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Senate Repeals 3% Withhold on Payments to Contractors

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

The Senate passed legislation by a vote of 95-0, followed by a vote by the House of 422-0 affirming the Senate rule that will repeal a three percent withhold on certain payments to government contractors. The measure is now in the hands of the President for his signature. The three percent withhold on payments was originally approved in 2006 (under the Tax Increase Prevention and Reconciliation Act) under the notion that contractors are frequently delinquent in tax payments, hence denying the government use of tax resources for meeting its spending obligations (see our August newsletter for previous commentary). The actual collection of the withhold "penalties" was originally to take effect in 2011, but was delayed in a final rule to 2013.

The degree of bipartisan support for the repeal is demonstrative of how unpopular and impractical this measure is given the current lackluster economic condition of the country. The bill created a firestorm of opposition from not only Senate and House members, but also government contractor affiliations as well as the U.S. Chamber of Commerce. Legislators and business community leaders contended that the added tax burden would unfairly restrict the cash flow of small businesses and inhibit job creation in the private sector. The impetus behind the repeal was undoubtedly job creation, a primary initiative of the executive and legislative branches of the federal government which will be a major 2012 federal election campaign issue; hence, the repeal of the three percent component of the tax bill comes just in time for all government officials to tout a major victory in job creation and economic stimulation. Perhaps a more important reason for repealing the withhold legislation component should have been that the underlying catalyst behind the original measure (government contractors are more prone to late tax payments) is not supported with any empirical data and simply lacks a rational basis; however, the executive and legislative branches have simply ignored the debate over why the 3 percent withhold was ever enacted.

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The cost of the repeal however comes with an offsetting provision—to offset the loss of tax revenue (and interest on the proposed 3% withholds) to the government, a provision has been included which would modify eligibility for Medicaid, the Children’s Health Insurance Program, and national health coverage exchange subsidies (under Affordable Care Act). Additionally, the amended legislation would also create a tax credit for hiring certain unemployed veterans, that provision being referred to as the Tester amendment.

Regulations Impacting Labor Relations Activities

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

In the final rule published in the November 2, 2011 Federal Register, the FAR (finally) incorporated President Obama’s executive order issued shortly after his inauguration. In fact there are two regulations, one requiring contractors to post the NLRA (National Labor Relations Administration) notice and the other making unallowable contractor costs to persuade employees whether or not to exercise their rights to organize and potentially engage in collective bargaining.

The requirement to post the NLRA notice received three public comments and all were a waste of time given the fact that the FAR Councils stated that they were adopting the final rule (adopted by the Department of Labor) and it would not be appropriate to make any changes. Hence, the FAR Councils published the proposed rule to superficially comply with the rule making process while knowing all along that there would be no changes.

The regulation regarding unallowable costs for contractors to persuade employees whether or not to exercise their rights to organize is more contentious for at least two reasons. It is stated as if to represent an unbiased position when it is obviously nothing more than a regulation preventing a contractor from incurring and claiming costs to persuade employees not to engage in collective bargaining. There has never been any employer (contractor) who has incurred any costs to persuade employees to engage in collective bargaining; hence, the regulation obviously impacts those costs which could be construed as persuading employees not to engage in collective bargaining. The losers in this regulation are ultimately the employees who will be persuaded to engage in collective bargaining by misrepresentations from

those with a vested interest in a collective bargaining agreement (i.e. those other than the employer) while the employer is not allowed to say or do anything even if the employer’s counsel on collective bargaining could ultimately protect the individual employee. This regulation has nothing to do with protecting the rights of the individual employee.

Beyond the purely political nature of this regulation, contractors will also find themselves dealing with the very fine line between allowable employee relations costs and unallowable costs. FAR 31.205-21 allows costs to maintain satisfactory employer-employee relations; however, taking actions to ensure that individuals have accurate information (pertaining to exercising their rights to engage in collective bargaining) is no longer an allowable cost. As with other regulations, this one will take effect once a contract is received including the prohibition and that prohibition and any potentially unallowable costs will only apply to the contract(s) with the new clause.

Although the prohibition (form persuading employees to exercise or not exercise their collective bargaining rights) is disingenuous in its entirety, it is particularly indefensible in its underlying assertion that “government contracts must be performed by government contractors whose work will not be interrupted by labor unrest”. In modern history, the only labor unrest impacting government contractors, thus government contracts, has been that associated with the labor strikes due to the failure to reach agreement on a new collective bargaining agreement. In other words, but for collective bargaining agreements and processes, there has been virtually no “labor unrest” impacting government contracts.

DCAA’s New Audit Approach to Defective Pricing Audits

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

In an August audit policy memo, DCAA informed its auditors (and anyone willing to check www.DCAA.mil) of a new audit program for post-award compliance with TINA (Truth-in-Negotiations Act or defective pricing as defined in FAR 15.407-1). As with all DCAA audit programs, this audit involves an expansive risk assessment and multiple internal team meetings ostensibly to reach a consensus on the specific audit steps but more likely to protect any one auditor from potential after-the-fact criticism by the GAO or an IG.

Additionally, appropriate planning is required so as to not delay the start of the actual audit until the records retention clause (FAR 4.700) has potentially lapsed in which case there will be no meaningful way to attempt an audit if there are no longer any records for audit (reference to the general rule in 4.703 that a contractor retain records for three years after final payment – in at least one case, we learned that a DCAA defective pricing audit was initiated four years after final payment; hence, the untimely audit was terminated before it effectively started).

Unlike virtually all other audit programs, the defective pricing audit involves a “go” or “no-go” decision based upon the risk assessment and any indicators of potential defective pricing; thus the potential to truncate the review without actually launching into a full-scale audit. The audit program identifies both a statistical sample and a non-statistical judgmental sample as an acceptable method to select and evaluate individual “transactions” such as subcontracts and other procurements. DCAA has apparently concluded that in application to a defective pricing audit a judgmental sample is an acceptable sampling approach and compliant with auditing standards notwithstanding the fact that DCAA seems to have limited its auditors to statistical sampling in all of its other GAGAS compliant audits. By implication, DCAA may be assuming that the transaction testing in a defective pricing audit will not identify any findings or that extrapolating to a universe simply does not apply to defective pricing.

In particular and in defense of judgmental sampling, audit exceptions applicable to a “transaction” (e.g. a specific subcontract cost or pricing data) cannot be extrapolated to any other subcontract cost or pricing data; hence, the recommended price reduction would be limited to a specific subcontract. This ultimately begs the question, why would DCAA not totally avoid time and resources consuming statistical sampling for defective pricing audits?

In developing its audit program for post-award-defective pricing audits, DCAA has once again demonstrated its inability to correctly read and apply a contract regulation. In many instances, DCAA refers to “most” current, accurate and complete cost or pricing data, completely disregarding the fact that the regulation only requires current, accurate and complete cost or pricing data. The modifier “most” was intentionally dropped from the regulations in the 20th century, but has not stopped DCAA from inserting the unnecessary and outdated modifier in its current audit program. Again and

again, DCAA audit policies demonstrate DCAA’s unofficial motto, “we prefer to believe what we prefer to be true”.

In addition to DCAA’s inability to correctly read the regulations, anyone subject to a DCAA defective pricing audit (or risk assessment) should be prepared for a number of seemingly “off-the-wall” audit requests including the following:

- Request for your bid proposals (plural) notwithstanding the fact that the only relevant bid proposal (singular) is the FPR (final proposal revision) and any additional data submitted prior to agreement on contract price. Assuming a contractor provides DCAA with iterative versions of bid proposals and the DCAA auditor actually reviews them, a colossal waste of contractor and auditor time related to audit tests of irrelevant data.
- Request for your labor rates and your indirect (OH/G&A) rates 90 days after agreement on contract price. Clearly data 90 days after agreement on contract price does not meet any definition of cost or pricing data relevant to the contract price.
- Requests to interview your buyers/procurement staff relative to subcontracts notwithstanding the fact that nothing in the access to records clause gives DCAA the right to interview any contractor employee for the purpose of a post-award audit.
- Requests for a walk-through of your bid proposal and estimating process to ensure TINA compliance (to ensure that the contractor provided the government with the “most” current, accurate and complete cost or pricing data). Similar to the point just made, nothing in any regulation requires a contractor to provide a “walk-through” of its bid proposal particularly when the estimators may not accurately recall a particular bid when that bid may have been submitted years before (e.g., DCAA is untimely/delinquent on virtually all of its audit responsibilities).

It should be noted that defective pricing is a no-win situation for contractors (the only possible actions are acceptance of the price as negotiated or the government’s pursuit of a downward price adjustment). In that context, the burden of proof is on the government; hence, the contractor has absolutely no motivation to cooperate with the auditor beyond that required by the contract clause. Specifically, the contractor should provide factual data in response to DCAA requests, but access to employees and “walk-throughs” are nothing more than time consuming activities invented by DCAA in designing the world

of contract regulations not as they exist, but as DCAA would prefer them to exist.

GAO Report Evaluates DCMA's Ability to Administer Government Contracts in Face of Significant Challenges

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

The General Accountability Office (GAO) issued a November 3 2011 report expressing concern in the ability of the DCMA (Defense Contract Management Agency) to effectively manage DOD contracts in the face of several years of a "seriously eroded workforce that left the agency unable to fulfill all of its missions (and) has posed a significant management challenge for DCMA". Nonetheless, the agency is recovering from a decade long era of "significant downsizing" and while still facing major challenges, has begun to rebuild its core capabilities and organization with the objective of meeting its mission of effective contract administration.

The GAO was requested to evaluate the effectiveness of DCMA, given significant reduction in contracts administration resources, to "(1) assess how the agency is positioning itself to meet its missions, (2) determine the extent to which contingency missions affect its oversight domestically, and (3) identify other factors that may affect its domestic missions going forward".

The report states that the agency's downsizing of personnel and consequently a move toward a decentralized and customer-focused strategy to principally deal with "areas of most importance to its customers", coupled with the movement of many of its more qualified personnel to administer overseas contingency contracting functions, resulted in inefficient and ineffective accomplishment of its oversight responsibilities. Compounding the DCMA administrative resources issue was the reassignment of many of its professionals to contingency contract oversight due to the outcome of a 2007 wartime commission evaluation; the commission found the Army's contracts personnel unable to effectively manage contracts administration in Iraq and Afghanistan. Hence, an increase in DCMA deployments from 83 to 272 between 2007 and 2011 to the Middle East was initiated, which in turn forced hiring of

new personnel, realignments in its domestic staff, and changes in working hours/shifts. And, consequently, contract administrative services suffered, such as quality administration, customer response turnaround times, cost and pricing evaluation, resolution of contractor disputes, and contract closeouts.

The GAO also noted several problematic issues persist in hampering DCMA's ability to fulfill its assigned responsibilities. One major roadblock to DCMA meeting its objectives going forward is shortages in Defense Contract Audit Agency (DCAA) audit personnel. DCMA relies on DCAA to audit government contractor business systems to include accounting and cost estimating system. The report states that adequate contractor business systems "are the government's first line of defense against fraud, waste, and abuse". And due to auditor shortages, DCAA focuses primarily on "demand work" (proposals, claims and other assignments specifically requested by contracting offices), leaving discretionary audits, such as updated reviews of business systems, as a lower priority. GAO notes that "DCMA contracting officers maintained their determination of many contractor business systems as adequate despite the fact that the systems had not been audited in a number of years—in many cases well beyond the time frames outlined in DCAA guidance".

To confirm the DCAA's timeliness problems in performing updated business system reviews, the GAO analyzed the status of three business systems (estimating, accounting and material management) for 17 selected defense contractors via a review of contracting office data. The GAO found "a substantial number of systems that had not been audited within the DCAA time frames; 12 of the contractors had at least one system without a current and timely audit. For example, as of May 31, 2011, 10 contractors had not had an overall accounting system audit within the last 4 years, and 9 had not had an estimating system audit within the last 3 years".

The report also highlights the change in DCAA audit policy for evaluating cost proposals. Recent audit policy changes restrict DCAA's scope of audit responsibilities to higher cost proposal audits, with the responsibility for analyzing all other cost proposals placed upon DCMA.

GAO recommendations for resolving DCMA's short-term and long-term issues in meeting accomplishing its duties timely include:

- Hiring external auditors on a temporary basis to evaluate contractor business systems;
- Developing alternative means to reflect the current status of business systems—one option to use the term “unassessed” to describe the status of a business system that has not been audited within DCAA's established time frames
- Providing guidance to contracting offices on how certain funds will be administered for DCMA new hires

As something of a side-note, it is unfortunate that this particular GAO review along with other GAO reviews and DOD-IG reviews have “danced around” the obvious problem of severely untimely DCAA audit services. We cannot even refer to these as DCAA audits, because in many cases, DCAA audit services have failed to yield the intended final audit report. All of this raises the question as to when will GAO, the DOD-IG, DOD, or perhaps Congress call a “spade a spade” in terms of categorizing DCAA audit services as ineffective, inefficient and unaffordable. Apparently no one in a position to challenge the underlying and fundamental problem of dealing with untimely audits is willing to publicly declare that DCAA has become dysfunctional in large part because of an absurd operating concept of trying to plan and perform audits when the performing auditors have neither due dates nor budgets.

Government Overpayments, Suspensions and Debarments and the Excluded Parties List (EPL)

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

As the government continues to struggle with its deficit, we have the OMB (Office of Management and Budget) announcement that the administration has prevented \$17.6 billion in losses from improper payments or overpayments. Further, 2010 was the first time in six years that the amount of reported overpayments has declined from the previous year. All good news if in fact there is any factual basis supporting any of this; unfortunately, none of this is factual data because it is solely premised upon agency estimates of overpayment which can only be equated to “potential” savings.

In its aggregate estimate of the percentage of overpayments, it declined from 5.42% in 2009 to 4.7% in 2010 (apparently the “estimates” were less precise in 2010; hence, only one decimal point). Applied to a universe of approximately \$2.444 trillion, OMB declared the savings to be \$17.6B (billion). As an additional point of reference, the total estimated improper government payments in 2009 were \$98B compared to \$72B in 2008; hence, growing alarm that the trend was going the wrong direction at a time when we could least afford it.

Although we would like to believe that the government has made a turn-around, it is entirely possible that the improvement is nothing more than agencies lowering estimates in response to growing pressures to show lower estimates. Estimates simply do not translate into measurable savings or reductions; hence, the current administration may declare savings when in fact the detailed discussions only refer to potential, but otherwise immeasurable savings.

Taking this one step further in terms of the illusory nature of the savings, the government announced that it has recovered \$1.2B in overpayments in 2011 (goal was \$2B) compared to \$.7B in 2010. However, the government in the past two fiscal years has only recovered approximately 1%; collecting \$2B while its estimates of overpayments in those same two years are almost \$200B. Although “estimates” portray success, reality is anything but a success.

Somewhat related to improper payments (whether caused by the recipient or merely improperly retained by the recipient), OMB is again advocating that agencies increase the use of debarment and suspension as the “stick” to motivate contractors to comply with laws and regulations. As was noted by OMB, DHHS (Health and Human Services), whose programs result in the vast majority of fraud recoveries, has not suspended or debarred anyone. Not only has DHHS failed to debar or suspend, but DHHS has only recovered \$60,000 from a total of \$1,600,000 in over payments (reported on PaymentAccuracy.gov). It remains to be seen if agencies will ramp-up debarments and suspensions, but at the very least these agencies will be given more attention and more “encouragement” in considering debarments and suspensions.

One final sub-topic concerning debarments and suspensions, a reminder that the FAR was revised in July 2011 to expand contractor and higher tier subcontractor responsibilities for avoiding subcontractor and lower-tier subcontractors who are on the EPL (Excluded Party List). In particular, the requirements now flow-down to all levels (below the first-tier

subcontractor) to determine if a subcontractor is debarred or suspended with the exception of COTS (commercial off the shelf) items where the requirement only applies to the first-tier subcontracts (it is not self-evident why COTS is limited to first tier subcontracts).

Although Public Law 103-355, section 2455(a) (incorporated into the FAR) states that “No agency shall allow a party to participate in any procurement activity if any agency has debarred, suspended or otherwise excluded the stated party from participation in a procurement activity”, the recent FAR change expands that to include a party proposed for debarment (a contractor must notify the contracting officer in writing before entering into a subcontract with a party which is debarred, suspended or proposed for debarment).

It should come as no surprise that within preventing and/or recovering improper payments and/or in avoiding parties who have been debarred (or should have been debarred), that government contractors are held to much higher expectations than government agencies. Certainly government contractors could not survive if they only managed to recover 1% of their estimated improper payments to employees and vendors nor would the government accept an improper payment rate of 4.7%.

Law Firm Held to DOL Compliance Review Provisions for Legal Services Provided to DOE

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

A law firm who contracted with the Department of Energy (DOE) is deemed a federal contractor, and therefore subject to the compliance evaluation provisions of the Department of Labor’s (DOL) Office of Federal Contract Compliance Programs (OFCCP), in an October 31, 2011 ruling issued by a DOL administrative law judge.

The ruling stipulated that the agreement between DOE and the firm was not a “personal services contract” since the firm’s attorneys were not subject to DOE management or control and services were performed at the firm’s offices using company provided facilities and equipment; therefore, the award to the law firm is not exempt from OFCCP’s regulatory definition of a “government contract”, meaning that FAR provisions

embedded within the contract permitting OFCCP oversight were correctly included and required compliance. (The specific FAR provision in question is 52.222-26, requires compliance with various employee labor rights, such as EEO, and invokes OFCCP’s compliance evaluation rights at the OFCCP’s discretion; this clause was incorporated by reference).

The firm, O’Melveny & Meyers, was awarded a “non-personal” legal-services contract in 2001, and in January 2009, OFCCP notified O’Melveny of its intent to perform a compliance evaluation and requested certain employee activity data. The firm declined to provide the requested information citing that it was not a government contractor, the award with DOE was indeed a personal services contract, and therefore it was not subject to OFCCP jurisdiction. Further, the law firm tacitly argued that the contract clause invoking OFCCP compliance reviews was included by error, since another clause within the DOE contract was also erroneously included.

If ever there’s an incident that should give any commercial professional services entity pause before entering into what appears to be an innocuous commercial type of arrangement with the government, free of government oversight prerogatives, this DOL ruling is it.

The law firm either incorrectly assumed that the government would not enforce certain contract terms that O’Melveny presumed were inapplicable, or they may not have carefully read and evaluated all provisions handed to them in the DOE solicitation and/or contract (influenced by the assumption that they neither applied or would not be enforced). In retrospect, the law firm or any government contractor needs to address this before responding to the solicitation and then entering into a contract. At a minimum a discussion with the contracting office was in order to determine if questionable contract clauses were indeed erroneously included.

A lesson for any professional services company that typically serves customers in the commercial (non-government) market place and whom are seeking contracted work with the U.S. government: understand the nature of the agreement, the detailed terms and conditions, and the extent to which government compliance oversight is applicable before signing the document. Mere assumptions that the awarding government agency has made a mistake in defining the contract terms and conditions, and without any discussion could cost a “government contractor” more than just added administrative misery.

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December 12, 2011 – 2012 Challenges for Government Contractors
Huntsville, AL

December 15, 2011 – FAR Part 31 Cost Principles
Orlando, FL

December 16, 2011 – 2012 Challenges for Government Contractors
Orlando, FL

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

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



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