

Government Contracts INSIGHTS

A MONTHLY PUBLICATION FOR GOVERNMENT CONTRACTORS

Volume 2

APRIL 2011

CAS Cost Impact – ASBCA Case 56701 Sustains Contractor Interpretation of Increased Costs in the Aggregate

By Michael E. Steen, CPA, Technical Director at Beason & Nalley, Inc.

In its decision released on April 11, 2011, the ASBCA addressed a contract dispute concerning the interpretation of 48 CFR 9903.306(e), Raytheon Company being the appellant; specifically, an accounting change which involved both increased and decreased costs on CAS contracts. In this case, decreased costs of \$57.2 million on flexibly priced contracts more than offset the unanticipated (or windfall) profit of \$40.7 million (calculated as an increase) on fixed price contracts.

The dispute arose from a 2008 DCMA demand for payment in the amount of FFP contract increase of \$40.7 million plus interest resulting from the accounting change without consideration of the offsetting decrease in \$57.2 million for the cost type contracts. Although the effect of the cost accounting change on Raytheon FFP contracts was actually a decrease in costs on all CAS contracts, decreases in allocated costs to FFP contracts are actually considered an increase cost under FAR Part 30. The logic, had the change been in effect at the time of FFP contract negotiations, the negotiated price would have been less.

In its decision, the ASBCA also rejected as purely speculative the government assertions that the accounting change (regarding the measurement of pension costs) would ultimately increase costs on future CAS covered contracts. In direct contrast to a DCAA hypothesis contained in a DCAA audit report, the ASBCA found that a CAS cost impact only applies to existing CAS contracts which oddly enough excludes unknown, potential CAS contracts. In fact the only oddity was DCAA's assertion which blindly ignored the applicable regulations, case law defining affected CAS contracts and the very obvious practical dilemma in terms of how could anyone possibly quantify the cost impact on future, unknown contracts.

CAS and the interpretations of cost impacts are anything but simple; nonetheless, the ASBCA decision sustained a contractor motion for summary judgment suggesting that the facts were the facts. In particular that costs impact in the "aggregate" means that lower cost on flexibly-priced contracts which substantially

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exceeded unanticipated profits on fixed price contracts is all that needed to be considered. In contrast to DCAA's assertion, the government was not entitled to \$57.2 million in lower costs on flexibly priced contract plus \$40.7 million related to fixed price contract cost reductions (unanticipated profits) or increased incentive fees.

Although we will not discuss all of the details within this newsletter, the 11 page decision also highlights significant government inconsistencies wherein the government contracting officer first determined that there was no cost impact (2003), but subsequently (2008) issued a demand letter for \$40.7 million having apparently been persuaded by a 2007 DCAA audit report (inclusive of DCAA's illogical hypothesis that future CAS covered contracts should somehow be considered in the cost impact). Apparently with CAS and the apparent teaming agreement between DCAA and DCMA, nothing is final so long as DCAA can "persuade" a contracting officer to reconsider what had been a crystal clear decision.

We are hardly surprised, but do find it troublesome that once again a contracting officer appears to have blindly "rubber stamped" a DCAA audit opinion which clearly contravenes the regulations. Although DCAA's current organizational charter and its strategic plan stresses its objective of protecting the taxpayer, ASBCA Case 56701 is anything but protecting the taxpayer. The government's contention was clearly at odds with the facts (hence, the motion for summary judgment was sustained) and was most likely influenced by DCAA's goal of aggressively pursuing cost recoveries apparently including those which are based upon interpretations which are so profoundly incorrect as to implicate technical incompetence by the government.

This decision (and other recent decisions) which have been unfavorable to the government also suggests that at least one US Senator may want to rethink her suggestion that "Contracting Officers should stick to auditors' conclusions on contract pricing to keep the officer's perhaps impaired judgment out of the negotiations". In contrast to the US Senator's assertion (or assumption), in the case of ASBCA Case 56701 the impaired judgment was in the context of the contracting officer's reliance on the DCAA audit opinion.

Lastly, although this decision is being heralded as a landmark decision in terms of defining a CAS cost impact vis-à-vis a cost increase in the aggregate, it only applies to a set of facts

involving a single change to a cost accounting practice where all costs on all CAS covered contracts were reduced as a result of a change in the measurement of pension costs. The decision does not begin to address the endless interpretations of a CAS cost impact applicable to multiple concurrent changes as well as those where the cost impact includes increased costs on flexibly priced contracts and decreased costs on fixed price contracts. It is safe to say there will be future cases where CAS cost impacts will not be as crystal clear as ASBCA Case 56701. In other words it remains to be seen if DCAA may have gotten it right (or basically correct) on other outstanding CAS cost impacts and we expect many of those are now being prioritized based upon the DCAA-DCMA joint cost recovery initiative (reference to an October 29, 2010 memorandum jointly signed by the Director of DCAA and the Director of DCMA).

DCAA Audit Guidance on CAS 405 Noncompliance for Dependent Health Benefit Costs

By Michael E. Steen, CPA, Technical Director at Beason & Nalley, Inc.

In its February 4, 2011 audit guidance (11-PAC-002(R)), DCAA instructs its auditors with respect to computing the cost impact for the CAS 405 noncompliance stemming from ineligible dependent health care costs (questioned under FAR 31.205-6(m)(1) as expressly unallowable costs as further discussed in DCAA's MRD 09-PSP-016(R), issued in August 2009). If your first impression is to discount this as unrelated to issues at your location, one should consider the much broader implications of this audit policy (audit interpretation).

It should be noted that DCAA is asserting that costs are "expressly unallowable" because of a contractor's failure to identify and exclude absolutely all health insurance costs for ineligible dependents notwithstanding the fact that numerous dependent health care audits (of purely commercial, non-government contractors) have concluded that such claims are typically between five and ten percent of total claims (or such was the case until forensic audits highlighted this extremely common problem). In the context of DCAA expectations, it is all too apparent that DCAA's criteria is absolute assurance that allegedly unallowable costs will not be incurred with no regard for the unaffordable administrative costs to attempt the impossible.

Based upon DCAA's audit guidance, the ineligible dependent health care costs are expressly unallowable which triggers a CAS 405 noncompliance and that noncompliance has no bounds in terms of closed contracts. In fact, DCAA is now focused on FAR 30.605(h) which currently states (in part) that a cost impact calculation shall include all CAS covered contracts and subcontracts regardless of their status (i.e. open or closed) or the fiscal year in which the costs are incurred (i.e. whether the final indirect cost rates have been settled). Contractor's should expect this new challenge on any and all CAS 405 noncompliances and recognize that a CAS 405 noncompliance will be attached to any incurred cost deemed expressly unallowable in a DCAA audit of a contractor incurred cost proposal (fortunately this will only apply to CAS covered contracts, full and modified, but not to contracts subject to FAR Part 31, and therefore exempt from CAS).

Unfortunately, in asserting that a CAS noncompliance impacts closed contracts, DCAA does not address the fact that FAR 30.600 was significantly changed in 2005 which included the newly introduced reference to open or closed contracts. In other words, the applicability to closed contracts is not a simple matter of applying FAR 30.600 as it exists today. However, that will not matter because the DCAA field auditor will charge forward relying on the February guidance which will cause this to be one more "filtering process" (to properly apply then applicable regulations) which will become the responsibility of the contractor in rebutting DCAA cost impact expectations and assertions. Taken to the extreme (which DCAA has with respect to dependent health care), per DCAA, "an adequate CAS cost impact must include a contractor analysis of all years in which the contractor incurred health care benefits that may have included ineligible dependents to determine the expressly unallowable costs".

In its February 2011 audit guidance, DCAA also refers to contractors' use of third party consultants to assess the cost impact of ineligible dependents on healthcare costs. DCAA also states that some of its audits have disclosed that the consultant reviews have not been adequate in assessing the total impact. Although DCAA provides no details of the alleged inadequacies, one can assume that at least one inadequacy has been the failure to consider closed contracts and closed years. Additionally, DCAA could assert that neither the contractor nor its consultant have properly measured the cost impact on pricing (which could be virtually impossible to accomplish considering that one would need to identify proposals, contracts awarded and the impact of very minor

reductions to eliminate healthcare costs for ineligible dependents).

Lastly, DCAA's strategy of identifying these "expressly unallowable" costs as a CAS 405 noncompliance also introduces (or confirms) the risk to a contractor that a single cost may invoke multiple penalties. In this case, FAR 42.709 penalties for claiming expressly unallowable costs and the CAS noncompliance interest (Section 6621) which goes back to the date of the noncompliance. No end is in sight for the ever expanding risks of being a government contractor subject to the unreasonable interpretations of DCAA audit policies.

Estimating Trap Doors: When Are You at Risk?

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Beason & Nalley, Inc.

Over the past three years, government contractors have witnessed a heightened sense of urgency in enforcing strict compliance with government regulations pertinent to every pre-award and contract performance functional area and internal control—particularly in bidding, billing, and financial control arenas where our Congressional representatives demonstrate a sometimes inexplicable paranoia that contractors are overcharging the "taxpayer". This sense of distrust has filtered into every aspect of procurement and contract administration activity, and translated into draconian application of bid and financial regulations and related oversight.

The government's by-the-book application of regulatory compliance expectations is no less inflexible for cost estimating processes and the resulting cost proposal development phase. Although DCAA has relinquished some of its field audit responsibilities due to changes in proposal dollar thresholds (see DCAA October 2010 guidance memo), the threat level is still considered "code red" for any contractor, large or small, required to submit a cost proposal.

More than any other time in my government compliance life (going on 45 years), contractors required to prepare bid proposals, where "cost analysis" will be utilized to evaluate proposals, must understand that the government expects an underlying estimating system to be in place, even though

regulatory requirements are loosely defined and those specific regulations are not applicable to certain awarded contracts.

Take for example, FAR 15.407-5—a statement that an acceptable estimating system is a great idea because everyone benefits—no specific estimating system criteria nor specificity as to awards where a sophisticated system would be expected; this provision goes on to delegate to audit activities the role for estimating system audits. One has to shovel down to the Defense Federal Acquisition Regulations Supplement (DFARS) (for DOD contracts) to ferret out more specific requirements. DFARS 215.407-5-70 states that “all contractors have acceptable estimating systems” (with no exceptions), but for contractors for which total prior year contract awards of \$50 million or more occurred (and cost or pricing data were required), transparency of estimating internal controls is expected via maintenance, disclosure, and potential audit review. DFARS 215.407-5-70 (d) and the implementing DOD contract clause DFARS 252.215-7002 does provide general attributes of a good estimating system and high level estimating system requirements.

So who is at risk of estimating system scrutiny, and potentially nasty-grams from auditors and administrative contracting offices? Certainly all government contractors that submit “cost” proposals to a DOD customer, and a higher risk if proposals require submission of cost or pricing data; be aware, however, estimating system expectations in different degrees are expected of all contractors to include companies that do business with any civilian procurement agency as well.

How about a few trap doors (aka, the government proposal/contract culture your company is in, things you’re overlooking, or cost proposal preparation process) that will add your name to the hit list of candidates for round-the-clock surveillance by the men in black. Consider the following:

- You’re a large company with a lot of FFP bids, where cost or pricing data is always required, and bids are \$10 million or over in proposal value—and you must also prepare estimates in conformance the FAR 14.408 Table 15-2 presentation, content, and cost or pricing data identification or submission requirements;
- Your company meets the DFARS estimating system disclosure and audit applicability in DFARS 215.407-5-70 (b);
- Your company has a history of “inadequate” proposals (under the subjective rules of the DCAA “adequacy checklist”) prior to the actual DCAA audit of that proposal;
- Company has a history of proposals being deemed “inadequate” as a basis for negotiation of a price upon completion of a government cost analysis;
- Company has a history of “defective pricing” (which is actually somewhat rare these days given DCAA’s inability to perform a significant number of these audits);
- Pricing sources and basis of estimate techniques are outdated, archaic, inconsistent from one bid to another, and/or bid proposals do not mirror cost accounting practices;
- Government perception that previous negotiated contract awards (based on cost proposal) had rendered too much profit—true, but rare, and;
- Company submits a large no. of cost proposals for which DCAA field audits are required, and your company is right across the street from the cognizant DCAA office (if this is the case, consider moving a few miles away, where traffic is horrific in the motorways for which auditors must travel to get to your location).

Best practices are to insulate the company with some form of consistently applied estimating process, with an emphasis on reliable BOE sources, verifiable pricing sources, and the inclusion of experienced company professionals in the proposal development. A detailed estimating manual is not necessary for smaller companies with minimal cost proposal activity, but for those companies, maintenance of high level policies should be undertaken.

DPAP Memo to DOD Buying Activities: Quit Duplicating Functions of and Auditing DCMA

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Beason & Nalley, Inc.

In an April 1, 2011 memorandum to DOD procurement directors and deputy secretaries, Mr. Shay Assad, Defense Procurement and Acquisition Policy (DPAP) Director, reminded buying activities to avoid performing contracts administration functions that were clearly vested with the Defense Contract Management Agency (DCMA). The DPAP

Director also made it clear for buying and other supporting DOD contracts organizations to lay off auditing the DCMA.

DCMA's responsibilities, the memo stressed, are broad in contracts administration activities and those duties are carefully prioritized and balanced to "reduce acquisition risk by focusing limited resources on the highest risk processes, products and programs". Thus, buying commands should not duplicate DCMA's assigned functions—doing so simply costs more money for both industry and the government.

In mandating acquisition activities to avoid auditing DCMA operations, Assad states that there is a chain of command within DCMA for review of any concerns raised by other DOD procurement agencies regarding DCMA's performance.

The memorandum does not elaborate on the genesis of the memo's message nor cite any specific examples where DOD acquisition activities are taking on DCMA duties or actively evaluating DCMA's ability (or inability) to perform its functions.

In a January 2011 DPAP memorandum, DPAP outlined segregation of certain oversight responsibilities between DCMA and DCAA; examples included bid proposal cost analyses depending on proposal dollar values, financial capability audits, and purchasing systems. In March 2009, DCAA issued a memo to its field offices of the responsibility and prerogative for elevating "unsatisfactory conditions" of government officials; thereafter, DCAA asserted its right to elevate significant disagreements with contracting officers in a May 2010 memo (reaffirmed a DPAP memo in December 2009); although the focus of both the May 2010 DCAA and December 2009 DPAP memo were pre-award bid proposal negotiation positions, DCAA has, given our experience with clients, liberally applied that complaint elevation policy to disagreements with ACOs on contracts performance issues. One might connect the dots and conclude that the April 1, 2011 DPAP memo could be targeting DCAA (related to "auditing" DCMA) given DCAA's propensity to actively challenge many contracts administration decisions when those decisions dismiss DCAA audit findings. However, the DPAP memo is not specific, and concluding that DCAA is the target of the memo is only speculation (however, we are in favor of someone intervening in the process where contracting officer authority has been diluted by direct audit threats as well as those threats of a review by DOD's IG).

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May 17, 2011 – **Understanding the Requirements for an Adequate Incurred Cost Submission (ICS)**
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May 18, 2011 – **Understanding Government Contract Audits and Dealing with Audit Issues**
Huntsville, AL

June 7, 2011 – **Cost and Price Analysis in Government Contracting**
Huntsville, AL

November 15, 2011 – **Cost and Price Analysis in Government Contracting**
Reston, VA

November 16, 2011 – **Understanding Government Contract Audits and Dealing with Audit Issues**
Reston, VA

If you need additional information, please contact Lori Beth Miller at lmiller@beasonnalley.com or 256-533-1720.

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July 12-14, 2011 – **The Master's Institute in Government Contract Costs**
Hilton Head, SC

July 11-12, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Hilton Head, SC

August 1-2, 2011 – Government Contract Accounting Systems Compliance

Washington, DC

August 3, 2011 – The Master's Institute in Government Contract Costs

Washington, DC

August 3-4, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Washington, DC

October 13-14, 2011 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risk

Orlando, FL

October 24-25, 2011 – Government Contract Accounting Systems Compliance

Washington, DC

December 7-8, 2011 – Government Contract Accounting Systems Compliance

Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
- Cyndi Dunn

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Specialized Training

Beason & Nalley, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Miller at lmiller@beasonnalley.com, or at 800-416-1946.

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Beason & Nalley, Inc.
Huntsville, AL
101 Monroe Street
Huntsville, AL 35801
T: 256.533.1720

Washington, DC
11400 Commerce Park Drive, Suite 220
Reston, VA 20191
T: 703.860-8062

Toll Free: 1.800.416.1946
Email: lmiller@beasonnalley.com
On the web: www.beasonnalley.com