

# Government Contracts INSIGHTS

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## Contractor Compensation Under Attack – The Saga Continues

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

As a follow-up to our September newsletter (including a Whitehouse proposal to limit contractor executive compensation at the same level as cabinet level compensation, currently \$199,700 and unlikely to be increased anytime soon), pressures to expand contractor compensation limits continue. Three Senators (Boxer, Grassley, Tonko) joined the Whitehouse with a letter to the Deficit Reduction Super-Committee, recommending a \$200,000 annual salary cap which would most likely apply to all contractor employees although the three senators are focused on contractor executives and managers. Amounts in excess of government executive (cabinet-level) compensation are being categorized as unreasonable, excessive and unaffordable notwithstanding the fact that long-standing FAR 31.205-6(b) criteria establishes reasonableness based upon benchmarking to comparable commercial companies. By such measures, a \$200,000 cap is unreasonably, if not absurdly low. Of passing interest, Senator Boxer was heavily involved in the original executive compensation statutory cap, an arbitrary cap in 1995 of \$250,000. Apparently, Senator Boxer has slept on it and some 17 years later determined that the cap should be \$200,000; by implication second-guessing her own logic in 1995. Neither consistency nor logic seems to be front and center in government regulations, particularly those which can only be described as petulant and politically motivated.

Although the \$200,000 cap appears to be a long shot at best, there is increasing bipartisan pressure to extend the existing cap (\$693K) to all employees (not just the top five executives/managers). In a letter to the super committee, Senators Lieberman and Collins extolled the committee to pursue expansion of the cap to all contractor executives and managers, not just senior management and be applied more broadly to government-wide contractors. In terms of logic, it remains to be seen why an expanded cap should not apply to all employees (not just executives and managers). To the extent the Federal Acquisition Regulations arbitrarily limit contractor compensation to levels below those which are reasonable measured against comparable commercial companies, there is no logic in limiting that cap to the top five executives.

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And just a reminder that the government has intentionally failed to publish a statutory cap for 2011 leaving contractors with the 2010 executive compensation cap for purposes of claimed costs as well as cost estimates (direct or indirect compensation, regardless of the future year(s) included in the cost proposal).

## State Property Taxes Deemed Allowable on CPAF (Cost Plus Award Fee) Contract

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

In ASBCA Case No. 57296, 8/9/2011, the court found for the contractor in awarding the contractor \$69K for taxes and \$7.9K for penalties and interest. The issue pertains to an Arizona TPT (transaction privilege tax) applied to tangible personal property purchased by the contractor under a government CPAF contract. There is a long-standing federal government assumption or assertion that the federal government takes title to property and inventory once those amounts are invoiced/paid by the government. However, states have challenged this assumption and have in fact prevailed in terms of assessing certain state taxes to contractor purchases under a government cost-type contract.

In the August 2011 case, the chronology of events reflects a disingenuous contracting officer who by all appearances acted in bad-faith. To its credit and consistent with the requirements of FAR 31.205-41, the contractor continuously advised the contracting officer of the circumstances and documented these communications. Although the contracting officer's attorney opined (February 2009) that the "TPT is a legitimate cost" but that the contractor should continue to seek ways to avoid the cost, the contracting officer issued a letter (July 2009) to the contractor stating that the "TPT is invalid on the government"; hence, unallowable and disapproved. In March 2010 the contractor submitted a claim for reimbursement of the tax, penalties and interest and the contracting officer never issued a decision on that claim (hence, the ASBCA case).

In finding for the contractor, the ASBCA made note of the fact that notwithstanding the opinion of the contracting officer that the TPT was not a legitimate tax applied to the CPAF contract, the US Supreme Court had previously upheld the validity of the Arizona TPT applied to federal contracts. Further, the ASBCA noted that "it is the government burden to establish

unallowability of claimed costs" which included a number of case law citations including two Bearing Point ASBCA cases issued in 2009.

The fact that this case went through the Contracts Dispute Act is indicative of the dysfunctionality of government contracting officers and advisory attorneys. It is not only disingenuous, but dishonest to disallow costs when an agency's legal advice was clear and irrefutable in its opinion and the basis for its opinion. Regarding the agency's legal advice that the contractor should continue to seek ways to avoid the tax, one must question the logic of such advice in apparent disregard of a US Supreme Court decision which upheld the application of the tax to federal contracts. Exactly how does a contractor continue to seek ways to avoid the tax after it has already been decided by the US Supreme Court?

## Briefing on Recent DCAA Guidance Memos

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

The Defense Contract Audit Agency (DCAA) issued four guidance memorandums to its field auditors in September 2011 with subject matter that includes gaining an understanding of internal controls in planning an audit; updated information for identifying unallowable lobbying costs related to Congressional earmarks; DCAA's discontinuance of purchasing system reviews, and; focus on adequate price analysis and commercial status determination of subcontractor bid proposal commercial items.

Following is a brief of each memo:

### *Lobbying Costs Related to Legislative Earmarks—11-PAC-015(R)*

The memo is a follow-on to an April 2008 audit guidance in which DCAA iterates that auditors should be vigilant in identifying any costs associated with contractor activities in seeking Congressional direct funding for certain projects that involve influencing Government officials in connection with those earmarks. Such costs are unallowable under FAR 31.205-22 and FAR 52.203-12.

The most up to date information provided to auditors includes notification that certain data bases, now available for auditor use, are being maintained which provides earmark information and contractors receiving those funds. Such data bases include one maintained by the Office of Management and Budget (OMB) and another by the Taxpayers for Common Sense (TSC), and auditors can use these tools to identify earmark recipients and subsequently review cost records to determine if related unallowable lobbying activities were excluded from claimed and/or bid costs.

Auditors are cautioned to be sure that lobbying activities are explicitly identified within incurred cost submissions as required by the FAR along with adequate data “to support their certification of lobbying or earmark costs as either allowable or unallowable.” Moreover, lack of or inadequate contractor procedures for ensuring that processes are in place for capturing such costs can be viewed by DCAA as an accounting system deficiency.

#### *Understanding of Relevant Internal Controls—12-PAS-016(R)*

DCAA management provides additional guidance on documenting an understanding of internal controls, along with an amended standard work paper (B-2), to enable auditors to more precisely connect the risk assessment to develop procedures focused on identified risk. Audit guidance states that most audits are compliance attestation engagements, whereby understanding internal controls pertinent to the specific audit (e.g., understanding estimating system controls for evaluating bid proposals) is critical in assessing control risk, which in turn facilitates tailoring audit procedures to determine if material noncompliance issues exist. The previous documentation process did not “clearly focus on those portions of internal control over compliance relevant to the current audit” to design audit tests pertinent to the audit.

Audit guidance summarizes the new B-2 work paper documentation content that should first include identifying significant cost elements or accounts or other functions/activities based on materiality, coupled with inherent risk factors; identify potential material issues; document an understanding of the underlying processes and policies; consider prior reported deficiencies that could “materially impact the cost or function, and; design audit tests specific to the risk.

The guidance repeatedly reminds auditors to avoid gaining and documenting an understanding of an entire system; rather

auditors must focus only on processes and controls that would materially impact the specific audit to be undertaken.

#### *Review of Subcontract Commercial Items—11-PSP-017(R)*

Perhaps the biggest headache to government contractors in the series of DCAA September 2011 guidance memos is DCAA’s guidance delineating audit responsibilities for determining that prime contractors are adequately analyzing subcontractor commercial items included within bid proposals.

The DCAA guidance memo requires auditors to determine if prime contractors are performing adequate price/cost analyses of subcontractor commercial items (FAR 15.15.404-3 & DFARS 244.402), and moreover, if the items held out as being commercial items meet the definition of a commercial item under FAR 2.101 (referred to as “commercial item determination” (CID)).

The guidance strictly applied requires contractors to perform the CID and price/cost analysis of commercial items in each subcontractor bid. Price/cost analysis is a requirement which literally interpreted (FAR 15.404-3) requires a renewed evaluation of price to current and relevant data for a commercial item included within each new bid, although the same commercial items may have been repetitively evaluated in preceding recent bid proposals. The current guidance does nothing to dissuade that conservative line of thinking, meaning that auditors are likely to expect updated price/cost analyses (or proof that the last analysis is still current) for the same commercial items with each proposal.

That being said, the more ominous auditor expectation of prime contractors in this guidance is that contractors must be able to prove, within each proposal in which a commercial item is included, that the item is indeed commercial with an adequately documented CID. Auditors are likely to discard historical or practical considerations, such as the subcontracted item is obviously commercial by its mere purpose or configuration, that a prior contracting officer determination two or three years before had rendered the item as meeting commercial guidelines (with a CO letter supporting the decision), or the item is frequently purchased (once or more a year) for the same top level hardware configuration which has not changed. The audit guidelines will encourage auditors to obtain repetitive documented demonstrations from prime and subcontractors that those same items are still commercial with each new proposal. Guidance verbiage opening the door to repetitive CID requests from auditors:

“...audit teams should avoid excessive reliance on past conclusions as conditions may have changed (e.g., the item may have been substantially modified)”.

The audit guidelines do not delineate any meaningful criteria for determining when a CID is adequate other than “Generally, support for a CID would include market analysis and sales history”. Obviously, if the item has been substantially modified, market analysis and sales data may not disclose a change in configuration or purpose.

Subcontract commercial costs that, in the auditor’s opinion, are not properly substantiated with an adequate cost/price and/or CID analysis are to be reported as “unsupported”. Another consequence for not completing adequate CIDs or cost or price analysis for commercial items: a flash report designating the absence of either validation as a significant estimating deficiency.

#### *Discontinuance of Purchasing System Audits—11-PPD-018(R)*

DCAA will no longer self-initiate purchasing system internal controls audits, since that responsibility now solely resides with the contract administration office, consistent with FAR 42.302(a)(50) and DFARS 244.302(b). In point of fact, the responsibility has always resided with DCMA; however, the DFARS Business System rule (May 2011) reinforced roles and responsibilities such that DCAA can no longer ignore the fact that DCMA, not DCAA, is solely responsible for contractor CPSRs. DCAA acknowledges that the primary thrust for avoiding this audit function is to improve the use of its resources while avoiding duplicative effort performed by other government agencies.

Auditors will nonetheless still audit purchase and subcontract costs included within incurred cost or forward pricing proposals. Further, auditors will continue to share with the ACO and Contractor Purchasing System Review (CPSR) team any reported business system deficiencies, leads, or other identified risks that may be important to the ACO’s review.

The memo also states that auditors may test key procurement system internal controls related to subcontract costs (not directly related to a CPSR), when such tests are necessary to design procedures to achieve the audit objectives. Although DCAA nominally defers the review of a contractor purchasing system to DCMA; DCAA appears to be incapable of actually relinquishing total responsibility to DCMA. Unfortunately,

DCAA’s quest for absolute “auditor independence” will not allow DCAA to defer anything in its entirety to DCMA.

## **DOD IG Report on Hotline Referral: Lack of DCAA Guidance on Currency of Audit Testing**

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

The Department of Defense Inspector General (DODIG) office issued a September 21, 2011 report confirming a DCAA auditor hotline complaint that DCAA lacks written audit guidance on the currency of audit testing of contractor data during business system audits. During the IG’s review, the auditors also learned that each DCAA regional office maintains an informal policy with different time frames in determining when testing is out of date, and thus retesting may be necessary.

The complaint stemmed from an EVMS audit which began in December 2008, with the auditor (also the complainant) performing tests of September 2008 Contractor Performance Reports which were the latest available EVMS report data at the commencement of the audit. Throughout the audit, the auditor relied only on the September 2008 reports as a basis for testing and elected not to evaluate any subsequently issued performance data (October 2008-August 2009).

The auditor finished the audit fieldwork in August 2009, the supervisory auditor completed his review in November 2009, and the draft report was submitted to the DCAA regional authorities for review. The DCAA Technical Programs division determined that testing was not current (since only September 2008 was evaluated), and requested testing on data derived from more recent performance reports. The DCAA Eastern regional office stated its policy was that data tested should be within a six to nine month period prior to audit report release to meet the testing currency requirement.

DOD IG agrees in its report that in order for evidential data to be sufficient and current, evidence supporting the audit opinion “should be reasonably current as the date of the audit report”. If the data tested supporting the auditor’s conclusions is not current in relation to the time the report is released, then the data is not sufficient thus contravening GAGAS requirements. The IG stated “the auditor should have tested a representative

selection of transactions across the year, and not just transaction from reports issued on just one day.” Interestingly, the DCAA auditor identified seventeen findings in a 90-page draft audit report.

Because there is no consistently followed policy as to when an audit is current as to testing of controls, nor any guidance for auditors stipulating criteria for determining currency of data, the IG recommended that DCAA prepare written policy and guidance to ensure auditors obtain and review sufficient evidence “to provide a reasonable basis for the conclusion that is expressed in the audits of internal controls and business systems.” The Director of DCAA agreed with the recommendation and stated that guidance will be issued by November 2011.

In its report, the DOD IG recounts the GAO reported insufficient audit testing deficiencies found during its review of DCAA internal control audits (GAO reports of July 2008 and September 2009) which is akin to the circumstances noted in the complainant’s report that generated the hotline referral. Because the IG’s purpose was only to review and dispose of the specific hotline complaint, their report does not discuss the continued underlying problems that create DCAA testing currency problems; hence obsolete audit findings by the time reports are completed, reviewed and issued: low priority placed on internal control audits with a stop and go audit process, audit overkill in application of audit procedures and depth of work, and DCAA’s unwillingness to let go of the notion that all findings are significant.

## Suspension and Debarment, Bribes, and False Claims in the News

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

As a reminder that government contracting comes with hefty penalties for certain violations, there has been some recent activity of note. Two Army Corp of Engineers employees were indicted in a bribery scheme that purportedly lasted four years and involved \$20 million. In addition to the government employees, two contractor (ANC-Alaska Native Corporation) employees were indicted bringing unwanted negative attention to the special small business rules applicable to ANCs. It should be noted that in all cases, the individuals have been indicted but have not had their day in court (innocent until proven guilty).

In another action, a FEMA contractor was found to have engaged in fraud on Hurricane Katrina temporary housing contracts and under the government’s counter-claim (special plea in fraud), the contractor forfeited the amount of its claim (\$3.8 million) and has been held liable for the false claims act penalties (\$77K) as well as reimbursing the government for the cost of the government investigation (\$275K). Of passing interest, the government utilized the services of a consultant to examine the contractor’s documents which disclosed that hundreds of inspections were billed twice. Apparently documenting contractor fraud is not an inherently government function (see Beason & Nalley September 2011 newsletter regarding inherently governmental and the continuing debate regarding what a contractor can and cannot perform versus what must be performed by a government employee). In any case a false claim can be a very expensive proposition for a government contractor.

In an action involving a GSA contract award, a large contractor agreed to settle a Qui Tam case through payment of \$20.4 million along with lesser payments by a subcontractor as well as penalties assessed on two government employees. The Qui Tam alleged that the government employees conspired with the prime contractor and multiple subcontractors to assure that a competitive award was directed to the prime contractor and its subcontractors. Allegations included facts that the government employee shared non-public information, selectively shared solicitation information, and inserted contract language to assure contract award to the “targeted” contractor. Although the settlement does not involve any suspension or debarments, certainly a prime and subcontractors are at risk that such activity could lead to suspensions, debarments or at the very least, semi-permanent disclosure in the government’s past performance data base (CPARS).

Unlike the government settlement related to the GSA contract, apparently the Department of Agriculture continues to unsuccessfully deal with contractors who fail to pass through rebates on government contracts. A Department of Agriculture IG (Inspector General) report asserted that contractors are using undisclosed rebate schemes to overcharge the government by as much as 50 percent. Products are sold to the government at “face” value while the actual price paid by the contractor is effectively much less by virtue of hidden rebates. By law and/or regulation, the government is (or should be) contractually entitled to credits and rebates

including an assignment of future credits upon contract close-out.

The Department of Agriculture IG suggested that threats of debarment or suspension could motivate contractors to pass through rebates as a reduction of prices charged on government contracts (an issue that the Department of Agriculture has been “investigating” since 2002). In senate hearings, Senator Claire McCaskill stated “I think there’s real money here if we pull this thread”. Although we prefer her quote (that dealing with contracting in Afghanistan was like “boxing with goats”), the fact is that if there is real money at issue, a competent IG would have recovered it as opposed to only now recommending that threats of suspension and debarment could discourage such schemes. The issue, apparently known or being investigated since 2002 should have resulted in cost recoveries assuming the government contracts include provisions which address credits and rebates. Perhaps FEMA can provide Agriculture with the contact information of FEMA’s consultant (who assisted FEMA in the false claim issue resulting in the government special plea of fraud discussed above).

One last news item which indirectly pertains to false claims and more specifically Qui Tams; in this case the income tax liability for a Qui Tam relator awarded \$8.75 million in a settlement wherein the government contractor entered into a settlement amount of \$37.9 million. Apparently the Qui Tam Relator failed to report his income (\$5.25 million which was the gross award \$8.75 million less the attorney’s 40 percent fee). Not only did the Qui Tam relator fail to prevail on the income tax issue, but he was assessed a 20% underpayment penalty. Apparently this particular Qui Tam relator was willing to act for the government in disclosing fraud or false claims by the relator’s employer, but the relator was not quite so willing to reduce his windfall by the applicable federal income taxes.

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Huntsville, AL

**November 1, 2011** – Cost and Price Analysis for Government Contracts  
Huntsville, AL

**November 9, 2011** – 2012 Challenges for Government Contractors  
Albuquerque, NM

**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

**December 5, 2011** – FAR Part 31 Cost Principles  
Greenwood, CO

**December 6, 2011** – 2012 Challenges for Government Contractors  
Greenwood, CO

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

### 2011 Federal Publications Sponsored Seminar Schedule

**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
- Wayne Murdock
- Asa Gilliland

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**Reader Inputs for Future Newsletters**

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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](mailto:lmiller@beasonnalley.com)  
On the web: [www.beasonnalley.com](http://www.beasonnalley.com)