a non-small business contractor with as little as a \$7.5 million DOD contract which is the CAS threshold for modified CAS coverage. If the final rule addresses or clarifies anything, it would logically be the intended coverage with respect to modified versus full CAS covered contracts.

These six systems include i) accounting, ii) estimating, iii) MMAS (material management and accounting), iv) EVMS (earned value management systems), v) government property, and vi) purchasing. With respect to each system, a contractor's failure to satisfy one or more of the stated criteria will result in a determination that the system is not adequate which will trigger the 5 percent withhold of government payments applied to those contracts with the new DFARS clause. The total withhold for multiple deficient systems would not exceed 10 percent, and there are provisions for reducing the withhold percentage based upon adequate corrective action plans. The regulation clearly assigns all authorities to the contracting officer (as opposed to DCAA); hence, the adequacy determination as well as the sufficiency of any corrective action plan(s) will rest with the contracting officer. Nonetheless, we can expect DCAA to play a very significant role in the government's review of accounting and estimating, a supporting role with purchasing, MMAS, EVMS and hopefully no involvement with government property ("hopefully" excluding DCAA simply because adding DCAA to the equation predictably eliminates any

potential efficiencies in the government review process).

Although the DFARS rulemakers (DAR Council) acknowledged that some of the criterion implies a degree of subjectivity, these rulemakers were self-assuring in further stating that "reasonable parties will be able to agree on necessary characteristics to meet each threshold given the unique set of circumstances". It remains to be seen to whom DFARS rulemakers were referring to in reference to "reasonable parties". Additionally, it is less than reassuring that DCAA will migrate to a reasonable interpretation of a material or significant deficiency notwithstanding that DCAA's Director has publicly stated that DCAA will audit in accordance with the rule and consistent with GAGAS (government auditing standards). In fact, DCAA's current interpretation of GAGAS is exactly how they've gotten to the stage where any and all deficiencies are deemed to be material with or without any measurable harm. Certainly, the DFARS Business Systems Rule does nothing to eliminate the possibility that nothing will change with respect to DCAA "materiality" interpretations leaving contracting officers with the difficult task of disagreeing with DCAA. With that in mind, DCMA (Defense Contract Management Agency) has already issued and published its internal guidance on the matter wherein a contracting officer will present his or her preliminary determination to an internal review board.

Perhaps the most enigmatic aspect of the DFARS Business Systems Rule is the lack of any direction from the government in terms of how the government intends to evaluate contractors for compliance. In its ambiguous response to public comments expressing concerns over DCMA/DCAA lack of resources to timely complete these evaluations, the DFARS rulemakers stated "the need to have effective oversight is unrelated to resources". More ominously, a spokesperson for DOD indicated his expectations that system deficiencies would be indirectly identified in other than business systems reviews or audits; as an example, an estimating system deficiency would be identified in the government evaluation of a contractor bid proposal, and that deficiency would yield a secondary report citing the

system deficiency. In DCAA vernacular, a “flash” report, but now with implications that a flash report could become the impetus for a 5 percent withhold. In the context of flash reports and deficiencies identified in other than full-blown system reviews, it also remains to be seen if either DCAA or DCMA can avoid misclassifying isolated errors as systemic deficiencies. Certainly DCAA’s track record has been to error on the part of reporting anything and everything as a systemic deficiency; hence, eliminating any risk of under-reporting issues unfavorable to DOD contractors.

Adding to the mystery of what to expect as the DFARS Business Systems review/audits displace DCAA long-standing “ICAPS” (Internal Control Audit Planning System) audits is the fact that DCAA has been pilot testing a replacement audit program purportedly associated with the accounting/billing system; however, DCAA has apparently requested that the pilot test site contractor not publicly divulge any details of this audit. It does appear that any replacement audit program will involve extensive transaction testing over a prolonged period of time without any interim audit reporting unless the ongoing audit identifies a “significant deficiency” at any point in time in which case we expect that DCAA will issue the equivalent of a “flash” report (which is consistent with statements made by a DOD spokesperson). Lastly, DCAA has neither modified nor rescinded a number of audit policies or audit programs which pertain to contractor business systems (located at www.dcaa.mil “open audit guidance”).

As it stands, DCAA audit policies still retain a number of controversial interpretations including the definition of a significant internal control deficiency (seemingly anything and everything), the concept of “flash” reports and limited scope audits, and the fact that a limited scope follow-up audit will not express an opinion even when all deficiencies have been corrected. Regardless of the applicability of the final DFARS Business Systems Rule, all contractors should be aware of the fact that nothing has changed with respect to the much broader applicability of FAR Part 9.104 including the requirement for accounting controls and the applicability of controversial DCAA audit policies to all contractors

as discussed in this newsletter under “Cost Accounting Systems—Nonmajor Contractors”.

Changing DCAA Audit Approach, Priorities, and Responsibilities

DCAA’s prioritization of audits, and means of accomplishing those audits, for CY 2012 will be guided by a number of CYs 2008-2011 events and DOD policy directives with the goal of utilizing available (and purportedly limited) audit personnel in the most effective manner by redefining DCAA’s scope of responsibilities to more effectively execute agency assigned audits in a GAGAS (government auditing standards) compliant manner thus limiting the possible criticisms from external reviewers, notably the GAO and DOD IG (Government Accountability Office and Department of Defense Inspector General).

A January 4, 2011 DPAP (Defense Procurement Acquisition Policy) memo was issued to better realign oversight responsibilities, and removed DCAA from the primary responsibility of either taking primary charge of or initiating certain functional and pricing audits (relevant to DOD), and transitioned those responsibilities to DCMA—those included: FFP and cost type cost proposals under \$10 million and \$100 million respectively; financial risk assessment and capability reviews; purchasing system reviews; Forward Pricing Rate Agreements, but not necessarily Forward Pricing Rate Reviews, and; Business System audits (see discussion in this newsletter, “Contractor Business Systems”). Following that directive, DCAA confirmed in its own memorandums the movement of responsibilities to DCMA, the latest of which confirmed that Earned Value Management Systems (EVMS) audits would be initiated and directed by DCMA. The DOD responsibility “realignment” process has not completely removed DCAA from supporting most of the above reviews, ordinarily by request, but rather has formally shifted or reconfirmed that the final determination of an acceptable “system” (purchasing system, EVMS, financial capability) belongs to DCMA (Defense Contract Management Agency represented by the contracting officer).

The outcome of the 2008 and 2009 General Accountability Reports (GAO) still impacts the DCAA audit approach, scope, and communication standards with government contractors although some nuances have abated somewhat, particularly in contractor and customer communication. Those GAO reports cited DCAA for failing auditing standards via inadequate transaction testing, poorly supported audit results and opinions, insufficient supervision, and more focus on audit product quantity than quality. Audits which were severely criticized included everything the GAO reviewed including internal controls, cost presentations (proposals, claims and incurred cost proposals), and contractor invoice reviews. The effect of the GAO comments has been a DCAA which is engulfed in absolute and unchallengeable conformance with GAGAS which means extensive and never-ending transaction testing often inconsistent with risk to the government; go, stop and restart audits (e.g., incurred cost proposals) that often require redundant audit effort and result in unpredictable completion dates; absence of any “floor” for determining materiality in assessing the significance of internal control or procedural deficiencies; extensive delays in exit meetings due to continuous DCAA management reviews, and; reluctance in auditors communicating with contractors on an interim basis during the audits (although this has improved).

DCAA’s September 10, 2010 “Rules of Engagement” guidance memorandum has eliminated some rigid auditor communication barriers with contractors, and going into CY 2012, we believe the communication process (exit meetings, disclosure of draft report results, etc.) will continue to improve. Better lines of communication with government contractors should at least place contractors on equal footing in understanding the basis for those findings in a timely manner, facilitating a more focused response to the DCAA issues; optimistically a more expeditious process in resolving open issues should result. Unfortunately, nothing currently suggests any significant improvement in the timely commencement and completion of audits as DCAA continues the journey of implementing more comprehensive internal review processes of its work product, which will certainly delay discussion of audit

results with contractors and issuance of reports (See DCAA memo 11-PPS-012—Independent Reference Reviews).

Finally, DCAA issued its program staffing plan for the government fiscal year 2012 (October 1, 2011 through September 30, 2012) outlining audits that are high priorities for accomplishing during CY 2012. Highest prioritized audits relate to DOD contract audits, and top priorities include:

- High risk proposal audits requested by DOD procurement agencies;
- Support to DCMA in the Joint Cost Recovery Initiative which include long-standing unresolved contractor and DOD contracting agency disputes involving large amounts due the government; such issues include Cost Accounting Standards non-compliance issues for which cost impact estimates indicate amounts owed the government ;
- DPAP/DCAA identified high risk incurred cost proposals (ICPs) (overseas contingency operations) for major contractors;
- Incurred proposals already in progress during the government fiscal year 2011;
- Non-major contractor incurred cost proposals where ICPs have been deemed adequate;
- DCAA pilot test audits for major contractor billing and accounting systems still in progress, and;
- DCMA/DCAA identified high risk defective pricing audits.

(See our September 2011 newsletter for more details on the DCAA staffing plan). In that program plan, DCAA acknowledges that its GFY 2012 resources are limited, particularly with regard to accomplishing the huge backlog of incurred cost proposals requiring final rate determination.

Audit priorities:

- DCAA will first and foremost attend to audits that directly or indirectly affect DOD contracts and subcontracts, whether requested (demand) or self-

initiated (discretionary). To the extent that DCAA has audit resources available to perform civilian agency (non-DOD) contract audit services, DCAA will undertake those if requested. Contractors that bid and incur costs largely or completely for civilian agencies will potentially take a backseat to DOD contractors. Unless DCAA dramatically adds to its professional ranks whereby non-DOD audit work can be provided to civilian agencies in a timely manner, we will continue to see those agencies moving toward other audit solutions such as the Department of Energy who has employed the services of private accounting firms.

- DCAA will not self-initiate any audits of functions for DOD contractors for which primary responsibility will reside with DCMA, e.g., purchasing system, financial capability, EVMS, or business systems (see also “Contractor Business Systems”).
- Department of Defense demand requests will come first (as always), which will include audits such as cost proposals and pre-award cost accounting systems (as a condition for obtaining a new contract); requests will however likely be for those above the dollar thresholds established by DPAP in January 2011 (FFP over \$10 million, cost reimbursable over \$100 million for prime contractors).
- Incurred cost proposals for DOD contractors falling within the DCAA’s parameters discussed above will be started, but completion of those will be contingent on audit resources (after meeting demand work).
- Defective pricing (post-award) audits already identified as high risk by DCMA/DCAA (those where high profit margins have been achieved—DOD contractors).

Audit approach:

- DCAA has given no indication that it will realign or reduce its depth of audit coverage, nor rethink its vague and highly subjective criteria for determining when a systems deficiency is “significant” thus, continue to expect exhaustive and never-ending testing for both demand and non-demand audit

assignments, lengthy time periods between audit commencement and completion, and insignificant and/or immaterial findings or questioned costs showing up in audit reports.

- Auditors will continue to maintain a cautious line of communication when discussing audit results with government contractors—as noted above, open communication has improved, but beware that in many cases auditors are still only disclosing audit results, contrary to current guidance, at exit meetings particularly for incurred cost proposals and defective pricing audit issues, and frequently expecting contractors to reply within a few days. Moreover, draft audit results and/or emails or other informal audit means of delineating audit outcomes are often confusing, poorly worded, incomplete as to basis for findings, or cryptically written leaving contractors a vast array of choices in trying to guess the issues at hand.

Although DCAA’s role in certain DOD contractor audits has been diminished, when DCAA is involved, the agency or its individual auditors through IG hotlines will “appeal” ACO or PCO decisions contrary to DCAA findings (and recommendations) if DCAA believes its findings were discarded with inadequate rationale or were simply ignored.

Forward Pricing Bid Proposals

There will be virtually no change from 2011 to 2012 regarding the manner in which government procurement officials will analyze contractor cost proposals; consequently, contractors should continue to be on high alert due to DCAA’s rigorous auditing approach of those cost proposals for which DCAA takes cost analysis responsibility.

As discussed previously, DCAA has relinquished its audit responsibilities in analyzing proposed costs for DOD FFP proposals below \$10 million and cost reimbursable proposals below \$100 million (except in certain situations). And consistent with DPAP policy, DCMA has begun assigning its professionals to perform cost analyses when DCAA cannot, albeit DCMA

requires additional time to recruit new and/or train existing staff in cost analysis techniques. When DCAA has been tasked to audit contractor cost proposals, however, our 2011 experience has been that virtually all client proposals have been initially rejected for adequacy, and upon conclusion of audited adequate proposals, DCAA has questioned or unsupported significant amounts of proposed costs in the vast majority of those proposals. Following those completed audits with questioned and unsupported costs, DCAA has in several instances issued “flash” reports highlighting purported underlying significant estimating system deficiencies that supposedly led to overstated or unsupported proposal costs.

Events and policies that have generated a high-risk cost proposal auditing environment for government contractors include DCAA’s continued quest to conduct bid proposal audits strictly compliant with GAGAS. Having been criticized by GAO reports in 2008 and 2009 DCAA has subsequently modified its approach to first include a more rigid evaluation process of proposals for “adequacy” (before an audit begins) based upon a highly subjective interpretation of cost proposal and disclosure/submission rules contained in FAR 15.408, Table 15-2. In 2011, DCAA updated its cost proposal adequacy checklist with; attributes for a compliant proposal supposedly contained in FAR 15.408, Table 15-2, but as noted in our December 2011 newsletter, the DCAA checklist actually expands the literal regulatory compliance requirements to DCAA’s own interpretation of what those provisions should be.

Assuming a contractor can ultimately pass DCAA’s version of proposal adequacy, the actual audit involves greatly expanded transaction testing often including statistical sampling and even some new challenges to long-standing assumptions that commercial item pricing was prima facie a fair and reasonable price. Based upon a 2011 audit policy DCAA auditors must evaluate not only the price reasonableness of subcontractor commercial items but also the support for the prime contractor determination of commerciality.

Similar to our prediction in our CY 2011 newsletter, government procurement officials continue to

emphasize the responsibility of prime contractors to undertake the primary role of cost analysis of subcontractor bid proposals, when FAR Part 15 regulations apply. That prime contractor role, at a minimum, will include requesting the appropriate cost/pricing information from each of its subcontractors consistent with solicitation instructions and regulatory parameters (e.g., cost and pricing data for subcontract proposals over \$700K unless an exemption applies); performing a price analysis of each subcontract proposal; obtaining sufficient cost data from each subcontractor (when cost data is required) and performing cost analyses; documenting the outcome of these evaluations, and; submitting to the procurement office. Contractors will therefore continue to be challenged to follow the rules or FAR 15.404-3, or otherwise notify contracting officers when those duties cannot be performed. Without a demonstration of due diligence toward fulfilling those pre-award regulatory requirements, prime contractors will face a higher risk of DCAA or PCO rendering subcontract proposal costs as unsupported, making it more difficult for prime contractors to negotiate a fair and reasonable price in a timely manner. To summarize likely cost proposal evaluation challenges for government contractors in CY 2012:

- Expect auditors to take a more inflexible position in deeming cost proposals as inadequate and request proposal changes, some of which may entail auditor preferred presentation changes, rather than substantive changes and/or those founded in regulations.
- Consistent with a trend that began two or three years ago, auditors will continue to demand budgetary cost information to support forecasted indirect rates for each of the prospective award periods stipulated in the solicitation, regardless of proposal value or the worthlessness of out-year forecasts which are nothing more than guesses. Contractor failure to meet the auditor’s interpretation of adequate indirect rate support will see those costs unsupported, and if significant, a potential disclaimer submitted to the PCO stating the proposal cannot be audited. The DCAA and PCO have been unable to communicate

expectations for contractor budgetary data that must support forecasting out year rate calculations; nor does the government otherwise recognize that attempting to derive reasonable forecasts several years out is meaningless since most companies cannot reasonably convert vague business goals into verifiable data as subjectively and inconsistently defined by various DCAA auditors. Moreover, DCAA's expectations are not supported by the applicable regulation, FAR 15-408, Table 15-2. Contractors submitting cost proposals will be at the mercy of the whims of an auditor and/or PCO in guessing what detailed budgetary data will meet government's expectations at any snap-shot in time to sufficiently support future year cost projections.

- DCAA will expect prime contractors to demonstrate an effort to perform cost analysis of its subcontractor's cost proposals, where the criteria of FAR 15.404-3 (b) & (c) are applicable; without a demonstration of prime contractor cost/price analysis (or documentation clearly identifying efforts to obtain and analyze subcontractor data), auditors will likely render proposed subcontractor costs as unsupported. Contractors will continue to see a stringent DCAA cost proposal "adequacy" process, where proposals will be returned for corrections before DCAA will undertake the audit, meaning delays in the price negotiation process; DCAA will insist that cost or pricing data supporting a bid proposal strictly adhere to the presentation and documentation requirements within FAR 15.408, Table 15-2 (be aware this regulation applies only to proposals for which cost or pricing data is required). Auditors are likely to summarily reject submitted proposals if all details of this FAR Part 15 provision/table are not met.
- Auditors will continue their trend of exhaustive proposal analyses procedures, to include variable sampling techniques and in-depth evaluation of any historical information used as a pricing basis.
- If during the pre-award proposal evaluation, where the government must determine that the contractor has an adequate accounting system (most often required for prospective flexibly-priced contract

awards) and the PCO/DCAA renders the accounting system inadequate, it goes without saying that the PCOs will be pressured to delay the award until the contractor can demonstrate an adequate system is in place, or otherwise disqualify the bidder. Contractors are cautioned that, notwithstanding risks specific to DCAA's evaluation of proposed costs, government procurement officials continue to insist on adequate cost accumulation systems as a condition for contract award, where upon award contractor billings will be based on recorded contract costs.

For proposals containing significant direct materials costs, auditors will expect competitive quotations to support those costs as opposed to historical procurement history notwithstanding the fact that FAR 15 does not specify one or the other.

Truth-in-Negotiations Act (TINA): Post-Award Audits for Defective Pricing

A combination of defined DCAA audit priorities for Government Fiscal Year (GFY) 2012, a revised DCAA audit program approach, and our observations with clients in having endured defective pricing audits in CY 2011 solidifies our prediction that more defective pricing audits will be initiated, and that government procurement officials, specifically DOD, will more vigorously pursue contract price reductions due to alleged defective pricing. Contract pricing actions at the top of the list for post-award audits will be large value FFP contracts, and extensive transaction testing to uncover defective pricing will largely focus on any action where the contractor has significantly under-run the targeted/negotiated cost.

As previously discussed in this newsletter, DCAA in its August 2011 staff allocation plan identifies post-award audits of "high profit" contracts already targeted by DPAP for review. No more parameters are given defining how such contracts were identified, but we believe those would include DOD FFP contracts exceeding \$100 million, contracts with contingency overseas contracts in supporting the U.S. Armed

Forces, and to some extent companies singled out by the Commission on Wartime Contracting as presenting the highest risk during contract performance where in the government's opinion "excessive profits" were realized.

DCAA also recently revised its defective pricing audit program in August 2011 which among other things includes a comprehensive risk assessment approach to better prepare auditors to support audit recommended price adjustments, and ultimately insulate themselves from external government oversight criticism. The audit program eliminated the old "probe testing" phase of the audit and replaced it with a comprehensive risk planning process (to include continuous and extensive meetings among auditors/managers assigned to the audit) in making a stop or go decision, tailoring the audit scope (if a "go") and solidifying findings. The revised program also stresses the commencement of these audits before records retention requirements have lapsed under FAR 4.700 regulations, requires a "walk-through" of the contractors "certified position", and encourages meetings with contractor procurement and estimating officials (retroactive understanding of basis for bid and related buying events pertinent to the negotiated pricing action). Collectively, the revised program and the DCAA staffing allocation plan guidance citing defective pricing as a high priority makes it unmistakably clear that defective pricing audits will be conducted more extensively during CY 2012 and these audits will involve more comprehensive evaluation techniques and transaction testing.

Because defective pricing audits are largely discretionary, expect the usual audit stop and go process from commencement to a final report since demand audits that require available audit resources take precedent over discretionary audits. Limitations on DCAA audit resources coupled with higher priority audits are likely to continue into CY 2012 which will force auditors to temporarily discontinue defective pricing audits resulting in a completion cycle time period of months, or years.

Beyond the under-run test which is by all measures the most critical risk assessment measure deployed by

DCAA, feedback from clients in CY 2011 identified specific risk issues to which auditors seem to give the most attention in determining potential for defective pricing:

- Availability as well as disclosure at or before the date of price agreement of historical data for the same or similar services or supplies
- Proposal presentation and pricing data did not comply with regulations prescribed by FAR 15.408, Table 15-2—obviously this should not have been the case if DCAA were involved in the bid evaluation process, thus this risk issue would exist where DCAA was not requested to review any component of the contractor's proposal
- Evidence that other data used to price the proposal was, in the auditor's opinion, outdated or contractor decisions after the date of agreement on price, were or should have been known and disclosed to the government (e.g. change to a make or buy decisions) Subcontract proposals requiring submission of cost or pricing data were inadequate (e.g., failed to meet standards in FAR 15.408, Table 15-2)
- Original proposals were rejected as inadequate by DCAA, DCAA noted significant cost issues during its review of the bid proposal(s), or existing reported estimating deficiencies have not been verified for corrective action.

Cost Accounting Systems – Non-Major Contractors

As discussed in the "Contractor Business Systems" section of this newsletter, contractors with CAS covered contracts face unknown challenges in anticipating the demands of and preparing for the to-be-determined DCAA audit approach to validating compliance with the new DFARS rule. Previously categorized as ICAPS audits executed at "major" contractors, DCAA has yet to publish an audit program designed around the DFARS Business Systems rule.

However, the more fundamental prerequisite qualifications for all contractors, FAR 9.104, including an adequate accounting system, have not been changed by the DFARS Business Systems Rule. The accounting system criteria remains that contained in the SF 1408 (Standard Form) applied to large or small contractors including those subject to DFARS (DFARS effectively supplements but does not displace FAR 9.104). In terms of the process, for pre or post-award accounting system audits, DCAA will typically not initiate the audit unless a demand (request) comes from a government procurement agency. Compounded by audit resource shortages and consistent with DCAA's latest guidance (February 2010), the only follow-up audits undertaken by DCAA will be limited to validation of corrective actions of previously issued adverse findings, but those follow-up reports would not express an "adequate" opinion if successful corrective action is validated. Although the primary focus of that guidance seemed to be major contractors, DCAA field offices have applied this policy to all accounting and other "system" audits.

Notwithstanding the prerogative of DCAA to initiate follow-up reviews (verification for corrective action), many field audit offices are simply not undertaking these, or when such follow-up reviews are finally executed, the agency may render the system at that time as not current, thus follow-up audit verification of previous adverse findings being deemed a useless exercise. Hence, contractors with previously issued adverse findings are often finding themselves at the mercy of DCAA's "on-hold until further guidance" policy and unable to overcome a potential obstacle to a receiving a new cost-type contracts, or in more limited cases, eliminating a nagging continued withhold of invoice amounts until the ACO (via DCAA review) can determine that corrective action has been taken. We predict, mainly due to audit resources rather than existing audit policy, that this dilemma will continue through CY 2012, and smaller companies will be hamstrung in getting a "clean opinion" when prior deficiencies remain unresolved for reasons beyond the control of the contractor.

Companies undergoing pre-award or post-award audits during CY 2011 have experienced a more comprehensive and lengthier audit process for the same reasons we've already discussed in this newsletter—shadow of congressional criticism via the GAO reports citing contractors for under auditing yielding a relentless need to meet GAGAS in all respects (fulfilled only if exhaustive transaction testing is conducted), shortage of auditors, and low priority (e.g. non-demand accounting system reviews) particularly for post-award cost accounting system audits.

Our experiences with many non-major or small business clients that we expect to continue into CY 2012 pertinent to cost accounting system reviews and present contractor challenges include:

- Accounting systems are frequently reported as inadequate, even if deficiencies are clearly immaterial; an inadequate opinion almost always includes a DCAA recommendation that the government begin withholding portions of billed costs (DOD contracts) until corrective action is taken and validated by the ACO (note the DFARS business systems rule should put an end to this because the concept of withholds has been limited to DOD contracts with this clause).
- Post-award cost accounting system audits will likely entail attribute sampling of historical cost transactions; testing has focused on contractor ability to segregate unallowable costs, identify costs to the proper direct or indirect cost objective, and support transactions with adequate documentation. DCAA's guidance on attribute sampling (October 2010 guidance memo) stipulates a minimum 90% confidence level, and a Government Risk (GR) of no more than 10%.
- Although pre-award audits may be conducted even if a formal and complete cost accumulation system is not in place (i.e., determine if the contemplated design of these system is acceptable), many auditors have rendered the accounting system inadequate because the system as planned has not been fully implemented; moreover, auditors have deemed

systems inadequate due to the lack of actual project transaction data (example: timekeeping system is not yet collecting labor data)—obviously contractors who have not received a first-time government contract requiring a cost accounting system would have no such data.

- Analysis of transactions selected and audit results derived from the analysis are sometimes flawed—examples, auditors rendering the internal controls in identifying unallowable costs as unacceptable because “expressly unallowable” transactions were found and not segregated, but closer examination discloses that the transactions were not documented sufficiently for anyone to make an expressly unallowable determination (hence, a “reasonableness” or documentation issue).
- The absence of formal written procedures is often cited as a significant deficiency even if actual cost accounting practices are functioning with absolutely no indication of any noncompliance with respect to government cost accounting expectations.

Incurring Cost Proposals (ICPs), Contract Closeouts, & Penalties on Unallowable Costs

Although commencement and timely completion of incurred cost proposals is a major problem with DCAA auditors, due in part to alleged lack of staffing for all categories of audit requirements, the government procurement authorities and DCAA continue to consider such proposals high risk and worthy of extensive review.

The inability of the DCAA to undertake and complete ICPs in a reasonable period of time has and will continue to inhibit the ability of government contractors to adjust billings to final indirect rates (even after a significant underbilling is determined) or to close out contracts to avoid deobligated funds issues and to clear the books of any contingent liabilities. Regardless of DCAA's inability to timely audit, the preparation and submission of ICPs is generated by certain contract payment clauses (e.g., FAR 52.216-7 and FAR 42.705)

which require timely submission of those ICPs regardless of DCAA's inability to timely complete these audits. Submission of ICPs is required no later than six months after the end of the contractor's fiscal year. Prior to the commencement of an ICP audit, the ACO (or DCAA) must deem the proposal adequate which in many cases is difficult to obtain given DCAA's previous interpretation that an ICP proposal was not adequate until all schedules as identified in DCAA's Information for Contractors Pamphlet (Chapter Six) were completed (interpretation was formerly borne of vague verbiage in FAR 42.705-1(b) that, in DCAA's opinion, supplemental data was required with submission).

However, in a May 2011 FAR final rule, the definition of “adequate” ICP was revised to stipulate which ICP schedules (or more accurately data) were explicitly required to render an ICP adequate, and which data or information were not mandatory upon ICP submission (but could be requested after submission). FAR 52.216-7(d)(2)(iii) stipulates only selected data be submitted—52.216-7(d)(2)(iv) identifies supplemental data which are not required for an ICP to be adequate. The outcome of this rule should put a stop to DCAA's insistence for all data shown in their Information for Contractors pamphlet be submitted or else; in addition the rule places the final determination of ICP “adequacy” in the hands of the ACO, and also clarifies or actually states for the first time in a regulation that prime contractors are solely responsible for the close-out of subcontracts. DCAA updated its ICP “adequacy” checklist noting that FAR 52.216-7(d)(2)(iv) schedules are no longer considered necessary for an ICP to be adequate and also acknowledging that requirements are for specified data and not specific formats. In terms of getting to the objective of final rates and contract closeouts, it is something of a moot point that ICPs are now more likely to be deemed adequate because adequate ICPs will languish in the audit queue just as inadequate ICPs.

Calendar year 2011 also produced a couple of other issues that could open the door for new audits. ASBCA Case 55626 decision (June 10, 2011) allowed the government and contractor, having previously executed a final rate agreement letter, to re-open those

agreements to make corrections, in this case, a “mutual bookkeeping mistake” which would ultimately increase costs to the government. The court declared that the rates were not identified as “final” and perhaps most important, the process does not include any formal contractor release statement as does a contract closeout.. Our experience this year has also noted several examples where DCAA has, after final indirect rates were settled, requested to reopen the ICP audit for settled years solely because DCAA did not perform adequate transaction testing. Although DCAA stipulated that the final indirect “rates” would not be reopened, the fact that DCAA is pursuing additional testing (direct costs) after the audit was closed should be unnerving to all contractors, especially when the catalyst for reinvigorating audit procedures for closed/settled years was DCAA’s failure to follow professional audit standards during the audit. It remains to be seen how this will play-out into the future as DCAA’s internal review processes should now detect internal inadequacies before the audit is deemed complete and in any case, contractors should be cautious in terms of any DCAA representations that previously agreed-to rates will not be affected by a reopened audit.

DCAA auditors continue to broadly if not carelessly apply the Penalties for Unallowable Costs provisions (FAR 42.709) when identifying expressly unallowable costs; in many cases the methodology and the computations are inconsistent with the regulations. Auditors continue to calculate penalties on entire amounts of costs deemed expressly unallowable without regard to the “allocable” portion of costs (indirect) only to those contracts with the penalties clause; moreover, costs rendered as expressly unallowable, when examined further, are not named and stated as unallowable, thus those costs would not draw penalties. Of interest to all contractors is that the ASBCA recently clarified a decision it made as to whether the \$10,000 waiver threshold in FAR 42.709-5(b) applies to individual unallowable costs or the sum of all unallowable costs within an ICP claim. (Thomas Associates, ASBCA No. 57126, Oct. 19, 2011). The Board overturned an earlier decision and stipulated that the mandatory \$10,000 waiver only applies if the sum of

the individual unallowable cost elements included in an indirect cost rate proposal does not exceed \$10,000. The initial decision held that the waiver application would apply to the value of each cost element that was deemed unallowable. Although the government (DCMA) has declared this case (as overturned) to be a success, the government has conveniently overlooked the fact that a number of “expressly unallowable” costs were determined by the ASBCA to not meet that definition; hence, not subject to the penalties as initially imposed by DCMA.

High risk issues to come during CY 2012 for government contractors required to submit ICPS:

- Contractors should submit ICPs on time (within six months after the fiscal year end), given that ACOs, in “cooperation” with DCAA, now have less flexibility in agreeing to extensions.
- ICPs must be adequate upon submission, and expectations of auditors will continue to go beyond schedule submission within the new FAR close-out criteria; auditors often return ICPs as inadequate due to mathematical errors, inability to trace schedule amounts to electronically interlinked schedules, or there is inconsistency with the auditor’s perception as to the organization of schedule data (use of DCAA’s own Incurred Cost Electronic Submission—known as ICES). Be aware that under the new FAR close-out rule, there is no requirement that contractors use the ICES model (often cited by auditors as mandatory), leaving it optional for the contractor to present the required data within its own spreadsheets and schedules as long as the substantive data under the regulations is provided. Also be aware that DCAA’s ICP adequacy checklist actually acknowledges that the data does not have to be in any prescribed format; however, it remains to be seen if DCAA field auditors will insist that contractors use the ICES model or similar spreadsheet using the rationale that these will actually expedite the ICP adequacy evaluation process (but having no impact on the DCAA audit which may not start until 2015 or beyond).

- If reimbursable subcontracts are a component of the prime contractor's final year-end costs subject to ICP audit, primes should be aware that the government will expect a satisfactory subcontract management process during the performance of those subcontracts. Auditors and ACOs have expected, ordinarily during DCAA prime contractor billing or accounting system reviews, a demonstration that the prime contractor employs a similar level of documented subcontractor billing and accounting system surveillance.
- Expect auditors to undertake extensive transaction testing of any ICP, and don't expect any initiation of ICPs in CY 2012 unless the contractor meets the high priority criteria discussed in this newsletter in "Changing DCAA Audit Approach..."; auditors will likely utilize statistical sampling methods for selecting transactions for examination, since such methods were reinforced by DCAA in guidance provided to field auditors in August 2010.
- Auditors will continue to question any costs where, in their opinion, there is insufficient documentation demonstrating the nature, purpose, and reasonableness of costs.

Provisional Indirect Billing Rates

The basis for calculating and methods for seeking government approval for provisional billing indirect rates, whether at the beginning or end of each fiscal year, continues to be a major challenge for government contractors largely due to contractor confusion as to when rates should be submitted for approval, the data/basis that should be used to support those rates, and how to determine if rates after submitted have been approved by the government for billing purposes.

Given the continued focus of the government to avert being overcharged by the contractor for services performed, or supplies delivered, contractor's diligence in communicating with the ACO/auditors to ensure indirect rates are considered acceptable is crucial going into CY 2012. Under the provisions of FAR 42.704, provisional indirect billing rates may be acceptable

based on either history or budgetary information for the forthcoming year. FAR 42.704(b) allows contractors and contracting officers (or designated auditors) to utilize prior fiscal year history as a basis for establishing provisional billing rates, as long as the government does not consider a detailed billing rate proposal with supporting information for the forthcoming year. Moreover, regulations allow adjustments by mutual agreement to provisional rates as the year progresses or upon submission of its incurred cost proposal—goal is to ensure that billed indirect costs are not significantly over or under year-end "settled" indirect rates. The problems facing government contractors is understanding the level of detail the government requires to support a provisional rate forecast (prior history or forecasted rates with supporting budgetary information), and what notification if any is required from the government indicating approval of those rates.

Given the shortage of DCAA audit resources, and based on prior history, contractors should not expect any pro-active government stipulations on data expected to support provisional indirect rates or formal ACO notification that the rates are acceptable. Based on our CY 2011 client history, we believe auditors will prefer contractors prepare forecasted budgetary data for the billing period as a basis for approved provisional billing rates rather than using previous fiscal year indirect cost data. Soon after submission of proposed rates, contractors should request that their ACO(s) respond (in writing) affirming the acceptance of the rates (either with or without a formal audit review) or identify issues with the proposals that require change.

Once provisional rates are established, FAR 42.704 states that these can be changed by mutual agreement to prevent significant over or under-payments (ultimately measured against final rates). Towards that objective, contractors will be held responsible for monitoring its provisional to actual rates as the year progresses, and notifying the ACO if and when adjustments to those rates are required—from the government perspective, this is especially critical if originally approved rates are significantly higher than likely year-end actual rates (based on fiscal year-to-date or year-end history) which will result in significant

overbillings. Upon completion of fiscal year end and calculation of preliminary final unaudited rates and/or at the time the contractor submits its certified ICP for the year, contractors should determine if billing adjustments might be necessary and seek mutual agreement with the ACO to change the previously approved billing indirect rates to those actual rates. Although DCAA audit policies commonly misstate the process for revising provisional billing rates as if the contractor can unilaterally adjust the rates at year-end or upon submitting the ICP, the fact is that the contractor should self-monitor as a basic internal control to prevent significant overbillings, which could translate into issuance of audit reports with adverse billing system findings, rescission of direct billing privileges, or unilateral withholdings of billed costs.

Cost Allowability

Identification of costs that are highest at risk for review and challenge in either cost proposals or invoiced amounts (flexibly-priced contracts) continues to be predictable based on past years' experience. Specific costs discussed below are much the same as costs we have repetitively forecasted as high risk over the past several years, and we see no real change in the type of or audit focus on those costs going into CY 2012.

a. Professional and Consulting Fees

Regulatory basis for the vast majority of questioned costs in this category has been the absence of required documentation (FAR 31.205-33(f))—adequate agreement, invoices identifying time expended and services provided, and work product (if applicable). DCAA has also latched onto a new strategy which is to challenge costs using 31.205-33(d) which delineates eight other factors which could be considered in determining the allowability of costs; in particular, a documented determination that the services cannot be more economically performed in-house.

Secondary as the basis for questioned professional fees is the underlying functions which give rise to

these costs. Functions generating such fees which are top of the list for audit evaluation are business development & marketing; defense against government proceedings; any function that appears to involve any political activity or legislative interface, and; changes in the financial structure or ownership of a company (organization costs).

b. Public Relations and Advertising

During CY 2011, all costs associated with anything that looked like a trade show were highest on the list of questioned costs, notwithstanding that some events that allowed a public forum for displaying a company's wares partially entailed technical training and specific customer contact (costs for these activities are expressly allowable as direct selling). Never mind, however, that contractors can make a legitimate case for partial allowability when allowable events are commingled with the broadly targeted advertising forum, auditors summarily questioned all costs for these activities.

c. Business Meetings and Conferences

Challenges of costs associated with these events have occurred largely because, in the auditor's opinion, there was insufficient documentation to substantiate the nature and purpose of these activities. Examples include: (1) in-house training event—employee sign-in sheet was not available, although completion certificates, instructor agenda & power point presentation, and internal requisition to procure services with a consulting agreement were in place, and; (2) rental of hotel conference room—company did not have formal requisition and company purchase order in place for the rental facility (total rental cost—\$900).

Two other reasons for disallowing the costs:

- Food provided during internal meetings—auditors rush to judgment that such events had features of “recreation” thus unallowable.

- Business lunches and evening dinners deemed personal in nature with no individual lunch meeting agendas, thus unreasonable. In a decision supporting the government (DCAA audit), ASBCA Case 57403 deemed unallowable \$478 for business/recruiting lunches because there was inadequate documentation including the fact that there never were any potential new hires at any of the 20 lunches. It should not go unnoticed that DCAA took the time to audit \$478 representing 20 lunches which cost an average of \$23 per occasion; it undoubtedly cost far more to audit, report and resolve this issue than the government ultimately recouped.

d. Employee Business Travel

Business travel expenses remains a frequent target of government auditors particularly during audits of incurred cost proposals, and the FAR 31.205-46 provisions are arguably the most frequently misapplied of the cost principles by government auditors in determining unallowable vs. allowable costs. Travel costs that are most frequently reviewed and challenge by auditors include the following:

- Business or first class airfare costs will be challenged even though provisions of FAR 31.205-46(b) provide a few conditions where air fare costs above the lowest available may be allowable. DCAA continues to disregard any contractor arguments that fares above the “lowest available” (presumably coach class) would meet one of the exceptions in the FAR cost principle.
- Per diem (lodging plus meals & incidentals (M&I)) amounts above the FTR, JTR or State Department travel regulations’ ceiling amounts are often challenged by applying individual ceilings for lodging and for M&I; the application of this provision from FAR 31.205-46 requires per diem (lodging and M&I) to be calculated in total, not by individual per diem component.

- Auditors will continue to challenge all employee travel expenses if documentation requirements stipulated in 31.205-46(a)(7) which require the date, place of the expenses, trip purpose and traveler name and association with the contractor are not evident.

e. Employee Compensation

Auditors will continue to analyze the reasonableness of executive compensation (FAR 31.205-6(b)) when reviewing annual incurred cost proposals (Schedule T) and challenging / questioning costs based on the use of their own wage surveys and techniques for calculating audit compensation positions. Auditors will continue to use their salary surveys for gaging executive salary reasonableness even when contractors subscribe to and utilize other well-respected salary surveys to support the allowability of compensation.

Also affecting the audit approach going into CY 2012 is the currently debated amendment to the Defense authorization bill which would place a cap on all contractor employee salaries with respect to compensation costs that could be recovered in government contracts. The Senate proposal is \$400,000 annually. Currently, statutory compensation ceilings apply to the top five highest paid employees in management positions (FAR 31.205-6(p))—the amendment would apply a cap to all employees. Although the final ceiling value is still in doubt, it is apparent that the application of any compensation ceiling will be extended to all government contractor employees.

Allowability of employee bonuses will stay high on the audit list for examination, with respect to the FAR 31.205-6(f) allowability criteria: (1) awards or payments must be supported by an agreement between contractor and employee, or an established practice or plan must be consistently followed by the contractor, and; (2) the basis for the award is supported. Bonus costs have been challenged because there is no defined and strictly applied calculation method for allocating bonuses to individual employees; actual

payment of accrued bonuses were not paid within a reasonable time frame (as determined by auditors, not by the regulations); no formal written bonus plan was in place (although a customary practice was apparent), and; the bonus plan was highly subjective with respect to the classification of employees who were eligible for bonuses. All of the foregoing reasons for challenging bonuses in and of themselves are invalid for challenging bonus costs. However, ASBCA Case 57403 did find for the government that a bonus of \$31,478 paid to the majority shareholder/owner was in fact unallowable distribution of profits under FAR 31.205-6(a)(6)(ii)(A).

Access to Records

In the never ending struggle for seemingly unlimited access to contractor books, records, and employees, the one unreachable target has been contractor internal audits. The long-standing Newport News Case (United States Court of Appeals—Fourth Circuit – 837 F. 2d 162) denied DCAA access to contractor internal audits on the basis that such access was not necessary to evaluate the allowability of the internal audit costs. More importantly, the Fourth Circuit noted that such access would all but eliminate the effectiveness of internal audits because such audits would obviously be influenced by the knowledge that an internal audit would be requested and reviewed by DCAA.

The continuing saga of government access to internal audits took a turn for the worse when the GAO performed a FY2011 review to assess the internal audit functions of seven DOD contractors and to report on DCAA's ability to examine internal audits and to use information from those audits. The GAO audit report, issued in December 2011 (a few months after its original due date), observed that of 1,125 internal audits performed by these seven companies in 2008 and 2009, 520 were related to the defense contract control environment. Further, the GAO recommended that DOD/DCAA pursue access to relevant internal audits, thus enhancing DCAA's ability to effectively plan work and meet auditing standards for evaluating internal controls. Related to the continuing debate over DCAA's

access to internal audits, an internal DCAA Director's email to the Director of DPAP recommended that FAR 52.215-2 be changed to specifically refer to internal audits and management reviews; however, DPAP apparently never took any action to initiate a regulatory change.

As the saga continues, so does DCAA's existing policy/interpretation of access to records as stated in a December 19, 2008 audit policy (08-PAS-042). DCAA does not make any reference to internal audits; however, DCAA does make reference to access to contractor employees as well as establishing very narrow expected response times (contractor responding to DCAA requests for supporting records). In some cases, DCAA is delivering ultimatums requesting detailed support for hundreds/thousands of accounting transactions by a specific date/time and stating that records received after that date/time will not be audited. Such ultimatums are contractually unenforceable and ultimately contribute nothing to the process other than in fostering ill-will between DCAA and the contractor(s) and widening the schism between DCAA and DCMA.

In addition to DCAA's expansive and inaccurate interpretation of FAR 52.215-2, DCAA continues to ignore the requirements of FAR 4.700, Contractor Records Retention. In particular, DCAA auditors have been told to insist on "originals" which is clearly at odds with FAR 4.703(c) and with respect to storing original records in electronic form (e.g. scanning), DCAA auditors have been told to challenge scanned documents because the DCAA auditor "did not have the opportunity to review and validate the scanning process". Apparently FAR literacy is not embedded in DCAA policy or training based upon the fact that nothing in FAR 4.703(c) qualifies the one year rule (for retaining originals after scanning) because DCAA failed to timely validate the process.

As discussed at the end of the section on "Contractor Reporting and Business Ethics", DCAA clearly overstates its contractual access under FAR 52.203-13 and -14. As it relates to the regulatory provisions for access to contractor records, DCAA is anything but consistent with the regulations, but DCAA is consistent

in terms of routinely overstating its contractual authority supporting DCAA's unofficial motto, "We prefer to believe what we prefer to be true".

Cost Accounting Standards (CAS)

In 2011, the minimally funded, thus somewhat dormant CAS Board did make a few changes including the following:

- CAS 412/413 Pension Harmonization with the PPA (Pension Protection Act). This action only impacts defined benefits pension plans/costs and because of its limited applicability and highly complex nature, will not further discuss within this newsletter.
- Changed the CAS applicability threshold to \$700K and linked this with the TINA threshold going forward. Note the \$700K threshold is the minimum contract value which could be a CAS covered contract, but there could be other exemptions including the small business exemption or the absence of a \$7.5 million trigger contract for modified CAS coverage (see 48 CFR 9903.201-1(b) for the CAS exemptions).
- Eliminated the CAS exemption for contracts executed and performed in their entirety outside the United States. If DCAA predictions come true, the burden of managing CAS compliance for foreign concerns will largely fall upon government prime contractors awarding CAS covered subcontracts to foreign concerns newly subject to CAS (but only CAS 401 and 402 and potentially the requirement for a CAS Disclosure Statement will apply).

Perhaps the biggest mystery concerning CAS and CAS compliance has been and continues to be DCAA's failure to audit for CAS compliance. For contractors subject to full CAS (FAR 52.230-2), DCAA's audit policy is to cycle CAS compliance audits of each individual standard over a three year period effecting a full CAS compliance review of all the standards over the aggregate three year period. As many CAS covered contractors have observed, DCAA has not been performing these cyclical audits (along with other audits not being performed by DCAA).

In the absence of DCAA's cyclical compliance audits, the biggest mistake a contractor could make is in assuming that there is little risk of a being on the receiving end of a DCAA CAS noncompliance audit report. DCAA has been identifying individual CAS noncompliances as a byproduct of other audits including audits of bid proposals, forward pricing rate proposals, contractor billings and incurred cost proposals. This risk is also very clear in various DCAA audit policies wherein the DCAA field auditors are advised to be aware of CAS noncompliances such as a CAS 405 noncompliance secondarily associated with an audit of a contractor ICP (incurred cost proposal). If that ICP audit identifies expressly unallowable costs (claimed by the contractor) and that contractor has CAS covered contracts, the DCAA auditor will issue the separate CAS noncompliance report resulting in a single set of facts yielding multiple contract noncompliance reports.

In those instances where there are alleged CAS noncompliances which invoke FAR 30.605(h)(1), contractors should be aware of the far-reaching definition of an "affected contract" which includes open or closed contracts and regardless of whether or not the final indirect cost rates have been established for applicable fiscal years. Additionally, a CAS noncompliance invokes interest at the Section 6621 rate (punitive rate for intentional tax underpayment) which is compounded daily. An example of the potential impact of a CAS noncompliance is ASBCA Case 54907 involving CAS 413 pension cost reversionary credit to the government. The contractor repaid the "principal" at issue, but did not repay any interest, challenging the simple interest demand from the contracting officer. As this case has trudged through the legal process, it now appears that the contractor is liable for approximately \$7 million attributable to total interest compounded daily. As they say, Oops!

Something of a last but not least regarding CAS, DCAA's inability to timely audit anything has also resulted in the unintended consequence of numerous versions of unaudited CAS DS (Disclosure Statements). For many contractors, the first in the queue goes back

to 2008 or 2009 followed by sequential CAS DS revisions. Ultimately, once DCAA audits the first (and inevitably insists on numerous changes, most inconsequential meddling in the details), there will be the snowball effect of having to change all subsequent CAS DS's. It just doesn't get any more inefficient than delayed audits triggering significant rework for multiple documents almost always for inconsequential revisions.

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