

Pacific Northwest Consultants, LLC

Special Interest Articles

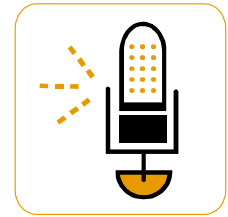
Cost Accounting Standards Update – See Page 2

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GAO and DCAA

By now, most readers are aware of the GAO report issued last July that disclosed instances where DCAA failed to comply with Generally Accepted Government Auditing Standards (GAGAS).

GAO reported that contractors and Government contracting officers improperly influenced the audit scope, conclusions, and opinions of audits, that working papers did not support reported opinions, that DCAA supervisors dropped findings and changed audit opinions without adequate evidence for their changes, and sufficient audit work was not performed to support audit opinions and conclusions.

The fallout from this report has been extensive. A senator expressed outrage and called for firings. The Senate Committee on Homeland Security and Government Affairs held hearings including testimony from aggrieved auditors. Current and former DCAA employees have been openly critical of DCAA in publications and blogs. DoD appointed a "blue ribbon" panel under the auspices of the Defense Business Board to look into charges of misconduct. And, DCAA asked the DoD-IG to review allegations of shortcomings.

Meanwhile, DCAA has been working internally to improve its processes and procedures. DCAA immediately announced that it would no

longer participate in "integrated product teams" (IPTs) or "alpha-contracting" processes. DCAA believed that participation in these programs can blur auditor independence.

DCAA also issued a number of memos telling staff not to compromise adherence to GAGAS. DCAA designated last August as audit quality month with "stand-down" days to emphasize compliance. The agency also initiated projects to assess staffing levels and to assess the propriety and usefulness of its metrics.

The metrics that DCAA used to measure performance seemed to be at the heart of many of the perceived problems. The DCAA Director wrote that "... in some instances we may have let metrics compromise performance of an audit in accordance with auditing standards."

In September, DCAA announced sweeping reforms of its performance measures. It eliminated 18 of its 19 existing metrics and added eight new ones. Gone are the metrics that rewarded auditors for working faster. Emphasizing speed often leads to corner-cutting. Metrics like incurred cost productivity, average hours per assignment, dollars examined per hour, meeting arbitrary cycle-time goals are gone. These old metrics tended to measure the speed at which auditors

performed their work and were largely invisible to the contractors under audit.

The new metrics tend to focus on performing quality audits – at least they all now begin with the word "Quality". However there is one metric in particular that should concern contractors and may become problematic. This metric is entitled "Quality – Audit Reports with Findings" and the initial goal is for 45 percent of all audit reports be issued with "findings" as an indication of the tangible value of the audit work performed by DCAA.

"Findings" in DCAA parlance means questioned costs, disallowed costs, internal control deficiencies, or other exceptions depending upon the particular audit. We are real concerned that auditors, in order to meet or exceed this metric (of course, they will want to exceed it for their own promotion potential and bonus payout) will begin to find problems where none exist or lose sight of materiality just to generate an audit finding.

Audit findings will require contractor time and resources to address, refute, prepare corrective actions plans, and implement new internal control systems. Auditors may want to stay a little longer and dig a little deeper just to meet their metric. This too will require more contractor resources.

Contractors need to be aware of DCAA's metric shift and expect a more difficult audit experience.



New rules for
amortizing actu-
arial gains and
losses

Cost Accounting Standards Update

Most Government contractors are exempt from full CAS coverage. However, FAR incorporates many CAS standards by specific reference either fully or partially.

The following standards are incorporated into FAR; CAS 404, capitalization of tangible capital assets, CAS 412 and 413, pensions, CAS 415, deferred compensation, CAS 416, insurance and CAS 420 independent re-

search and development. Additionally, non CAS covered contractors have the option to adopt CAS 409, depreciation.

FAR 31.201-6, Accounting for unallowable costs states that the practices for accounting for and presentation of unallowable costs will be those as described in CAS 405. FAR 31.203, indirect costs, includes requirements that sound very much like CAS 418, alloca-

tion of direct and indirect costs.

Sometimes auditors will inappropriately rely on CAS language in their evaluation of non-CAS-covered contracts. While CAS may be helpful in evaluating certain accounting practices, it is important to understand the context in which an auditor has taken a position on non-CAS-covered contracts.

CAS 412 and 413 and the Pension Protection Act of 2006

In September, the CAS Board published an Advance Notice of Proposed Rulemaking on the harmonization of CAS 412 and 413 with the Pension Protection Act of 2006 (PPA).

The PPA amended the minimum funding requirements and tax-deductibility of contributions to pension plans and required the CAS Board to revise CAS 412 and 413 to be consistent.

Essentially the proposed rule makes two changes. First, the Board is proposing to reduce the amortization

period for actuarial gains and losses from 15 to 10 years. The 10 year amortization period provides more timely adjustment of plan experience while not introducing unmanageable volatility. The second change is the proposal to revise the "assignable cost limitation" so that it does not apply until the actuarial value of assets equals or exceeds 125% of the actuarial accrued liability plus normal costs. These two changes taken together should reduce the volatility of pension costs charged to Government contracts.

The Board also proposed a five year transition period for implementing these changes in order to make the possible cost increases more manageable for procuring agencies.

The proposed rule would allow companies to use the same actuarial methods and valuation software for ERISA, financial statement and government contract costing purposes. This will allow contractors to avoid unnecessary actuarial effort and expense.

CAS 403 Operating Revenue Thresholds

CAS 403 requires that home office residual expenses be allocated to segments using the three factor formula if residual expenses (expenses that cannot be specifically identified to a particular segment) exceed certain operating revenue thresholds (3.35% of the first \$100 million, .95% of the next 200 million, .30% of the next \$2.7 billion and .2% of all amounts over \$3 billion).

These thresholds have not changed since 1972 and there have been a number of calls to study and revise these thresholds.

The CAS Board commissioned a staff discussion paper (SDP) to assess whether the current thresholds require revision. The staff concluded that a revision was appropriate and recommended thresholds starting at \$470 million (compared to \$100 million). The

SDP was published in the Federal Register in February. Three public comments were received and all were favorable to a change.

At the June CAS Board Meeting, the board instructed the staff to finalize the new threshold amounts.

Random Musings

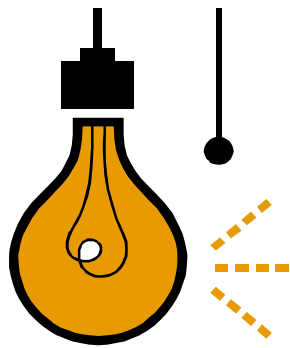
Airport Security Fast-Pass Memberships - On June 25th, GSA issued a bulletin to inform agencies that fees for individual employee memberships in registered and/or trusted traveler programs are not allowable expenses or reimbursements for purposes of Federal government travel under the Federal Travel Regulations (FTR). Please note that this particular prohibition does not apply to Government contractors. According to FAR 31.205-46, the only sections of the FTR that apply to Government contractors are the maximum per diem rates, the definitions of lodging, meals, and incidental expenses. We recently heard of a case where DCAA attempted to use this bulletin to question fast-pass memberships.

Cost of Termination. When the Government terminates a contract for convenience, it must compensate the contractor for the incurred costs on the completed work, a fee or profit on that work, and the termination costs. FAR places various limits on this compensation for both fixed and cost reimbursement contracts. Sometimes it seems that the

cost of terminating a contract exceeds what the Government would have paid had the contract run its course. Recently GAO looked into this and found it wasn't true.

Contractor Ethic Rules being revised. In response to Congressional charges that the Bush Administration was trying to exempt favored contractors performing in Iraq and Afghanistan (such as Halliburton) from the new ethics rules, the exemptions for contracts performed entirely outside the US and for commercial contracts is being eliminated.

Note to self: the Taxpayer is the Customer. During the Senate Committee hearings on DCAA's performance (see Page 1) Senator Lieberman kept asking DCAA witnesses who their customer was. The witnesses all replied that their customer was the contracting officer or the military services. The Senator kept rebuking them, telling them that their customer was the American taxpayer. You would have thought that after the first rebuke, successive witnesses would have known how to answer that question.

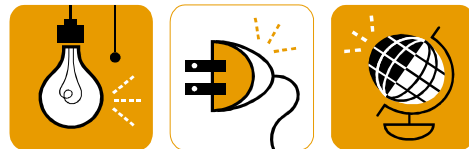


What ...! Our incurred cost proposal's been rejected!

Incurred Cost Submissions

For Government contractors with cost reimbursable and T&M contracts, FAR requires the submission of adequate incurred cost rate proposals within six months after the end of each fiscal year (see FAR 42.705-1(b)(1)). The clause also states that adequacy of the proposal and supporting data will vary depending on such factors as business type, size and accounting system capabilities. For guidance on what generally constitutes an adequate final indirect cost rate proposal and supporting data, the same FAR section refers contractors to DCAA's Model Incurred Cost Proposal in Chapter 6 of DCAA Pamphlet No. 7641.90, Information for Contractors ([click here to download a copy of the pamphlet](#)).

Recently, DCAA has be-



come more aggressive in rejecting incurred cost proposals with inadequacies. According to an "Alert" the Agency issued in October 2007, inadequacies included (i) failure to reconcile books of account to claimed costs, (ii) failure to reconcile total payroll to total labor distribution, (iii) schedule of direct costs by contract and indirect expenses applied at claimed rates, (iv) listing of auditable subcontracts and related information, (v) listing of costs billed/claimed on T&M/Labor Hours contracts, and (vi) schedule of cumulative direct and indirect costs claimed and billed. The alert states that the inadequate proposals from major contractors have contributed to an increase in hours expended to perform the audit.

DCAA has sometimes in-

appropriately rejected incurred cost proposals, failing to follow FAR and its own guidance. In many cases, the first time a contractor hears that its proposal has been rejected is in a letter from DCAA. This is contrary to FAR 42.705-1(b)(1) which requires the contractor, contracting officer, and auditor to work together to make the proposal, audit, and negotiation process as efficient as possible. It is also contrary to DCAA's own guidance which parrots the same FAR wording except DCAA uses the word "should" whereas FAR uses the word "must" work together.

If DCAA is acting precipitously, remind them of the FAR requirement to work together. If your submission is missing a schedule, quickly provide it. If it's already part of the submission, tell them so.

Check your Insurance



Contractors can purchase insurance or maintain a program of self-insurance. According to FAR 31.205-19, the cost of purchased insurance or a "charge" for self insurance is allowable subject to certain limitations. Generally, the cost of purchased insurance must follow sound business practice and the rates and premiums must be reasonable. The charges for self insurance cannot exceed the cost of purchased insurance. Self-

insurance charges for the risk of catastrophic losses are unallowable.

Actual losses except for nominal deductible provisions in keeping with sound business practices and minor losses such as spoilage, breakage, and disappearances of small hand tools that occur in the ordinary course of business are unallowable.

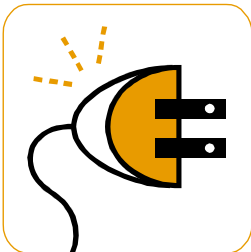
So, if you experience unin-

sured losses, don't count on recouping the cost under your Government contracts.

Contractors with uninsured losses from Hurricane Katrina are discovering this first hand. They are taking big hits on their profits.

You should review your insurance coverage to ensure that you have the appropriate level of protection.

Get it in Writing



Recently, we had an experience where based on a limited floorcheck (two part-time employees) an auditor wrote up five internal control or timekeeping deficiencies. The auditor conducted his exit conference over the phone and then slyly asked the company if for audit report purposes, he could simply indicate that the contractor "reserved comment" on his findings. Since we were participating in the conference call,

we advised the contractor to request the auditor to draft statements of conditions and recommendations and provide the company a reasonable time to respond.

Reserving comment is almost like pleading "no contest". It is a tacit admission of guilt. It allows the auditor to issue an audit report (and meet his metric) without considering or addressing the contractor's side of the story.

In this case, we felt the auditor's conclusions were wrong on many different levels and the auditor had failed to follow audit guidance related to significance and materiality. More startling was his admission that he hadn't discussed his findings with his supervisor.

The contractor has still not received the written audit findings – perhaps because the auditor is having difficulty establishing their legitimacy.

Common Types of Procurement Fraud

Defective Product/Product Substitution: Where contractors deliver goods and services which do not conform to contract requirements.

Defective Testing: Failure of a contractor to perform contractually required tests, or failure to perform such

testing in the required manner.

Bid-Rigging: The absence of competition deprives the government of its most reliable measure of what the price should have been.

Bribery and Public Corrup-

tion: The breach of an employee's duty of loyalty.

Defective Pricing: Discussed elsewhere in this newsletter. A perceived or actual violation of the Truth in Negotiations Act may serve as the predicate for a fraud investigation and civil or criminal prosecution. DCAA

reviews every positive defective pricing finding for possible referral.

False Invoices. Submitting progress payments and public vouchers when the contractor knowingly failed to comply with contract terms.

Accounting Practice Change

Here is a case worth watching because of the implications for contractors seeking to modify their accounting practices after contract award.

The Navy awarded a cost reimbursable contract to Todd Shipyards for, among other things, dry dock work. The contract required the contractor to maintain a dry dock in certified status and have it ready and available for both scheduled and unscheduled repairs should the government exercise its options.

Todd incurred costs to achieve and maintain government certification of the dry dock and it sought to

account for certification expenses as direct costs to the contract. This was a change from its prior practice of allocating these types of costs as indirect based on dry dock usage.

The government denied the claim on the basis that the request was predicated on the government's decision not to exercise dry dock options on a number of ships. This was fully within the government's discretion. Todd on the other hand argued that the accounting change was premised on the government's promise to reimburse it for the cost of maintaining the dry dock in a state of readiness. Moreover, Todd had sought gov-

ernment approval for the change from indirect to direct prior to contract award and pending resolution of an equitable method of allocation, had "provisionally" charged the costs indirect.

The government's motion to dismiss Todd's appeal was denied by the ASBCA. The ASBCA ruled that the record required development to determine whether the accounting change sought by Todd was warranted, prospective, allowable, and unreasonably denied as Todd asserted, or was unjustified and impermissibly inconsistent and retroactive, as the government argued.



Accounting changes after contract award – the reason for making the change is important.

Defective Pricing Audit Terminology

At the handshake date, when the Government and contractor have agreed upon a price, the contractor is required by the Truth in Negotiation Act (TINA) to certify that it has submitted current, complete, and accurate cost or pricing data in support of its proposal. DCAA has a regular program of testing for compliance with the Act. It refers to these audits as defective pricing reviews.

There are certain prescribed tests the auditor will perform in conjunction with these reviews. You might have heard some of these arcane terms banded about without understanding what they mean or why the auditor is performing

the steps.

Audit Baseline. The audit baseline is usually the last proposal submitted by the contractor to the Government, adjusted for factual information provided up to and during negotiations. The purpose here is to determine all factual data provided. Updated indirect rates and updated/revised vendor quotations are examples of factual data that are often provided during negotiation..

Underrun/Overrun Testing. Underrun/overrun testing identifies potential defective pricing leads by comparing actual costs incurred or current estimates

at completion to the audit baseline. These are always performed at the cost element level and depending on size and nature of contract, may be performed for each line item.

Probe Transaction Testing. Based on the foregoing procedures and other risk assessment steps, the auditor will examine specific transactions within the highest risk major cost elements.

Reliance. In order to prevail in a defective pricing case, the auditor must show that the Government relied on the cost or pricing data submitted in establishing a fair and reasonable price.

Shedding light on strange terminology



A great place to begin your search for new accounting software

Smart Stops on the Web

Justia Regulation Tracker <http://regulations.justia.com/>

Based in California, Justia is focused on making legal information, resources and services easy to find on the Internet. The company provides Internet users with free case law, codes, regulations, legal articles and legal blog databases, as well as community resources. Justia works with educational, public interest

and other socially focused organizations to bring legal and consumer information to the online community.

The sections we find very useful is the Regulation Tracker. This allows a user to search or browse all new rules, proposed rules, administrative orders, executive orders, and notices that appear in the Federal Register. You can browse by Department (e.g. De-

partment of Defense), by Agency (e.g. the Federal Procurement Policy Office for CAS related regulations) or by year. Alternatively, you can search by key word or phrase.

There is considerably more to this website than just the regulation tracker. It contains links to the cases from most Federal courts and other educational and informative materials.

Interesting Software – Amazon Jungle Disk

There are many advantages to storing backups on the Net; you don't need to buy dedicated backup software or DCs, DVDs, or external USB drives, backups are not stored locally and thus secure against fire and theft, and you can access them from any internet connection. There are some serious downsides as well; you must depend on a third party, transmitting data over the internet

introduces additional security risks, its generally slower, you cannot create system images, and you are dependent on the service remaining in business.

There are many alternatives available, from the heavily advertised Carbonite (\$50 per year per machine) to the very capable EMC Mozy Home (\$5 per month per machine). But one service that has impressed us is Jungle Disk from Ama-

zon (the book people).

With Jungle Disk, any number of machines can access one account. Pricing is \$20 to buy the program with a monthly charge based on volume. 10GB of storage would cost about \$2.50 per month. For companies that don't require a huge amount of online storage, this is a cost-effective way to go.

<http://www.jungledisk.com/index.aspx>

Need Training?

PNWC provides specialized training in a variety of government contracting areas. Our standard training modules generally take three to four hours while our extended training modules are designed for one and two days. PNWC training qualifies for CPE in most states.

PNWC training modules are continuously updated to

reflect the most current regulations and trends in the Government including current high risk areas identified by DCAA.

Current training modules include:

- Truth in Negotiations (TINA)
- FAR Cost Principles (Allowable and Unal-

lowable costs)

- Internal Controls over Labor and Timekeeping
- Internal Controls over Estimating Systems
- Ethics for Government Contractors
- Terminations and Claims.



Contractor Code of Ethics

In past issues, we've discussed the new requirement for contractors to implement ethics codes and to post hotline posters. This requirement applies to contracts over \$5 million and 120 days duration awarded after December 24, 2007.

Within 30 days of contract award, contractors must have a written code of business ethics and conduct in place and have provided a copy to each employee. Additionally, the contractor must promote compliance (there's a vague and ambiguous term that is certain to lead to disagreements between contractors and the Government) with its code.

Unless the company is a small business concern, the contractor must establish an ongoing business conduct awareness program

and an internal control system, within 90 days after award. The internal control system is intended to facilitate discovery of improper conduct in connection with Government contracts. Features of such systems may include periodic reviews of company business practices, internal reporting mechanisms such as hotlines, audits, and disciplinary actions for improper conduct.

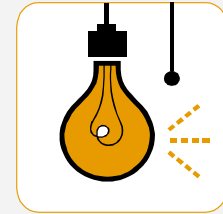
Enforcement by the Contracting Officer

With respect to enforcement of the new rule's mandatory requirements, guidance included with the rule clarifies that contracting officers are not expected to verify compliance with the rule, but may inquire about compliance as part of their contract administrative duties. Some contractors and even some within the Government have latched upon this to discount the importance of

the requirement, believing that there is no punishment for failing to comply. Surprisingly, the Chief of the Army Procurement Fraud Branch wrote that contracting officers are not going to evaluate the internal control system but only verify its existence and prime contractors don't need to monitor their subcontractor's compliance, just verify the subs have a system.

But don't forget about the auditor.

We believe this attitude forgets the role of the auditor in assessing contract compliance and the adequacy of contractor internal control systems. DCAA is already testing compliance with this regulation in post-award accounting system audits (small contractors) and overall environment and accounting control audits (large contractors). Failure to comply will result in at least a significant internal control deficiency.



Don't believe that no one from the Government will ever check to see if you comply with the new ethics regulations.

Contractor Cost Data Reports (CCDR)

The CCDR system serves as the primary cost database for most DoD cost estimating efforts. DoD uses data collected in the CCDR to prepare program cost estimates for major systems, develop independent Government cost estimates in support of cost and price analysis and to estimate future contract costs, and other long range planning efforts.

There are four levels of reporting requirements; I, IA, II, and III depending on projected cost. Category IA refers to special interest

programs. Reporting requirements and the level of detail required, will vary depending on category.

The Defense Cost and Resource Center (DCARC) is the primary organization responsible for reviewing CCDRs. Upon receipt of a CCDR from the contractor, DCARC performs a validation for numerical and clerical accuracy and consistency. Based on its review, DCARC either issues a validation memorandum or, if the CCDR fails validation, will require the contractor to devise and implement a

corrective action plan.

Most of the time, DCARC will request audit assistance in its validation phase. Auditors typically verify CCDR data to contractor books and records and review for contractor compliance as to the flow-down requirements for subcontractors. Recently, new guidance was issued instructing auditor to report as a deficiency the contractor's failure to document within its overall accounting and management policies and procedures, specific procedures for accumulating data and preparing CCDR reports.

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From left, Ron Sabado, Paul Cederwall, Bill Vermie, and Terry Nuzzo.

Pacific Northwest Consultants, LLC

PNWC is dedicated to providing Government contract consulting, litigation support, and training services. We provide affordable consulting and training services to help Government contractors grow their business, increase profits, and comply with Government contracting

rules and regulations.

PNWC's consulting and training services include forward pricing, incurred cost, terminations and equitable adjustments, cost accounting standards and defective pricing allegations. We assist in developing adequate internal control systems and

company-wide ethics programs.

PNWC staff has extensive teaching experience. They have developed and presented training classes covering all aspects of Government contracting.

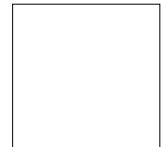
Our Staff

Pacific Northwest Consultants, LLC was formed in January 2006 by four individuals who decided to combine their various expertise and interests into a full-service Government consulting group. Com-

bined, PNWC's consultants and trainers have over 120 years of Government contracting experience with the Defense Contract Audit Agency. Two of the four are licensed CPAs and hold a variety of other ad-

vanced degrees and certifications. All have had teaching experience at the collegiate level.

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