

# newsletter

## Government Contracts Consulting

MARCH 2010



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### Contingency Fees for Recapture Audits

President Obama signed a memorandum which directs Government agencies to recover billions of taxpayer dollars through the use of specialized recapture (or recovery) audits wherein the audit fees are contingent upon the dollars recouped. The objective is to recover the billions wasted through error or fraud. The memorandum does not indicate whose error (the Government or Government contractors), but the remainder of the memorandum leaves little doubt that Government contractors are presumed to be the cause of Government overpayments.

Of passing interest, the President's memorandum compares "tax dollars to monopoly money, bartered and traded, divvied up among lobbyists and special interests where billions of dollars in waste is accepted as the price of doing business". The memorandum notes that federal agencies have estimated FY2009 improper payments of \$98B to contractors, grantees and other recipients of federal funds. With respect to the continuing problem with improper payments, agencies are required to appoint a Senate-confirmed official primarily accountable for erroneous payments and agencies are also required to set goals for addressing improper payments (but strangely enough those goals do not necessarily involve reductions of improper payments).

It appears that agencies will be allowed to use actual recoveries to pay for the recovery or recapture audits and the administration expects the audits to return at least \$2B to taxpayers during the next three years, double the current amount of projected recovered costs. As stated, using incentive based, high specialized accountants and fraud examiners, the Government expects to recover just over 2% of the proper payments which also represents a whopping .00005% of the FY2011 budget. Impressive? Not exactly and apparently the Government cannot rely upon

Government employees to accomplish this presidentially mandated recovery notwithstanding the administration initiative to shift functions from out-sourcing to in-sourcing.

Although it was not discussed in the President's memorandum, the Government already uses a long-standing "contingency" mechanism to recover overpayment and fines and penalties associated with those overpayments. This mechanism is the Qui Tam process where the relator is entitled to a rather significant percentage of the dollars. As reported by the Department of Justice relative to its fraud recoveries in FY2009, Qui Tam relators were paid \$255M for settlements of approximately \$2B (approximately 13% aggregate paid out to relators). This suggests that contingent recovery audit fees (which implicitly target recoveries from a similar universe) shouldn't be more than 13% if the Government expects the costs of recovery audits to be competitive with the aggregate Qui Tam "commission". Of course, no one has determined or estimated if contingent recovery audits will displace Qui Tam recoveries or for that matter, what happens when a recovery audit uncovers overpayments previously reported to the Government under a sealed Qui Tam. Perhaps duplicate commissions for the same recovery would occur given that the recovery audit would have no knowledge of the Qui Tam and vice versa (note: the President's memorandum on recovery audits did not make any distinction between pure cost recoupment and fines and penalties whereas all three are included in published Qui Tam recoveries).

It remains to be seen if the recovery audits will achieve the highly challenging "stretch goal" of finding 2% of the estimated overpayments or if the recovery audits will somehow displace the highly lucrative Qui Tam industry. At least the Government has not yet declared that Government auditors or investigators will be compensated on a "commission basis" (although that has been proposed, but never truly implemented other than through interpretations of a Government auditor / employee as a Qui Tam relator).

It should be self-apparent that the more cost effective solution is to address the front-end of the process to eliminate a significant amount of the agencies' overpayments as opposed to contingency audits for uncovering these after the fact. In the final analysis, if the recapture audits actually net a \$2B recovery over the next three years, it will be purely symbolic when compared to an estimated federal budget of \$10.5 Trillion for those same three years.

## Prime Contractor Management of Subcontracts

In the constantly changing contract compliance world according to DCAA, prime contractors are being held to a higher standard for "management" of subcontractors than ever before. Nothing has changed in any regulation nor has DCAA posted any change to or any new audit policy memorandum, but there is a significant shift in DCAA expectations for prime contractor compliance with FAR 42.202(e) (2).

The FAR provision has long since stated that "the prime contractor is responsible for managing its subcontract. The CAO's review of subcontracts is normally limited to evaluating the prime contractor's management of the subcontracts (see Part 44). Therefore, supporting contract administration should not be used unless it meets one of three exceptions". The exceptions are very limited and none of the exceptions is related to the subcontractor's limitations imposed upon prime contractor access to subcontractor records. The implication of FAR, and as applied by DCAA, is that the prime contractor should flow down the same access to records clause as applied to the prime contractor (i.e. FAR 52.215-2). In contrast to Government solicitations whose instructions almost always take into account practical disclosure constraints (subcontractor competitive sensitive data which should not be disclosed to the prime contractor for obvious reasons), the FAR does not make a similar statement in application to prime contractor access to subcontractor records during subcontract performance.

In spite of an extended history where DCAA automatically audited subcontracts while auditing prime contracts at a particular contractor, it appears that DCAA has re-read FAR 42.202 and has changed or is changing its approach. In terms of the evolution and history of DCAA's automatic involvement with subcontracts, DCAA insisted that a prime contractor notify DCAA when the prime awarded an auditable subcontract for the sole purpose of making sure that a different DCAA office could populate its audit universe to include these auditable subcontracts. Unquestionably, DCAA wanted this information because DCAA planned to audit the subcontracts' incurred costs as it had always done (with rare exception). The fact that DCAA, DCMA and Government contractors have long since evolved into a process where DCAA automatically covered "auditable subcontracts" doesn't make it correct, particularly when evolution conflicts with a more precise if not literal reading of the FAR.

However, times change and in this case audit processes change even when regulations do not. Unfortunately and unlike the regulatory rule making process, there is no Federal Register announcing a proposed change in DCAA audit policy nor is there any guarantee that DCAA will publicize a significant change by posting an audit policy at [www.DCAA.mil](http://www.DCAA.mil). In this case, DCAA is only “announcing” this change within ongoing DCAA audits of prime contractor billing systems wherein DCAA auditors are now expecting the prime contractor to provide documentation supporting the fact that the prime contractor is “managing” its subcontracts. The obvious question, what is included within the definition of “managing” subcontracts and the obvious answer (coming from DCAA) is the criteria DCAA would apply if it were auditing the subcontracts—in other words, change nothing other than shift the subcontract audit from DCAA to the prime contractor.

Of note, the FAR which invokes prime contractor management of subcontracts does reference FAR Part 44. There is nothing in FAR Part 44 which explicitly defines “management” of subcontracts; however, one can extrapolate those requirements in the context of a CPSR (Contractor Purchasing Systems Review) and specifically FAR 44.303, Extent of Review. That section does include a list (CPSR criteria); however, those criteria are front-loaded (i.e. criteria predominantly apply to the initial award of a subcontract with little or no reference to subcontract administration during performance). In fact with respect to subcontract management or administration, there are only two criteria which would logically apply during subcontract performance; (i) post award management of major subcontract programs and (ii) management control systems including internal audit procedures to administer progress payments to subcontractors. However, there isn’t any FAR Part 44 reference regarding administration of payments on cost type or T&M subcontracts.

In its performance of prime contractor billing system audits (and actually most audits today), DCAA has assumed the role of interpreting or translating general requirements into very specific audit criteria. Therein, DCAA is expecting prime contractors at a minimum to gain and document an understanding of a subcontractors accounting and billing system and to verify subcontractor invoices to the subcontractor’s books and records. DCAA also expects the prime contractor to take steps to monitor subcontractor provisional billing rates and to make sure that the subcontractor timely submits the annual incurred cost proposal as required by the flow-down of FAR 52.216-7. In application to T&M (Time & Material) contracts, the DCAA expectations

extend to prime contractor verification of the qualifications of the subcontractor employees (i.e. access to subcontractor employee personnel records).

As DCAA has challenged prime contractors, the prime contractors have predictably assumed some of DCAA’s processes such as the use of an ICQ (Internal Control Questionnaire) to document the prime contractor understanding of the subcontractor’s systems. Subcontractors are now receiving the ICQ (renamed to protect the innocent) without any meaningful explanation as to why they are now being asked to complete a multiple page survey with questions which seem to have no relevance to the subcontract. For example a prime contractor request for information for a commercial item acquisition including questions pertaining to number of employees, direct and indirect headcounts, financial statements, segregation of unallowable costs, time and attendance policies and processes, job cost reconciliation processes, internal controls to assure that all billable costs are billed to the customer, etc. This is by all appearances a generic list of survey questions regardless of the subcontract type regardless of the obvious inapplicability of several questions. Perhaps unintentional, the prime contractor is truly following DCAA’s lead by asking questions which simply do not apply or in the words of more than one auditor, asking the question “because it is on the list”.

In spite of the fact that the regulations don’t really begin to answer the question of what is expected of a prime contractor, we do know that DCAA is actively making its audit assessment against DCAA’s audit criteria. In turn, this is forcing prime contractors to ask for substantially more information and more access to subcontractor records. Subcontractors are forced to sort out the relevant from the irrelevant and to decide if and how to allow prime contractors the access to subcontractor books and records. And all of this is attributable to DCAA’s decision to reverse its long standing role with respect to audits of subcontracts while failing to make one major distinction, nothing in FAR 42.202 suggests that prime contractor “management” of subcontracts involves audits subject to Government auditing standards or generally accepted auditing standards. Prime contractors are only required to “manage” their subcontracts as significantly differentiated from DCAA audits with their prerequisite requirements to comply with Government auditing standards (or at least attempt to comply).

## Small Contractor Wins Insourcing Fight

A small Government contractor who had been notified that its contract work would be taken over by federal civilian employees (insourced) has won a major victory by initiating a lawsuit which ultimately caused the Air Force to withdraw its decision to insource that effort.

Rohmann Services, Inc. had filed a case with the U.S. District Court in San Antonio challenging the government's insourcing decision. The contractor used the flawed cost benefit analysis criteria established by the Government against the Air Force. Current (A-76) guidelines require the Government to perform a cost analysis to determine if savings would be achieved by bringing jobs back into the federal employment ranks for performing tasks currently performed by the private sector. Such an analysis must obviously be a symmetrical comparison, e.g., apples to apples, and include all costs that would be incurred by both Government and contractor before a decision is made to move jobs back to the public sector.

In calculating the cost for insourcing, the Air Force reportedly failed to include all costs incidental to performing the same level of work currently held by Rohmann; for example, the Air Force omitted costs for several job positions and failed to include supporting overhead costs and fringe costs for Air Force employees who would be performing the work. The resulting cost comparison illegitimately identified a cost savings to the Government, which was also in line with the Government's conventional thinking that the public sector can perform the same work less expensively than the private sector.

By all indications, once Rohmann Services challenged the erroneous and invalid cost comparison, the Air Force withdrew the decision to insource. The Air Force's withdrawal of its initial insourcing decision is (or should be) hugely embarrassing to the Government, and the obvious Air Force calculation errors casts doubt as to the objectivity used by the government in such analyses, while also giving the appearance that future cost comparisons will be contrived to support a pre-conceived case for insourcing consistent with the distorted notion by Congress that contractors are simply too expensive.

In spite of the Government's existing bias favoring insourcing, the outcome of this lawsuit should incentivize Government contractors to challenge future decisions for insourcing whereby Government agencies must publicly demonstrate that its calculation methodology and cost comparisons considered

the "full cost of manpower". As a result of the Rohmann case, Government agencies must also overcome the likelihood that insourcing decisions lacking objectivity and based upon sloppy cost comparisons, will withstand legitimate challenges.

## Training Opportunities

### 2010 Beason & Nalley Sponsored Seminar Schedule:

#### **April 29, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

Location: Reston, VA  
Time: 8:30 AM – 4:30 PM  
Cost: \$450 per person

#### **May 13, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

#### **June 17, 2010 – FAR Part 31 Cost Principles**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

#### **June 24, 2010 – Fundamental Requirements of Cost Accounting Standards**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

#### **September 16, 2010 – FAR Part 31 Cost Principles**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

#### **October 21, 2010 – FAR Part 31 Cost Principles**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

#### **November 9, 2010 – Understanding Government Audits and How to Resolve Audit Issues**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

#### **November 17, 2010 – Cost and Price Analysis in Government Contracting**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

If you need additional information, please contact Lori Beth Miller at [lmiller@beasonnalley.com](mailto:lmiller@beasonnalley.com) or 256-533-1720.

## 2010 Federal Publications Sponsored Seminar Schedule

### May 3-4, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)

San Diego, CA

### May 4-6, 2010 – The Masters Institute in Government Contract Costs

San Diego, CA

### June 8-9, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks

Las Vegas, NV

### June 9-10, 2010 – A Manager's Guide to EVMS

Las Vegas, NV

### June 22-23, 2010 – Government Contract Accounting Systems Compliance

Las Vegas, NV

### July 13-15, 2010 – The Masters Institute in Government Contract Costs

Hilton Head, SC

### August 2-3, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)

Arlington, VA

### August 2-3, 2010 – Government Contract Accounting Systems Compliance

Arlington, VA

### August 4-5, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks

Arlington, VA

### August 4-6, 2010 – The Masters Institute in Government Contract Costs

Washington DC

### September 21-22, 2010 – Government Contract Accounting Systems Compliance

Seattle, WA

### October 13-14, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)

Las Vegas, NV

### October 19-20, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks

Herndon, VA

### October 25-26, 2010 – Government Contract Accounting Systems Compliance

Washington DC

### November 30-December 1, 2010 – A Manager's Guide to EVMS

Las Vegas, NV

### December 6-7, 2010 – Government Contract Accounting Systems Compliance

Las Vegas, NV

#### Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Chad Braley
- Courtney Edmonson
- Cyndi Dunn
- David Miller

Go to [www.fedpubseminars.com](http://www.fedpubseminars.com) and click on the Government Contracts tab or call Beason & Nalley, Inc. at 800-416-1946.

#### 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](mailto:lmiller@beasonnalley.com), or at 800-416-1946.

#### 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](mailto:lmiller@beasonnalley.com).

Beason & Nalley, Inc. provides accounting, business, financial and consulting services with a focus on serving government contractors. Beason & Nalley, Inc. goes well beyond the bounds of what one would normally consider to be "typical" services. We provide services such as government contracts services, outsourced accounting, audit, tax and Deltek Costpoint® consulting and more. Our goal is to provide the business owner with options for their financially related administrative needs. Our service list is comprehensive. Contact us.



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