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newsletter

Government Contracts Consulting

Provided by Beason & Nalley, Inc.

July 2008

YOUR RIGHTS TO UNDERSTANDING, EVALUATING AND RESPONDING TO AUDIT ISSUES

Those of you who work for government contractors and undergo frequent government audits of your cost presentations, cost accounting system, and financial internal controls must understand that you have a right to effectively evaluate and respond to almost all auditor findings and issues. This privilege permits you to not only be provided adequate explanation by the auditors as to the basis for the issue, but also to having sufficient time to respond after being notified of those issues.

If audit challenges of billed costs, internal controls, or other compliance processes be those of the Defense Contract Audit Agency (DCAA), be aware that the DCAA audit manual

(DCAAM) stipulates in various sections of its manual that contractors be afforded opportunities to interim and exit conferences where the basis of issues are presented to the contractor, and the contractor be given ample time to respond.

One example of audit guidance that outlines auditor responsibilities in discussing issues with contractors and allowing time for responses is within DCAAM 6-708.1 (incurred costs). DCAAM 4-303 and 4-304 also stipulate audit guidance for conducting interim and exit conferences with contractors.

Gaining Understanding of Basis for Audit Findings

During audits of financial controls and billed costs (incurred cost proposals), auditors should be providing to you their preliminary findings and questioned costs, and the audit rationale behind those issues. Although those findings

may not be final until after DCAA management review and the issuance of a draft report, you should at least be provided, either verbally or in writing, an overview of those issues prior to a final exit meeting.

Whether provided during an interim or an exit meeting, the basis for those findings should be clearly communicated to the contractor. This means that you are owed the regulatory basis for the finding; the manner in which any questioned billed costs were calculated (if applicable) and; evidential data that was evaluated and the audit procedures employed to analyze that data.

If the auditor challenges costs claimed within your incurred cost proposal, the auditor should be able to identify the specific contract provision and/or FAR reference (FAR Part 31 Cost Principles) that prohibit the billing of such costs.

It is particularly important that you clearly understand the rationale for any costs that are questioned entirely on the basis of reasonableness, where such challenges always encompass a higher degree of judgment on the part of the auditor.

Having Adequate Time to Respond

All contractors should be afforded ample time to evaluate the audit findings, and to prepare a written response to those findings. The more complex the finding, generally the more time you will need to respond.

Generally speaking, you should be allowed about thirty days to respond, in writing, to audit internal control/accounting deficiencies and questioned incurred costs. Being given only a few days to prepare a written response to complex audit findings, the basis of which was not either clearly disclosed or discussed with the contractor during the audit, is unreasonable.

During the response period, the auditors should be receptive for continued dialogue and additional questions regarding the basis for audit findings so as to afford you a fair hearing in the resolution of those audit issues.

Understand that if you have already been afforded adequate audit information identifying the basis for the findings and time to respond to those findings prior to audit conclusion, DCAA auditors will not be as receptive to extensive response periods after the audit is completed and a draft report has been presented for contractor comment.

Best practices to ensure that you have all the information to evaluate the auditors' findings and time to respond include:

- Maintain close contact with auditors who are reviewing your costs/systems to ascertain latest audit issues—request periodic meetings if necessary to discuss audit progress.
- Request auditors' calculation worksheets when it becomes necessary to understand how questioned costs were derived; this is particularly important if the auditor challenges costs based on cost allocation methods.
- Request the evidential data that was evaluated, and the audit techniques that were employed, resulting in questioned costs or deficient internal controls.
- If denied additional time to respond to audit findings, work the issue immediately through the DCAA chain of command; involve the ACO immediately when DCAA mandated response time is inadequate.



DCAA POLICY MEMO ON REPORTING INTERNAL CONTROL DEFICIENCIES

In our April Newsletter, we mentioned new DCAA Audit Guidance on Reporting Internal Control Deficiencies, issued March 3, 2008 (08-PAS-011(R)). That memorandum gives DCAA auditors almost no flexibility in terms of the reporting an audit opinion for any observation related to internal controls. As stated in the first paragraph of

DCAA's memo, "All internal control deficiencies that result in or could result in costs being charged to Government contracts that are not in accordance with applicable laws, regulations, or contract terms should be reported as significant deficiencies and be considered material weaknesses, unless the potential unallowable cost is clearly immaterial".

Through some of our clients, we are now beginning to experience the impact of this change in audit policy; specifically "last years' suggestions for improvement" have now become reportable "significant internal control deficiencies". Perhaps more importantly, a previous audit (with suggestions for improvement) would have opined that the system of internal controls was adequate; now the identical circumstances will result in an opinion of system inadequacy (in part or in full).

In one case, a contractor experienced a billing system audit whose fieldwork lasted 28 months, ending in April 2008. Of more than passing interest, the auditor initially (before March 3) advised the contractor that there were no "reportable findings" only to return after DCAA issued its March 3, 2008 memo to advise the contractor there are now

reportable findings (by virtue of DCAA's new reporting criteria, but unrelated to any change in FAR nor any new findings).

For a different contractor, its lack of written policies and procedures (for identifying unallowable costs under FAR 31.201-6 and CAS 405) is the basis for DCAA's opinion that the accounting system is inadequate in part. Of course there is no regulatory basis for this reportable deficiency; it is based entirely upon DCAA's internal control audit "control objective matrix". In fact, some of the regulations explicitly require written policies (e.g. CAS 418.40), whereas most have no requirement (e.g. CAS 405), yet DCAA, independently expands the requirement for written policies and procedures to any and all systems of internal controls.

Additionally, this audit actually reports that the contractor manually identifies unallowable costs and records them on separate expense sheets (not part of the formal accounting system). In other words, the system is inadequate in part notwithstanding the fact that the contractor complies with FAR/CAS, but the lack of policies creates the risk that there could be some future noncompliance.

Should the field auditor/field office be taking these positions? "Yes" given the fact that they are held to DCAA policies; however, the fundamental issue is DCAA's authority to create procurement policy versus audit policy. One could assert that this is audit policy premised upon Government Auditing Standards, but one cannot overlook the significant contractual impact of "audit policy" which will adversely impact a contractor's ability to obtain new government contracts. Risk averse

contracting officers may avoid contracting with contractors with "inadequate systems of internal controls" when the significant internal control deficiency would have been nothing more than a passive suggestion for improvement but for a change in Government Auditing Standards which is the basis for DCAA's March 3, 2008 policy memorandum.

Perhaps unintended, but this appears to be a "backdoor" into procurement policy and certainly a process which avoids all of the inconveniences of notices of rulemaking, obtaining public comments and time consuming administrative "stuff".

COMPENSATION STATUTORY CAP FAR 31.205-6(P)

As previously reported in many sources, the 2008 Statutory Cap applicable to each home office or business segment for the five most highly compensated employees in management positions is \$612, 196. This was the topic of DCAA's May 19, 2008 Memorandum for Regional Directors, 08-PPD-018(R) and is nothing new to the government contracting community.

Although "old news", it does serve as a reminder that the limitation exists and that its application is very specific. For example, the precise wording is to "employees in management positions" which would not apply to a very senior engineer or scientist in a non-management position. Nor does the definition of compensation (subject to this cap) include commissions notwithstanding the fact that commissions maybe the primary form of compensation for in-house salespersons. Likewise, the statutory

cap does not apply to the employer contributions to a defined benefit pension plan, but do apply to the employer contributions to a defined contribution plan.

One very important reminder-- all costs (including compensation, commissions, and fringe benefits) are subject to overall reasonableness criteria, FAR 31.201-3, and for compensation, FAR 31.205-6(b). These reasonableness tests can involve far more than the top five most highly compensated employees in management positions, particularly for a business segment with six or more exceeding the statutory cap.

HOT TOPICS: ALLOWABILITY OF PATENT COSTS

Recently, we have encountered several questions regarding the allowability of patent costs. Patent costs are specifically referenced at FAR 31.205-30, where Part (a) notes that patent costs are allowable to the extent that they are incurred as a requirement of a Government contract. So how do you know if your patent costs are a requirement of a government contract? Typically, these costs will originate with Research & Development (R&D) efforts related to a government contract which yields a "subject invention" (i.e. patentable). The answer to the "requirement of a government contract" lies with the inclusion of certain FAR 52.227 provisions, for example FAR 52.227-13 which transfers patent ownership to the government. Other provisions (i.e. FAR 52.227-11) may not transfer ownership, but do grant the Government royalty-free rights to the "subject invention". FAR supplements may also address patents, e.g. DFARS 252.227-7034 "Patents-Subcontracts"

as a contract clause. The inclusion of these types of clauses typically indicates that any patent costs incurred as a result of the contract effort are allowable. Other allowable patent-related costs are those incurred as a result of general counseling on patents, an example of which would be legal costs incurred for a meeting with your general counsel to discuss the overall process for obtaining a patent.

It is important to note that the costs incurred as a result of the pursuit of a patent are typically professional in nature and would further need to meet the requirements of FAR 31.205-33 "Professional and Consultant Service Costs". As a general rule, best practice is to contact your contracting officer to receive approval prior to beginning the pursuit of a patent and/or consider outside assistance if there are any questions regarding the allowability of the patent costs.

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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. Sandra Baker at sbaker@beasonnalley.com, or at 256.533.1720.

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