

newsletter

Government Contracts Consulting

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Bills Introduced to Repeal Three-Percent Withholding on Payments to Contractors

Two bills were introduced by several Senators that would repeal an IRS tax provision requiring all federal, state, and local governments to withhold three-percent of payments made to all “persons” for services or property provided to the contacting government entity.

The provision, which is scheduled to be effective January 1, 2012, was implemented as part of the Tax Increase Prevention and Reconciliation Act of 2005 and is applicable to any individual payment of \$10,000 or more. The IRS issued a December 2008 proposed rule to the tax code which outlines implementation guidance for enforcing this rule. The provision applies to all government contractors, large or small and does not exempt any type of contract nor any specific private sector businesses or industries. One impetus for the 2005 “tax” withholding provision was purported evidence that many government contractors were delinquent in paying their federal taxes, but nonetheless still continued to receive new government contracts and payments on existing government contracts. Hence, implementation of punitive measures applicable to all government contractors, rather than targeting such measures toward those who are “tax cheats”.

Government contractor activist groups and certain legislators recently went on the attack citing that the tax withhold requirement will impair company cash flow (particularly small businesses), thus hindering the ability to expand business opportunities, hire new people, and invest in the company infrastructure. The Government Withholding Relief Coalition (Coalition) noted that the requirement will cost more than it’s worth. Indeed the Department of Defense estimates that

implementation and enforcement of the new rule will cost \$17 billion or more over the first five years after the rule's effective date.

Senators sponsoring bills that would repeal this provision, and the Coalition, agree that enforcement of this provision will restrict operating funds and in some cases cause government contractors to absorb more debt via borrowing additional funds for maintaining operating capital. This added-borrowing scenario will also generate more business administrative expense to the contractor, which could be passed along to the government in contract bid and billed costs.

In-Sourcing Decisions: TSA and DOD Dilemmas

The debate continues on the approach and criteria the government should use in making job in-sourcing decisions. Although recent acquisition reform initiatives place very broad standards for determining when jobs are or are not "inherently governmental", it leaves the door open for each agency to determine when jobs should be contracted out (out-sourcing) or placed within the federal employment ranks. Spectators observing on-going in-sourcing vs. out-sourcing events are quick to note that each agency has its own in-sourcing agenda, criteria, and authoritative structure for making such decisions.

Consider the recent events with the Department of Defense (DOD) and the Transportation Security Administration (TSA).

The TSA recently put a freeze on an out-sourcing initiative in hiring new airport security agents, deciding that it is in the best interest of the flying public that those jobs be placed in the hands of TSA employees rather than private sector companies. The TSA Administrator announced that no further applications from private contractors would be accepted for the "Screening Partnership Program". That program allowed airports to waive using TSA employees, and instead utilize personnel from the private sector.

TSA's decision was, in large part, driven by two unions, the National Treasury Employees Union (NTEU) and American Federation of Government Employees (AFGE), both unions insisting that airport screening jobs were "inherently governmental", and further that a partnership of employees of the private and public sector did not foster an effective and cohesive "federalized screening system and workforce". The AFGE's president also submitted a somewhat naïve comment rationalizing the use of federal employees for TSA airport security positions: "The nation is secure in the sense that the

safety of our skies will not be left in the hands of the lowest-bidder contractor...". The AFGE president is apparently ill-informed regarding the government procurement process, by erroneously assuming that "lowest cost" is the principal (or only) criteria for selecting private sector contractors. Moreover, one has to wonder if this union official strongly objects to the current White House administration philosophy and mandate for competing as many contracted services as possible, at the risk that the lowest (and most inept) bidder might be selected.

Not all legislators are happy with TSA's decision to terminate the privatization program. Rep. John Mica was perplexed at the decision to discard the "most successfully performing passenger screening program" in the past decade. He stated that TSA should perhaps review the roles of more than 3700 administrative personnel in D.C. "who concocted this decision", and work on reducing the inflated 62,000 TSA employee "army".

The Department of the Army, however, has stiffened its resolve to maintain a "well-reasoned, analytical based and systematic manner" in determining when in-sourcing should be used in filling DOD civilian jobs. Secretary of Army John McHugh issued a directive which permits his sole discretion in approving any Army in-sourcing proposal. That directive insists that in-sourcing proposals be fully documented and justified, and that fund availability and alternatives be considered as well.

McHugh's position in evaluating in-sourcing proposals places checks and balances on the Secretary of Defense Robert Gates' 2009 initiative to move 30,000 defense service contractor positions to government employment ranks. Professional organizations have been quick to criticize Gates for arbitrarily establishing in-sourcing goals as purely "quota driven" whereas these same organizations have praised McHugh's resolve in resisting in-sourcing posturing solely based on a DOD-wide populist notion that inflating the federal ranks results in better value to the taxpayer.

The General Accountability Office (GAO) coincidentally released a January 18 report regarding the military departments' use of certain data in evaluating in-sourcing options. The GAO report notes that the Army has more effectively utilized "annual services contract inventories" than the other military departments, specifically in identifying candidates for in-sourcing contracted services. Nonetheless, the report also stated that the military departments need reliable information "on the roles and functions played by contractors" to make informed and wise in-sourcing decisions.

Without such data, the GAO implies that a higher risk is placed on the government when DOD “core missions” are out-sourced to government contractors.

The GAO report addressing the military departments’ criteria for making in-sourcing decisions, coupled with McHugh’s directive for supporting Army in-source proposals, should stand as a lesson to all government agencies—that is, determinations of in-sourcing vs. out-sourcing must be supported with empirical data and should not be decisions that are political or popular in nature. Whether the lesson of the GAO report (and McHugh’s directive) discussed above crosses the river to other government agencies remains to be seen.

Senate Committee Hearing on Improving Federal Contract Auditing: The Agony and the Ecstasy

A Senate Ad Hoc Subcommittee convened on February 1 to receive testimony from a few government contracting industry representatives and oversight officials from various government agencies. The purpose: to discuss government agency oversight problems and how to improve the federal contract audit process.

Representatives attending the hearing included, among others, the DCAA Director; Acting Chief Financial Officer, Department of Education; Managing Director, Financial Management and Assurance, General Accountability Office; Representative of the U.S. Chamber of Commerce, and; Director of Investigations, Project on Government Oversight (POGO). The hearing was chaired by Senator Claire McCaskill of Missouri.

Much of the dialogue in the written and oral testimony revolved around DCAA’s current state of affairs, such as its inability to respond to audit requests from civilian agencies, its improvements after the 2008 and 2009 GAO reports, DCAA vs. contracting office responsibilities, and need to create a Federal Contract Audit Agency to improve contractor oversight.

The Director of DCAA touted the agency’s FY 2010 accomplishments such as having performed over 4,000 audits of contractor proposals, 390 of which were conducted for civilian agencies with a savings (for civilian agencies) of \$870 million. Additionally, DOD audits (performed by DCAA) encompassed almost 90% of total government contract audits in FY 2009. DCAA, during FY 2009, performed 76 percent of civilian contract audits, and over the past few years, the

percent of DCAA’s audit budget devoted to civilian agencies has increased from 9 to 13 percent.

Nonetheless, DCAA has been unable to keep up with civilian agency audit needs during FY 2010, largely because of a more comprehensive audit approach under GAGAS that requires more audit hours to complete virtually any audit. DCAA’s audit staff increased in 2009-2010, but not enough to offset the dramatic increase in hours per audit. Testimony from the Department of Energy (DOE) and Department of Education (ED) representatives reinforced the audit backlog dilemma; because DCAA is unable to provide audit resources to these agencies in a timely manner, DOE has turned to the private sector and engaged an accounting firm to conduct some audits. ED has a huge backlog of incurred cost proposal audits but apparently has not been able to resolve their immediate audit needs. One suggestion to overcome civilian agency audit backlogs was to create a separate civilian audit agency, but the Feb 1 hearing yielded no substantial interest in that option.

The DCAA Director offered no real solutions to the civilian agency backlog, other than to pontificate the merits of DCAA’s risk based audit approach, process for elevating audit finding disputes (when DCAA disagrees with contracting offices), and consolidation of “business systems” internal controls under a DFARS proposed rule—in short, the Director recommended that all civilian agencies embrace the same approach as DOD regarding the above initiatives (to include implementing a “business system” rule like the DFARS rule, on a government contract wide basis) as a means for strengthening the civilian contract audits. The Director noted that the risk based audit approach, intended to redirect audit resources away from low risk to high risk compliance issues, recently included giving up audit cognizance of bid proposal audits below new thresholds for field pricing assistance (for DOD), certain financial capability audits, and purchasing system audits.

Both Senator McCaskill and the DCAA Director saw no need for the creation of a Federal Contract Audit Agency to address the audit backlog problem, or to otherwise strengthen the government-wide oversight process; Senator McCaskill indicated that improving the DCAA operations was critical to strengthening the audit process, making DCAA a “central repository for federal contract auditors”.

Senator McCaskill offered several layers of confidence in DCAA’s ability to provide adequate audit oversight aside from her desire to keep DCAA as the primary federal audit agency. Her comments included suggestions to contracting officers to

adhere to audit recommendations during price proposal negotiations, suggesting that contracting officers are impaired in their independence to fairly negotiate a price with a contractor. She went on to say that “contracting officers have an ongoing relationship with the contractors that sometimes impact their ability to see everything clearly as it relates to some of the behavior of the contractors”—translated, DCAA can be independent and objective because they are in and out of a contractor’s domain in no time, but contracting officers are more likely to display symptoms of independence buffoonery and foolishness because they become too cozy with government contractor personnel. Of course, Senator McCaskill offered no empirical data to support her assertion; hence, we are presumably to take it at face value solely because she is an elected official. Of passing interest, Senator McCaskill, a self-proclaimed auditor, declared in February 2010 that the contracting problems in Iraq would not be repeated in Afghanistan based upon her “discussions” with oversight agencies in Afghanistan who assured McCaskill that they were working with each other. Discussions, void of any other facts, are not exactly a basis upon which any auditor would place any reliance.

The Senator’s huge display of confidence in DCAA during the Subcommittee hearings is in direct contrast to her pointed and harsh rhetoric toward DCAA after the 2008 and 2009 GAO reports disclosed lack of independence in dealing with contractors (something that contracting officers are now guilty of)—she was especially critical of DCAA allegedly intimidating auditors to refrain from any cooperation with the GAO during its audits to the point where, in reading the Senator’s castigating comments to the then DCAA Director, one would have thought DCAA supervisors had actually bound and gagged some of its auditors and thrown them in the closet the day of a GAO visit.

The representative for the U.S. Chamber of Commerce, Mr. Sandy Hoe, a partner with McKenna Long & Aldridge, submitted testimony complaining about a recent DPAP decision that allows DCAA to determine certain rates as well as DCAA’s “no-risk” approach in performing audits creating unnecessarily lengthy audits that impair contracting officer decisions which require timely resolution (examples—bid proposals, accounting system audits, and contract close-outs). Mr. Hoe was especially critical of the DPAP memo which requires DCMA to unilaterally and without question use DCAA recommended rates, under the Forward Pricing Rate Proposal (FPRR) premise for establishing bid and provisional indirect rates. Mr. Hoe believes that contractors will have little latitude in otherwise justifying that the DCAA FPRR rates are

inaccurate and/or unreasonable. Mr. Hoe stated that this policy change is inconsistent with the regulations and judicial decisions that clearly place final determination of forwarding pricing and billing rates in the hands of the respective contracting officer.

Not to be outdone, the POGO watchdog group’s representative expressed concerns regarding the direction of DCAA—POGO’s concern is that DCAA is not doing enough, and requires more independence. POGO objects to changes in audit policy using a risk based approach that results in the forfeiting of audit involvement, such as giving up oversight of bid proposals submitted to DOD under the new threshold guideline. POGO prefers DCAA undertake more audit responsibility, become more transparent in its ability to disclose publicly “who fouled up” under certain circumstances (a form of publicly shaming a contractor when necessary), and hire many more auditors. The self-declared watch dog group also believes that DCAA has significant “Access to Records” issues, and should use its subpoena power more frequently--assertions made without any meaningful empirical data other than the fact that DCAA has only used its subpoena authority on one occasion, and that resulted in a decision that DCAA’s subpoena authority did not extend to internal audits.

DOD Declares that the Defense Industry Enters a New Era

In statements made on February 9, 2011, Dr. Ashton Carter declared that DOD would oppose any further consolidation of major weapons systems contractors (by implication a reference to the seemingly endless consolidations beginning in the mid-1990s as DOD downsized). In his comments, Dr. Carter alluded to a September 14, 2010 memo with 23 points towards “Better Buying Power” and he also introduced seven guideposts to affect his strategy to do more without more. Of interest Dr. Carter also made the following statements that DOD will:

- rely on market forces to make the defense industrial base more efficient (but not if market forces involve further consolidations of major weapon systems contractors)
- welcome needed adjustments (efficiency) but will require transparency
- avoid conflicts of interest (from those consolidations that it does not otherwise oppose for other reasons)
- encourage new entrants into the market
- pay attention to subcontractors

- share savings with contractors where program costs are reduced (by implication, fixed price incentive contracts as opposed to cost plus fixed fee contracts).

Dr. Carter also made the following assertions:

- market forces are necessary to prevent the defense industry from being further distanced from the main currents of 21st century technology
- competition drives productivity (by implication, without competition DOD contractors have no incentive to be productive)
- DOD contractor value is largely created by DOD and DOD must protect its investment by avoiding (contractor) poor risk management (a reference to other industries whose failures have significantly impacted the economy, thus the government).

Although it may have been unintended, we find these three assertions to be highly uncomplimentary of a Defense Industry which has previously merged, downsized and restructured resulting in huge cost reductions to the benefit of the DOD. Defense contractors internally restructured even when faced with absurd regulations which dis-incentivized restructuring (for restructuring costs to be allowable, DFARS required a two-to-one payback (savings measured against restructuring costs) when simple economics would have suggested that anything greater than one-to-one meant benefits exceeded costs). And now according to Dr. Carter, we are told that the defense industry has somehow distanced itself from 21st century technology. We are somewhat mystified at this particular assertion, but not as much as we are mystified at Dr. Carter's statement that DOD will encourage new entrants into the market. His and other anti-contractor sentiments will do anything but encourage new entrants into DOD contracting.

DCAA and DCMA Cost Recovery Initiative – Phase Two

In a joint memorandum dated October 29, 2010, DCMA and DCAA identified a cost savings initiative wherein the two agencies were going to protect the taxpayers by pursuing issue resolution/cost recovery on approximately 450 significant unresolved issues involving 300 DCAA Form 1s and \$300 million at issue. In a January 18, 2011 Audit Guidance Memorandum (11-PAC-001(R)), DCAA instructed its auditors on the next step, which is for DCAA to calculate rough order of magnitude (ROM) calculations for unresolved Cost Accounting Standards (CAS) cost impacts. In its most recent

memorandum, DCAA notes that these ROM calculations will be “non-audit services” and these are not the same as the GDM (General Dollar Magnitude) or DCI (Detailed Cost Impact) described in FAR 30.600. DCAA's guidance repeats multiple times the statement that a ROM calculation is not a GDM or a DCI because FAR 52.230-6 imposes the requirement for either a GDM or a DCI on the contractor.

Apparently DCAA Headquarters believes that its auditors have relatively low reading comprehension skills; hence, DCAA Headquarters perceived the need to endlessly explain that a ROM is not a GDM. Further and without actually explaining the difference, DCAA guidance states that the DCAA ROM calculation should not be same detail or format as a contractor GDM and if the DCAA ROM is similar to the Contractor GDM, there is probably something wrong with the contractor GDM (i.e. it is probably not sufficient within the context of meeting the FAR requirements for a GDM). Finally, if DCAA computes a ROM calculation and it is similar to the contractor GDM, the DCAA field office needs to coordinate with its regional office to address potential auditor independence issues.

Although we firmly believe that DCAA has a legitimate role in contract oversight, we find this most recent DCAA audit guidance memorandum bordering on paranoia. DCAA Headquarters is so over-absorbed with absolute compliance with government auditing standards (GAGAS), that it cannot issue a simple memorandum without shifting the focus away from calculating a ROM to that of GAGAS compliance. Further DCAA offends its auditors by repeating the same statement (a ROM is not a GDM) at least five times. DCAA's paranoia is further illustrated by its conclusion that a DCAA calculated ROM cannot be similar to a contractor GDM. Oddly enough, both the ROM and the GDM are supposed to be estimating/approximating the same cost impact, but if they somehow appear the same or too similar, DCAA has an independence issue.

Finally, it strikes us as a bit peculiar that DCAA has issued this audit guidance as a “releasable” memorandum when it only pertains to its internal interpretations and coordination with DCMA. In contrast, DCAA had issued as “non-releasable” an audit policy on statistical sampling only to three months later reissue that audit policy as releasable audit policy. The obvious question, why release an internal DCAA-DCMA coordination memorandum (other than as a less than subtle form of intimidation) and not an audit policy on statistical sampling--the latter potentially impacting virtually any contractor audited by DCAA?

FCA (False Claims Act) Recoveries in FY2010

In its annual announcement the Department of Justice (DOJ) reported FCA recoveries of \$3 billion in FY 2010 (September 30, 2010). As with virtually every previous year, the lion's share of the recoveries, 83 percent (\$2.5B) is from healthcare fraud and 77 percent of total FCA recoveries involve Qui Tams.

Regarding the large and continuing contribution from Qui Tams, Senator Charles Grassley stated that Qui Tams are the "most powerful tool in rooting out fraud". In fact the FCA recoveries appear to support this statement notwithstanding the fact that the DOJ and virtually every agency IG (Inspector General) freely take credit for these recoveries. It seems to us that it is a bit easier for a government agency to uncover fraud when it is handed-to them by a Qui Tam relator.

One final observation which simply goes along with all negative (and highly politicized) press directed at defense contractors; the DOJ announcement, in a single sentence, referred to its success in recovering monies from healthcare fraud and from "profiteering from wars in Southeast Asia" (reference to Iraq/Afghanistan which is not exactly Southeast Asia). In terms of the actual recoveries, the DOJ identified \$10.6 million from Iraq/Afghanistan. By association, \$10.6 million recovered from defense contractors is somehow equivalent to \$2.5 billion recovered from healthcare fraud. Apparently the actual data does not count as long as the DOJ wants to perpetuate the myth that defense contractors are categorically unethical.

Training Opportunities

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Reston, VA

April 28, 2011 – FAR Part 31 Cost Principles
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May 17, 2011 – Understanding the Requirements for an Adequate Incurred Cost Submission (ICS)
Huntsville, AL

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

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April 12-13, 2011 – Government Contract Accounting Systems Compliance
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Las Vegas, NV

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

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Instructors

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

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Reader Inputs for Future Newsletters

Beason & Nalley, Inc. develops its topics based upon recent regulations, information, publicly accessible Government policies and our experience in assisting clients with regulatory compliance. However, we are also interested in the ongoing compliance experiences of our readers; hence, we invite your input in terms of suggestions for topics based upon your compliance experiences. Suggested topics along with any background information (i.e., your experience) should be sent to lmiller@beasonnalley.com.

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