



## CONSTRUCTION

# WHAT'S NEW FOR FEDERAL CONTRACTORS

The federal government is the largest purchaser of goods and services in the economy. Not surprisingly, many accountants have clients who are either bidding for or performing government contracts or grants. Practitioners may want to be aware of some of the more salient recent developments in government contracting.

## FASTER PAYMENTS FOR SMALL BUSINESSES

A policy announced by the Office of Management and Budget (OMB) required agencies, as of Nov. 1, 2011, to establish new payment procedures to attempt to pay small businesses within 15 days after receipt of a proper invoice.<sup>1</sup> However, the policy of providing for faster payments to small businesses was only established as a goal, not a requirement. For this reason, bureaucratic compliance with the new policy has been slow in coming.

## DCAA AUDIT FOCUS

Over the past year, the following areas have been the subject of heightened audit scrutiny by the Defense Contract Audit Agency (DCAA):

### Contractor Business Systems

The Department of Defense (DOD) Federal Acquisition Regulation Supplement (DFARS) was amended to require contractors to have acceptable business systems to perform DOD contracts. Accordingly, DCAA has tasked its auditors with measuring compliance in this area. The details of these requirements are discussed in a separate section below.

### Proposal Walkthroughs

Proposal walkthroughs are a new initiative that has apparently been well-received by contractors. A walkthrough entails having a contractor's cost team make a presentation to the DCAA auditors responsible for auditing the proposal, i.e., walk the auditors through the numbers, answer their questions, etc. After this initial grounding in how the cost proposal was prepared, the auditors then do their work to ascertain whether the actual submission is consistent with what the contractor intended. Anecdotal evidence to date indicates that both contractors and auditors have been pleased with this process.



## Allowable Executive Compensation

Under Federal Acquisition Regulation (FAR) 31.205-6, executive compensation is limited to amounts established by the Office of Federal Procurement Policy (OFPP). Below those limits, the amount of compensation is supposed to be “reasonable” — the criteria for which all accountants know are subjective. Nonetheless, the DCAA has established a specially trained task force to go after what it considers to be unreasonable executive compensation.<sup>2</sup> Not surprisingly, DCAA’s attempts to disallow unreasonable compensation spawned litigation in this area. The first case to be decided, discussed in greater detail below, resulted in a win for the contractor.

*As any market gets smaller, the competition gets tougher — and the government contracts market is no exception.*

## Commercial/Government Cost Allocations

Government auditors know that contractors with both government and commercial customers have an incentive to over-allocate indirect costs to their government contracts. Mindful of this, the DCAA has been more carefully reviewing the indirect cost apportionments between a contractor’s government and commercial contracts.

## Related-Party Transactions

Related-party transactions are a chronic problem at the small business level, given the small business owner’s proclivity to do business with family members. In the law, a business deal is generally not considered to be an arm’s-length transaction due to the relationship of the parties. This being the case, a contractor that charges costs arising out of a related-party transaction to its government contracts unwisely places a heavier burden on itself to justify the fairness of the prices. In any event, this is an area of vigilance for government auditors.

## Incurred Cost Submission Backlog

Finally, there is the chronic problem of incurred cost submissions. Simply put, there is a substantial backlog. While some contractors are only three years behind, others are six or seven years behind. This problem is so significant that it routinely receives the attention of DCAA management, who undertook various steps to address it. While some progress was made, to date the backlog persists.

## FAR UPDATES TO ACCOUNTING REFERENCES

In a final rule that became effective on Feb. 2, 2012, the FAR was amended to update its references to U.S. Generally Accepted Accounting Principles (GAAP) to be consistent with the Financial Accounting Standards Board’s (FASB) Statement No. 168.<sup>3</sup> Under that statement, FASB’s Accounting Standards Codification is now the authoritative source of GAAP.

## DFARS BUSINESS SYSTEM RULES MADE FINAL

The interim DFARS Business Systems Rules encompassed the following: the accounting system (to include the billing system), the estimating system, the purchasing system, the property management system, the earned value management system, and the material management accounting system.<sup>4</sup> With only insignificant changes, these rules were made final in 2012.<sup>5</sup> At present, these requirements only apply to DOD contracts, but they are likely to be adopted by civilian agencies in the near future.

The DFARS Contractor Business Systems clause applies whenever the Cost Accounting Standards (CAS) apply.<sup>6</sup> (Small businesses have an exemption from CAS, so these new business systems rules will not apply to them.) When these rules do apply, though, they allow contracting officers to withhold up to 10 percent of a contractor’s invoice for a “significant deficiency” in a business system. A “significant deficiency” is defined as a “shortcoming in the system that materially affects the ability of officials of the [DOD] to rely upon information produced by the system that is needed for management purposes.” Since significant deficiencies for the accounting and estimating systems are determined by the government auditor, this leads directly to the next topic.

## ASBCA DECISIONS

Two recent decisions by the Armed Services Board of Contract Appeals (ASBCA) are of particular interest to contractors.

### DCAA Loses Executive Compensation Case

In an ASBCA decision, the DCAA lost its attempt to disallow what it considered to be unreasonable executive compensation. The case *J.F. Taylor, Inc.*, involved the compensation of the

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top five executives for four years.<sup>7</sup> After comparing their executive compensation for fiscal years 2002 through 2005 to compensation market surveys of similarly situated contractors, DCAA determined that the compensation was unreasonable. The DCAA further decided that the total excess compensation over the four-year period amounted to approximately \$850,000. Repayment of the excess amount was subsequently demanded in several Administrative Contracting Officer final decisions. These decisions were duly appealed to the ASBCA.

The ASBCA found the statistical methodology used by the DCAA to be flawed and therefore unreasonable. On the other hand, the methodology applied by the contractor's experts, who found only about \$42,000 to be unallowable, went completely un rebutted by the government. In the absence of any contrary evidence, the contractor's approach was found to be reasonable.

Executive compensation is a major initiative for the DCAA, and it is also a subject of interest to Congress.<sup>8</sup> While the DCAA was obviously disappointed with the result in the *Taylor* decision, the case should be viewed as a setback for the government's efforts in this area, and not a defeat.<sup>9</sup>

### Some Indirect Costs May Be Unallowable

The ASBCA made another noteworthy decision in *Splashnote Systems, Inc.*<sup>10</sup> Although the amount in dispute was not significant (around \$85,000), the issues involved disallowances of various indirect costs to include deferred independent research & development (IR&D), bonus payment and meals.

Essentially, the board found that the deferred IR&D costs did not meet the terms of the contract or the FAR; the bonus was actually a prohibited distribution of profits; and the costs of the meals had not been adequately documented under any of the cost principles that might have made them allowable.<sup>11, 12,</sup>  
<sup>13</sup> This case is a reminder that the burden is on the contractor to satisfactorily substantiate its costs. If costs are not properly documented, they are unallowable.<sup>14</sup>

## THE TIGHTENING CONTRACT MARKET

I'm not cynical by nature (quite the opposite), but I have a pessimistic view about the next several years in the government contract market. Massive debt at all levels (federal, state, and local) will require significant cutbacks to government spending. No matter who wins in November's elections, there will have to be programmatic reductions and eliminations.

That said, the government contract market will get smaller. As funding levels lessen, there will be increasing competition for the fewer and fewer opportunities presented. In such a market, there are likely to be more bid protests as contractors fight fiercely for each award. Even after a contract is awarded, government agencies will be pressing contractors to do more for less (already a mantra at some government agencies). However, contractors will be increasingly reluctant to do additional work for free, so there probably will be more claims activity. In short, the immediate future will bring increasing friction between government agencies and the contractor community.

As any market gets smaller, the competition gets tougher — and the government contracts market is no exception. Accordingly, contractors with knowledgeable and experienced staff will have a competitive advantage for the diminished number of opportunities over contractors who do not. Eventually, weaker performers will be pushed out of the market.

In my view, the good old days are behind us. Working with the changing regulatory complexities, to include enhanced oversight and transparency, will place a heavier burden on contract administrators. Over the next several years, there will be a market of budget retrenchment in which contractors will likely face heightened competition for diminished opportunities.

## CONTACT

### GEOFFREY T. KEATING

Drinker Biddle & Reath LLP  
geoffrey.keating@dbr.com

[navigant.com](http://navigant.com)

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## ABOUT THE AUTHOR

**Peter McDonald, CPA, ESQ.** is a director with Navigant's Government Contractor Services practice and is a nationally respected practitioner with more than 30 years of government contracting and consulting experience. He serves on the board of advisors for the *BNA Federal Contracts Report* and the *Thomson West Cost, Pricing & Accounting Report*. He is the recipient of the Boards of Contract Appeals Bar Association Life Service Award. Contact him at [pete.mcdonald@navigant.com](mailto:pete.mcdonald@navigant.com).

1. OMB Memorandum No. M-11-32, Sept. 14, 2011.
2. 41 U.S.C. §435; FAR 31.205-6(p). The OFPP amounts for the years involved in *Taylor* are: FY2002 - \$387,783; FY2003 - \$405,273; FY2004 - \$432,851; FY2005 - \$473,318. The OFPP amounts since then are: FY2006 - \$546,689; FY2007 - \$597,912; FY2008 - \$612,196; FY2009 - \$684,181; and FY2010 - \$693,951. As of this writing (March 2012), no amount had yet been announced for FY 2011.
3. 77 Fed. Reg. 202, Jan. 3, 2012.
4. 76 Fed. Reg. 28856, May 18, 2011.
5. 77 Fed. Reg. 11,355, Feb. 24, 2012. See also "DOD Issues Final Rule for Oversight of Contractor Business Systems," by David Hansen, *BNA Federal Contracts Report*, Vol. 97, No. 182, Feb. 24, 2012.
6. DFARS 242.7005.
7. *J.F. Taylor, Inc.*, ASBCA Nos. 56105, 56322, \_ BCA \_, 2012 WL 261272 (Jan. 18, 2012).
8. FY 2012 National Defense Authorization Act; H. 1540 — limit is the salary of a Cabinet secretary (approximately \$200,000), but S. 1867 — limit is President's salary (\$400,000). See "Senate Defense Bill Limits Reimbursement of Contractor Executive Compensation Costs," by Deborah Billings, *BNA Federal Contracts Report*, Vol. 96, p. 558, Dec. 2, 2011; and "House-Passed DOD Authorization Bill Aims to Boost Competition in Acquisitions," by Deborah Billings and Jessica Coomes, *BNA Federal Contracts Report*, Vol. 95, p. 571, June 7, 2011. Neither bill has been enacted, but the efforts in both Houses indicate Congressional interest in this area. More recently, the Commonsense Contractor Compensation Act of 2012 (S. 2198) was introduced in the Senate mid-March of this year. The bill, which enjoys bi-partisan support, would impose a compensation limit of \$400,000 on all contractor employees government-wide. See Bloomberg BNA's *Federal Contracts Report*, "Latest Developments," March 16, 2012.
9. See "DCAA Loses Executive Compensation Appeals," David B. Dixon, Esq., *BNA Federal Contracts Report*, Vol. 97, No. 12, March 16, 2012.
10. *Splashnote Systems, Inc.* ASBCA No. 57403, 2011 WL 6153096 (Nov. 29, 2011).
11. FAR 31.205-18.
12. FAR 31.205-6(ii)(B).
13. FAR 31.205-34, FAR31.205-43, and FAR 31.205-46.
14. FAR 31.201-2(d).

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