

# HIGH-VISIBILITY PROCUREMENT & AUDIT ISSUES

## Calendar Year 2009

Our discussion of issues that we believe will be of importance to the U.S. Government procurement and audit officials during 2009 are based on our tracking of procurement trends and experience with clients during this past calendar year. The listing of projected high-emphasis issues presented in this newsletter represents our personal outlook of what we think will be Government “hot topics” for CY 2009. Although we make no guarantee that such issues will either evolve into, or continue to attract the high level of Government oversight as with prior years, we recommend that all government contractors be prepared to endure government procurement scrutiny of contractor financial, management, and other functional areas that are affected by the topics/issues we have included in this document.

## Impact of GAO July 2008 on DCAA Oversight

DCAA continues to react to the unfavorable GAO report and its conclusions that 14 of DCAA’s audits were in non-compliance with Generally Accepted Government Auditing Standards (GAGAS). The fundamental issue involved a lack of auditor independence, which manifested itself as audit opinions, which were more favorable to the auditee (contractor) than were the supportable facts as documented within the audit workpapers. Purportedly, the contractor or a government contracting organization or both influenced DCAA to issue a more favorable opinion, thus compromising the integrity of the procurement process as viewed by the GAO.

In addition to the July GAO report, there are lingering rumors that the GAO is nearing completion of a review and unfavorable report on DCAA’s failure to comply with GAGAS on a number of internal control audits. As DCAA reacts and continues to self-assess, the government contracting community is ultimately on the receiving end of any changes in audit policies and in this case, that “contracting community” includes not only contractors, but also procurement and administrative contracting organizations.

In all cases, DCAA has made changes to make a clear statement that it is independent with respect to the contractor as well as independent from the potential influences from the recipient(s) of the DCAA reports. DCAA is no longer a “team” member on IPT’s (integrated project teams) and will no longer allow contracting organizations to influence (limit) the audit scope or the audit opinion. To further distance itself from misperceptions of a loss of auditor independence, DCAA will not be advising contractors as to specific solutions (recommendations) to remedy audit issues and DCAA appears to have largely disengaged from providing interim audit results. For example, DCAA traditionally advised contractors on readily correctible adequacy issues during disclosure statement and policy reviews; however, a number of more recent DCAA audits have withheld all such disclosures until completion of audit fieldwork.

Similarly, when reporting an issue, DCAA’s recommendations are now in a very general context of “correct it” without stating how to correct it even if the corrective action is all

but obvious. As further outlined in our discussion of internal controls audits (which follows), DCAA has moved to a pass-fail (adequate-inadequate) audit opinion and has essentially eliminated any debate as to the “in-significance” of an internal control deficiency. Eliminating flexibility and auditor judgment essentially forces any and all audit observations into an audit report, which ultimately minimizes the possibility that a third party (i.e. GAO) will be able to fault DCAA for failing to report an issue. As a contractor, you should anticipate that any gap between DCAA’s expectations (their internal control objectives listed on their intranet) and your policies and procedures will be reported as a significant deficiency along with a DCAA opinion that the particular system is inadequate. It remains to be seen if report recipients (contracting officers) will be able to determine what audit exceptions are truly significant from those which are insignificant, but reported nonetheless (to avoid GAGAS compliance issues). If left to the auditors, particularly the GAO, we will move into a world of risk avoidance instead of risk management notwithstanding that risk avoidance is in direct contradiction with FAR subpart 1.102-2. Similarly, DCAA has all but declared, with help from the GAO, that it is not a part of the acquisition team, which fosters cooperative relationships as envisioned within FAR Subpart 1.102-4(d).

## Revisions to FAR Part 3 and FAR Part 9 on Business Ethics and Conduct and Mandatory Disclosure of Certain Violations

After a long and controversial series of proposed rules, initial rules and final rules, the FAR councils have codified government expectations for Contractor Codes of Business Ethics and Conduct or “COBEC” (FAR subpart 3.10) and additional causes for suspension or debarment (FAR Subpart 9.4). The requirements for COBEC, published in November 2007, were limited to a code of ethics as well as displaying hotline posters. However, in order to satisfy the demands of the DOJ (Department of Justice) and Congress, the final rule, published in November 2008, expanded into enforcement rules, not the least of which is mandatory disclosure (reporting to an agency Office of Inspector General or OIG) of certain violations including fraud, civil false claims act and significant overpayments on government contracts. Although the final contract clauses (52.203-13/14) are only applicable to contracts in excess of \$5 million, awarded on or after December 12, 2008, the fact is that corollary changes to FAR Subpart 9.4 are essentially retroactive. As subparts 9.4 are today, any contractor with government contracts including FAR Subpart 9.4, are subject to the mandatory disclosure of certain violations based upon credible evidence and such disclosure must be the timely reporting to an OIG. To facilitate such timely reporting, a number of OIG’s have “thoughtfully” provided mandatory disclosure forms on publicly accessible websites. In terms of what is reportable under sub-part 9.4, it is any of the cited violations, known by a contractor principal (e.g. executive or manager), up to three years after final payment on the affected government contract(s); hence, the potential retroactive nature of subpart 9.4.

The impetus for these new requirements are a combination of (i) DOJ influences as it combats procurement fraud and ii) Congressional reaction to perceptions of fraud, waste and abuse in Iraq/Afghanistan as well as Hurricane Katrina recovery efforts. Notwithstanding the fact that the most consequential ethics violations and fiscal mismanagement were attributable to the government, the contractor community gets to share in the administrative burden of “COBEC” and mandatory disclosure. A Contractor must fully understand the new regulations and which components of the regulations apply, when and how they apply.

## Contractor Financial and Management Internal Controls

Government contractors subjected to any type of DCAA management and financial internal controls audits will likely find more stringent application of DCAA audit procedures in assessing compliance with DCAA established “control objectives”, and audit reported findings that are deemed significant regardless of materiality. The types of audits we are referring to are identified in Chapter 5 of the DCAA Contract Audit Manual and are often referred to as ICAPS audits.

As noted in the above “Impact of GAO July 2008 on DCAA Audit Oversight” discussion, auditors and auditor managers are challenged to (1) overcome a tarnished image for reportedly failing to conduct audits in accordance with government auditing standards and (2) to avoid an appearance of collusion with government contractors in conducting audits and reporting deficiencies. Coupled with the fallout of the GAO report, three DCAA audit guidance memorandums issued this year will make it more difficult for auditors **not** to report any and all deficiencies noted during internal controls reviews, or to otherwise deem possible deficiencies as insignificant.

A DCAA guidance memorandum issued to auditors in March 3, 2008 stated that “all internal control deficiencies that result in or could result in costs being charged to Government contracts that are not in accordance with applicable laws, regulations, or contract terms should be reported as significant deficiencies and be considered material weaknesses, **unless the potential unallowable cost is clearly immaterial.**”

Two more guidance memorandums were issued on December 19, 2008 that will push DCAA auditors in rooting out and promptly reporting significant internal controls deficiencies. The first of these guidance memorandums speaking to internal controls audits eliminates the summary opinion option of “inadequate in part” from DCAA report choices in defining adequacy of internal controls. This means that auditors will no longer have a “middle ground” opinion for deeming a system adequate—it’s now either pass or fail, and given current DCAA guidelines, all it takes is one reportable deficiency (which can be deemed material, or for which immateriality cannot be clearly established) to render a system unequivocally inadequate. Additionally, this DCAA memo also encourages auditors to recommend that contracting officers **suspend a portion of billed costs** (for DoD contracts) under DFARS provisions.

The other December 19, 2008 DCAA guidance memorandum encourages auditors to immediately perform “limited scope” internal controls audits, when, during an audit (other than one established for internal controls), a specific deficiency is noted. Not only will auditors issue traditional “flash” reports citing the specific related issues, but auditors must now pursue an audit of the specific control activities related to the “control objective” in which the “flash” deficiency is noted, rather than waiting and performing a complete controls review of a broader functional area (discussed in Chapter 5 of the DCAA Contract Audit Manual). A limited scope audit report will be issued, and provided the deficiencies noted in a related audit are validated, an opinion deeming the entire system of controls inadequate will be included in that report.

The DCAA guidance memorandums will result in many more audit reports on internal controls, with inadequate opinions, whether limited or full-scope. We believe that, unless

other audit guidance is issued to better define significant issues which would mitigate the possibility of reporting “procedural only” or isolated deficiencies, 2009 audit reported opinions will contain more “inadequate” opinions based on inconsequential findings, result in suspension of billed costs (if applicable), and mandate more administrative time for contractors to address and respond to those issues. It is entirely possible, with the limited scope guidance, that larger companies, subjected to cyclical ICAPS audits, could be fighting adverse opinions, based on limited scope findings, for several internal controls systems, which are deemed as inadequate in a single fiscal year.

We conclude, unless other audit guidance is issued to better define significant issues which would mitigate the possibility of reporting “procedural only” or isolated deficiencies, 2009 audit reported opinions will contain many more “inadequate” opinions, result in suspension of billed costs (if applicable), and mandate more administrative time for contractors to address and respond to those is-sues. Based on this past year, we believe the following four functional areas are highest at risk for reportable internal controls audit findings:

### **1. Control Environment and Overall Accounting Controls**

Auditors have routinely challenged “gaps” in written procedures, and those gaps are often frequently de-fined through a simple comparison of contractor procedures to the DCAA Internal Control Matrix. Reported findings have been issued in many cases only on the basis of procedural verbiage lapses without regard to the adequacy of actual practices. Changes in FAR Part 3 and Part 9 will presumably be used by DCAA to reinforce its expectations within this functional area and for what it is worth, DCAA will now be in the position to cite a contractor for a failure to comply with an explicit contractual requirement albeit some of DCAA’s expectations (internal control objective matrix) remain DCAA’s expansive and self-defined controls (not expressly stated in FAR).

### **2. Compensation System**

The primary focus of such reviews has been on controls for establishing and managing compensation for higher paid personnel in meeting the “reasonableness” requirements of FAR 31.205-6. Consistent with paragraph 1., above, auditors also have historically measured the adequacy of written procedures, and actual practices, to the applicable Internal Controls Matrix and, in some cases, rendered what we considered to be highly judgmental auditor “preferences” for procedure language as significant findings.

### **3. Billing System**

Based on the conditions we discuss in above paragraphs, we believe this functional area will generate more audit attention in 2009, with possible outcomes of disallowing/suspending billed costs, revocation of direct billing privileges, challenge of provisional indirect rates, and returned incurred cost proposals as in adequate. We therefore believe the focus of audit evaluations of billing systems during CY 2009 will include:

- a. Ability to provide adequate and timely incurred cost submissions
- b. Adequacy of system for capturing unallowable costs
- c. Ability of system to identify overpayments, and demonstration of prompt return of refunds

- d. Adequate tracking of actual incurred costs for flexibly-priced contracts to contract ceiling amounts
- e. Timely adjustments of invoices for year-end final indirect rates
- f. Adequacy of written procedures (when compared to DCAA's Internal Control Matrix)

#### **4. Labor Charging and Timekeeping**

Auditor trends in challenging labor charging internal controls, which we believe will continue into 2009, are:

- a. Employment of uncompensated overtime practices (salaried personnel), to include all employees regardless of materiality
- b. Use of highly-detailed work authorization forms, to include information ordinarily not captured on such forms (such as contract scope)
- c. Ability of contractor to identify changes in sub-mitted time charges, especially within an electronic timekeeping environment
- d. Prompt employee certification and submission of daily time charges, with the definition of "prompt" often at auditor discretion regardless of lack of errors or no overcharging to government contracts
- e. Expectations that employees will know where the hotline posters are located as well as be able to confirm that the employee has been trained in "COBEC" (see the second topic above).

### **Pre-award and Post-award Accounting Systems**

Contractors not identified as "major" contractors are most frequently subjected to a review of financial accounting and cost accounting internal controls during these audits. The same issues and areas of audit focus we identified above in our discussion of "Contractor Financial and Management Internal Controls" are applicable to non-major contractors. Principal areas of focus during these types of audits have included general practices for direct and indirect cost allocation, capturing unallowable costs, billing costs out of the system, and accurately capturing costs by project for monitoring to contract ceilings. An additional area of audit attention will be the financial stability of the company, regardless of the size of the company. We also caution all government contractors, large or small, that auditors will consider written procedures a mandate for all cost accounting and contracting functions. Contractors who are on the radar screen this year for these audits should revisit existing formal procedures and determine if those procedures require more expansive verbiage, or the addition of procedures not yet formalized in writing are required.

### **Accounting for Unallowable Costs**

All government contractors with contracts for which bid proposals require cost analysis, or where billings will be based on actual incurred costs, are at risk for scrutiny of a system for identifying unallowable costs, and excluding those costs from bids and billings. Based on experience with our clients in 2008, auditors seem to have embraced a much more narrowed interpretation of FAR 31.201-6 (Accounting for unallowable costs) which incorporates provisions of Cost Accounting Standard 405. In some cases, auditors have been reluctant to settle for an accounting system which, under Cost Accounting Standards (CAS) 405-50(b), allows "less formal cost accounting techniques" for identification of unallowable incurred costs, but rather insist on specific, and

sometimes individual auditor preferred techniques. In several cases, auditors deemed any system, which did not specifically have separate general ledger expense accounts for capturing unallowable costs as not meeting FAR and CAS provisions. Although that method is only one option for accounting for unallowable costs, the message here is that auditors will likely be more myopic in judging such systems, and government contractors should be prepared to explain the mechanics and controls of their systems for adequately ferreting out unallowable costs. In conjunction with unallowable costs, we also caution clients to become familiar with the provisions in FAR 42.709 dealing with penalties assessments on unallowable indirect costs so as to ensure that DCAA has properly followed the guidelines for assessing/calculating penalties (42.709-1(a)). Contractors should know which types of costs are subject to penalties; understand which contracts are subject to penalties, and; recognize when waivers of the penalties provisions are mandated by regulation (42.709-5). We anticipate that auditors will continue to aggressively recommend penalties on unallowable costs, and we encourage contractors to be diligent in capturing and removing those costs from incurred cost proposals (final indirect rates) before certification and submission to the Government.

## Allowability of Specific Costs

Some of the cost categories we believe auditors will continue to evaluate in detail, during incurred cost proposal reviews are discussed as follows:

### **Organization Costs**

Costs to plan and execute the organization or reorganization of a business, including mergers and acquisitions are unallowable per FAR 31.205-27. Such costs typically include legal and accounting (employees or consultants), brokers, investment counselors including those associated with raising capital such as stock or long term debt. As such, organizational costs tend to reside in a cost accounts other than “organizational costs” which in part explains why professional and consulting fees and legal costs have more expansive FAR documentation requirements. Of note, but not always properly applied by DCAA auditors, organizational costs exclude the administrative costs of short-term borrowings, which may include fees associated with the unused portion of a credit facility. Short-term interest expense is unallowable, but not the fees to secure the “working capital”. One other potential issue is the distinction between unallowable organization costs and allowable economic or market planning costs within FAR 31.205-12 and -28, respectively. It is at best a grey area, but you should reasonably define your “line in the sand” and consistently adhere to it.

### **Professional and Consulting Fees**

Such costs remain on our list of costs most frequently questioned by DCAA due to lack of documentation requirements, as prescribed by FAR 31.205-33(f). Costs are deemed expressly unallowable when the following documentation supporting professional costs are not evident: (1) details of all consulting/agreement arrangements, (2) invoices with sufficient detail as to time expended and nature of services provide, and (3) consultants’ work products. Although the FAR documentation requirements are loosely defined with no specificity, for example, as to what “time expended” and “consultants’ work products” should encompass, our experience in dealing with 2008 audit challenges of incurred professional fees (because documentation requirements had not been met)

demonstrated a lack of flexibility by auditors in accepting documentation that should have, in our opinion, met those requirements. Contractors should maintain and have available information that meets these documentation requirements and be prepared to rebut audit requests for other information (personal preference) if contractors believe data they have preserved otherwise meet the vaguely defined documentation provisions.

### **Public Relations and Advertising**

We believe that auditors will continue to focus on costs, which appear to be unallowable public relations, and advertising costs, and auditors will be more likely to challenge such costs if contractors do not have sufficient data to clearly support the nature of such costs. Be aware that the following types of costs are highest on the list of costs suspected to be related to (1) entertainment or (2) broadly targeted public relations and general capabilities advertising activities:

- Open houses to the general public, especially if features of entertainment are included, to include food and beverages provided at the open house.
- Anything that looks or smells like a trade show.
- Direct selling activities (which are allowable) where evening events/business meetings are conducted.
- Any PR/advertising activity conducted, albeit one that meets allowability criteria, conducted during a time frame where the company has undergone a merger or acquisition.

### **Business Meetings and Conferences**

Auditors have been, and will continue to be, more aggressive in challenging certain costs for any type of business meeting or conference where there is a hint that such activities encompass any activity that looks like “recreation”. Auditors have, in our opinion, unfairly questioned costs for legitimate business meetings (meeting criteria of FAR 31.205-43) essentially using irrational parameters that are matters of “reasonableness” and some-times auditor person preference, rather than applying objective analyses of the underlying evidential data supporting the purpose and outcome of those meetings. In spite of documentation available demonstrating the business nature of business meeting/conference activities (purpose/justification, attendance list, agenda, presentation documents, etc.), auditors have sometimes presumed that those meetings, where food is provided or offsite locations were utilized for those meetings, are suspect as entertainment and have questioned all costs associated with those meetings regardless of data clearly supporting the business purpose.

### **Employee Business Travel**

Along with business meetings and conferences, travel expenses have been on DCAA’s “high risk” list of accounts since before most of today’s auditors were born. Business travel seems to be suspect regardless of which audit agency (IRS, DCAA or other) is wearing the green eyeshades. FAR 31.205-46 adds to the fun by virtue of the numerous constraints which apply to government contractors, but otherwise do not exist in the commercial world (e.g. executives with commercial companies do travel using first class or business class air fare). The government will only reimburse costs incurred by the frugal traveler, measured by government (FTR/JTR) location specific limits on lodging,

meals and incidentals as well as limits on other than the lowest available coach or equivalent airfare.

In late 2007, the FAR Council proposed changing the latter to apply the “lowest available” airfare limit to that available to a specific contractor (as opposed to the general public); however, that revision has not become final. In 2007 and into 2008 DCAA was measuring lowest customary coach or equivalent airfare using Department of Transportation airfare data, which was irrefutably incomplete and never intended for DCAA’s usage as a reliable or valid benchmark (which has not stopped DCAA from attempting to use it). Recognize that anything other than restricted coach air fare (typically far less than walk-up and/or unrestricted coach) maybe subject to challenge, especially if you use the unrestricted, “walk-up” coach air fare to compute unallowable business class (some corporate executives are allowed to travel using business or first class; hence, the need to measure the unallowable portion of that air fare).

As to documentation in general, travel must be documented as required by 31.205-46(a)(7) including date, place of the expenses, trip purpose and traveler name and association with the contractor. Typically, a very generic trip purpose maybe challenged as inadequate, particularly if the trip was to an “exotic” location. One last complication is the DCAA assertion that 31.205-46 applies to consultants or subcontractors. It is by no means clear, given that 31.205-46(a) only refers to “contractor personnel” and FAR does not define that term. In many cases, contractor procurement policies invoke the FAR limitations (applied to independent contractors and consultants) in which case, the more restrictive company policies have answered the question (which is always the case, if your specific policies are more restrictive than the FAR, you’ve created your limitations).

## **Executive Compensation**

As the saying goes, when you’ve got a good thing going, don’t stop and such applies to DCAA’s ubiquitous audits and challenges of executive (and other compensation) using the reasonableness criteria in FAR 31.205-6(b). As an automatic audit test during each incurred cost audit (annual incurred cost proposal), DCAA expects you to provide a “Schedule T” (total compensation of the top five most highly compensated employees) from which DCAA (field auditor) can almost blindly complete its benchmarking form, send it to DCAA’s compensation specialists (Mid-Atlantic) and within a very short turnaround determine the amounts of unreasonable employee compensation. DCAA asserts that it uses reliable surveys and has recently cautioned its auditors to challenge contractor surveys, which may not be equally reliable (reference to DCAA Policy Memo 08-PPD-035(R), dated October 9, 2008). You will likely face stiff opposition in satisfying DCAA as to the reliability of any survey data you use to prove reasonableness (other than if you happen to use the same one as does DCAA) because the provider of the survey will tightly control the details. In other words, DCAA will likely benchmark using its surveys and will challenge compensation, which exceeds the median plus 10 percent (that formula is in part based upon a 1996 ASBCA Case). A contractor can potentially justify more than the median if the contractor had a very good year financially in comparison to its competition, but in any case, expect that your compensation, at least that reported on Schedule T of your incurred cost submission, will be audited.

## Employee Bonuses

Compensation is subject to multiple tests by virtue of the many subparts contained in 31.205-6, including (f) which applies to bonus and incentive compensation. In application, the allowability of bonus compensation is less likely to be challenged if awards are paid in accordance with a documented agreement (policy or plan), consistently followed and the amount of the awards are supported. However, the regulation actually provides more flexibility for allowability, specifically, if an *established* plan or policy is consistently followed, *as to imply, in effect* an agreement to make such payment. Arguably, after the first year of paying employee Christmas bonuses without any formal, written plan, the subsequent years could meet this test. Of course the much preferred strategy is to craft a written policy with someone or some organization (e.g. HR) serving to validate and/or administer the plan (but always with some flexibility, if nothing else, an employer should never guarantee a bonus based upon a rigid formula). However, keep in mind that extremely high bonus compensation could raise the risk that total compensation may not be deemed reasonable, as noted in the preceding discussion.

## Legal Fees

Legal costs are predictably a high-risk cost category because DCAA auditors will almost automatically audit the detailed transactions if they are considered significant. FAR 31.205-47, Legal Costs, is a relatively complex regulation with the most predictable component subject to audit being those costs which are related to a proceeding involving a government (federal, state, local, foreign). Within subparagraph (b), a number of actions (proceedings brought by a government) are potentially unallowable depending upon the outcome, but even if the outcome does not render the costs unallowable, 31.205-47(e)(3) will limit the contractor recovery to 80%. The key definition invoking these limits appears to be that for a "proceeding" which includes an investigation. However, a recent Civilian Board of Contract Appeals (CBCA) decision (The Boeing Company, Successor-in-Interest of Rockwell International Corporation, CBCA, Nos. 337, 338, 339, 978, 12/10/08) held that a "proceeding" may not be an all-encompassing definition as is commonly interpreted by the government. The word "proceeding" is subject to multiple definitions depending upon the circumstances and the government cannot disallow costs without appropriate regulatory backing. One other nuance, there have been investigations involving access to a contractor's records when the contractor was not the target of the investigation (e.g. it may involve a government employee who has contacts with the contractor). In any interpretation of 31.205-47(b), the proceeding targeting other than the contractor is not a proceeding, which invokes potentially unallowable legal costs.

## Adequate and Timely Incurred Cost Proposals

Auditors will continue to apply a strict interpretation of the regulations for timely submission of adequate incurred cost proposals. We expect that, similar to 2008 trends, auditors will be ready to reject any final indirect rate proposal if any proposal is viewed as insufficient pursuant only to a very limited adequacy review upon receipt by the auditors.

Specifically, we believe that proposals will be rejected under the following circumstances: (1) Proposals are not submitted within six months following the end of the contractor's FY (unless an extension has been approved). (2) Proposal is either not prepared in the sequenced schedule format or not inclusive of **all** schedules and data (whether relevant or not) identical to the "Model Incurred Cost Proposal" in Chapter 6 of the DCAA Information for Contractors Pamphlet (42.705-1(b)(1)). (3) Proposal includes amounts in schedules which should, but do not tie to each other. (4) Proposals appear to include any costs, which, by nomenclature, appear to be unallowable. (5) Proposals are not submitted in electronic form (which is not required, but nevertheless considered a feature of "adequacy" by some auditors). (6) Proposals are not certified as required by FAR 42.703-2.

## FAR Part 31 Reasonableness Criteria

Given the types of and rationale for audit findings during 2008, we believe that auditors will elevate the use of "reasonableness" as a basis for questioning incurred and billed costs, and in passing judgment on a contractor's accounting practices and related internal controls. Our assessment of numerous specific audit issues with our clients in 2008 has shown that more costs have been questioned on the basis of auditor judgment, rather than upon specific regulatory provisions which unequivocally name and stipulate costs as (expressly) unallowable. In most of these cases, auditor interpretations of "reasonableness", more than allocability, were implicitly or explicitly used as the basis for questioned costs, and sometimes, the benchmarks or parameters for justifying those costs as unreasonable were either not clear or reflected the auditor's personal opinion. However, in many cases, there was indeed insufficient data so as to permit the auditor a clear understanding as to the nature and purpose of the expenses.

"Reasonable" verbiage is included throughout the provisions of FAR Part 31.205 cost principles, and is indeed the core of allowability for compensation expenses (FAR 31.205-6). However, reasonableness is a matter of judgment, although contractors must be able to adequately support the reasonableness of all costs. We believe that audit challenges, using reasonableness as the primary guide, will continue, and we caution all government contractors to gain a complete understanding as to the auditor's rationale for those challenges before accepting the auditor's findings. We also remind contractors that adequate documentation as to the nature and purpose of all expenses will go a long way in averting audit challenges of costs or internal controls on the basis of reasonableness.

## Allocability Issues

Allocability involves the assignment of costs to cost objectives, and a contractor's allocability criteria maybe CAS or FAR 31.201-4. If CAS is applicable, the allocability rules are far more specific, but the common thread is the test of allocating costs to cost objectives based upon a causal or beneficial basis (note the criteria is "or"; hence, proper allocations need only satisfy one or the other criterion).

It is important to note that where CAS and/or a specific cost accounting standard does not apply, it cannot be used (FAR 31.201-2(b)). For non-CAS covered contractors, we have found that DCAA has imposed specific pro-visions of non-applicable standards upon contractors not subject to CAS in determining allocability (such as CAS 403

applicable to home office allocations). If the contractor agrees with the logic, there is no reason not to use the logic; however, neither DCAA nor the contractor should be equating this to CAS applicability. The FAR councils repeatedly state that they select certain standards or portions thereof for incorporation into the FAR and only those apply.

We have also found that allocability challenges from DCAA are often after the fact (i.e. in the context of an incurred cost audit) wherein the auditor opines that a different allocation methodology is a better or best allocation. Frequently, these challenges occur in spite of DCAA audits of forward pricing and/or billing rates or even prior year incurred cost submissions.

There is no requirement that a contractor use the “best” allocation methodology; only that it reasonably assign costs to cost objectives based upon causal or beneficial criteria. What is the best allocation method is (i) a very subjective opinion and ii) a function of current facts which may have changed over the course of a fiscal year, and constantly changing cost allocations is wholly impractical. Moreover, after-the-fact changes to allocation methods contravene a very important ground rule that cost estimating and cost accumulations are consistent. Similarly, DCAA’s Contract Audit Manual (CAM) indicates that once a methodology has been audited and accepted, it should not be challenged unless circumstances have significantly changed (CAM 6-606.1(c)). As further stated in FAR 31.203, Indirect Costs, “the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation”. After the fact challenges to allocation methods that have been used to estimate, price contracts are impractical, and they unduly complicate the allocation process; hence, unless the auditor can clearly demonstrate that there is an inequitable allocation, a historical allocation methodology should be left intact.

## Resolution of Audit Issues

Based on 2008 experience in assisting clients with audit issues, we still see a trend where government contractors are not always provided sufficient information to adequately respond to and resolve audit issues. We continue to see where auditors do not provide any or sufficient data in writing to clients clearly defining the basis for questioned costs or inadequate internal controls, nor are government contractors given a sufficient amount of time to evaluate and respond to audit findings. Although we believe the liaison may improve between contractor and auditor during the 2009, we remind government contractors of their entitlement to satisfactory explanations and ample opportunity to review and respond to audit challenges. Guidance to auditors within the DCAA Contract Audit Manual (specifically Chapter 5 for internal controls and Chapter 6 for incurred costs) requires auditors to discuss with the contractor audit issues and the basis for those findings. Further, contractors should be afforded a final exit meeting where all issues are discussed, and government contractors be provided sufficient time to respond in writing (except in cases of forward pricing estimates).

## Documentation and Access to Records

Adequate documentation is a key factor in supporting con-tract costs (direct or indirect) and is both a general requirement (FAR 31.201-2(d)) as well as a specific requirement (FAR 31.205-33). There are at least two other sub-elements relative to documentation and access to records, one the timing and two the access to contractor employees.

In December 2008, DCAA issued an audit policy memo (08-PAS-042(R), dated December 19, 2008), which addressed timing and access to contractor employees.

It is now DCAA's interpretation that readily available data should be provided to DCAA "upon request" unless the "request requires analysis or extenuating circumstances exist". In its public, final memo, DCAA avoided any specific definition of timely access; however, internal DCAA documents suggest 3-5 days ("upon request" is of course not 3-5 days). DCAA is also asserting that it has access to employees and that auditors should generally obtain information directly from the person responsible for the information. Contractor use of "audit liaison" should not delay or "inhibit the auditor's access to contractor personnel otherwise needed to conduct the audit." Almost none of DCAA's policy assertions or interpretations is expressly supported by the FAR; particularly as it relates to access to contractor employees. The FAR provides very limited government access to employees, in one case to verify qualifications for T&M contracts, in the other within government expectations for contractor cooperation under mandatory disclosure requirements of "COBEC" (the second article). A contractor is otherwise well within its contractual rights to limit DCAA's access to "contractor records" and "to a contractor plant" as specifically stated in FAR 52.215-2. The last time we checked, an employee is neither a record nor a contractor plant.