Astute readers may have noticed that we've focused this week on the "challenges" associated with small businesses that seek to sell goods and services to the Department of Defense. If you are a small business and win your first "flexibly priced" contract, the resulting euphoria may blind you to the downside risks. For example, there's this whole accounting system "adequacy" thingee (which includes an evaluation of your indirect cost allocation structure and your calculation of indirect cost rates). And there's a requirement to submit an annual proposal for "final billing rates" using an "Incurred Cost Electronically" format that you probably haven't heard of before winning that golden cost-plus contract. These two areas are among the many landmines that await your business as it tries to collect the promised funds from the DOD.

So here's the bottom-line for small businesses entering the defense marketplace: If you focus on contract execution and don't pay attention to the back-office administrative requirements, your story will not end happily. You could easily end up paying the U.S. Government far more than it paid you (as our friends at Quimba Software learned, **to their chagrin** .)

Yet another potential landmine that you could trigger would be failing to deal with this "unallowable cost" thingee that's addressed in FAR Part 31. (That's where Quimba tripped-up.) If you are a small business, you may only have a vague idea as to what the FAR is—let alone have sufficient expertise in navigating the identification and segregation of unallowable costs (and the calculation of acceptable indirect cost rates). We suggest you had better learn more about this area—and quickly. The ability to properly account for unallowable cost implicates not only the adequacy of your accounting system, but also the adequacy (and accuracy) of your annual proposal for final billing rates. If you blow the proper accounting for unallowable costs, you are going to make DCAA very happy—because they will get to issue an audit report with lots and lots of questioned costs in it.

It may sound self-serving, but we honestly believe that if you are clueless regarding government contract cost accounting, then it would be a very good idea to hire a subject matter expert to assist you in that area. That's not to say that hiring an outside SME is a guarantee of a successful outcome. Indeed, Quimba **learned the hard way** that not all government contract cost accounting advisors are cut from the same cloth. Quimba's problems with DOD need not typify that of every small business, but if you don't at least
come close
to getting the contract accounting and billing correct, you are going to have similar problems.

It is not going to be pretty.

Today's article is about another small business, one (like Quimba) focused on innovative technology and R&D (and performer of SBIR and STTR contracts) that fell afoul of DCAA and DCMA. But before we discuss the problems of **Inframat Corporation**, we want to bring you up to speed about *expressly* unallowable costs and why they can cost your company more than mere garden-variety "unallowable" costs.

We've discussed the "flavors" of unallowable costs before on this blog, notably in **this article**. We wrote that the FAR contract clause 52-242-3 states—

If the Contracting Officer determines that a cost submitted by the Contractor in its proposal is expressly unallowable under a cost principle in the FAR, or an executive agency supplement to the FAR, that defines the allowability of specific selected costs, the Contractor shall be assessed a penalty equal to—

(1) The amount of the disallowed cost allocated to this contract; plus

(2) Simple interest, to be computed—
(i) On the amount the Contractor was paid (whether as a progress or billing payment) in excess of the amount to which the Contractor was entitled; and

(ii) Using the applicable rate effective for each six-month interval prescribed by the Secretary of the Treasury pursuant to Pub. L. 92-41 (85 Stat. 97). If the Contracting Officer determines that a cost submitted by the Contractor in its proposal includes a cost previously determined to be unallowable for that Contractor, then the Contractor will be assessed a penalty in an amount equal to two times the amount of the disallowed cost allocated to this contract.

That contract clause is not the only place that contractors are put on notice regarding the potential imposition of penalties and interest for including expressly unallowable costs in their final indirect rate proposals. For example, FAR 31.110 states—

1.

Certain contracts require certification of the indirect cost rates proposed for final payment purposes. See 42.703-2 for administrative procedures regarding the certification provisions

and the related contract clause prescription.

2. If unallowable costs are included in final indirect cost settlement proposals, penalties may be assessed. See 42.709 for administrative procedures regarding the penalty assessment provisions and the related contract clause prescription.

So let's just take it as a given that when any contractor receives a "flexibly priced" contract, it is put on clear notice that inclusion of expressly unallowable costs, billed as either direct or indirect costs, may lead to imposition of penalties and interest by the U.S. Government.

Inframat apparently knew that risk, but thought its "sob story" would convince a DCMA Administrative Contracting Officer (ACO)—and later, an ASBCA Judge—that it wasn't deserving of such a fate. Inframat's story convinced neither the ACO nor the Judge. Here's the **Judge's decision** on the matter.

The first thing we noticed about the ASBCA decision was that Inframat was represented by Mr. Nicholas Vlahos, Inframat's "General Manager/Controller". Apparently, Inframat did not think it worthwhile to hire an attorney to represent its interests. In fairness, the quantum in dispute was only $26,016 plus "simple interest." We can see Inframat's management making the decision to forego attorney's fees for such a small amount. On the other hand, we've **opined before** that "your choice of attorney matters one hecuva lot." We don't know if Inframat's decision to forego representation affected the ultimate outcome, but we are very sure it didn't help them any.

Inframat submitted its "certified final incurred cost rate proposal" for its Fiscal Year 2004 in August 2006. (The Judge did not discuss why Inframat's submission was fourteen months late.) DCAA issued an audit report in November 2007, and asserted that Inframat had included expressly unallowable costs in its submission. The Judge noted that DCAA questioned "pensions, legal fees, interest, convention/ seminar, travel, consultant, audit, entertainment and advertising costs and expenses as expressly unallowable." (We're fairly confident that a strong attorney would have argued that not all of those items were expressly unallowable, but that's not the point of this article.) DCAA recommended that $21,238 in "level one penalties" be assessed.

In February 2011, the cognizant DCMA ACO issued a letter to Inframat transmitting the DCAA audit report and notifying the company that he intended to impose penalties. (The Judge did not discuss why it took DCMA more than three years to send the letter, or whether DCMA had a duty to mitigate the interest damages it claimed, which had increased over those three years.)

Inframat responded to the ACO and did not dispute DCAA's findings; instead, Inframat asked for mercy. Inframat asked the ACO to waive the penalties (as was within his authority to do) because the company felt it had taken appropriate corrective actions so as to ensure that the errors in accounting for unallowable costs would not recur. Inframat told the ACO—

During 2003 the company was using an accounting software package called DELTEK after a recommendation from DCMA. After the Deltek system was installed the company failed to make yearly maintenance payments and thus, support for the system broke down. The accounting staff was unable to use certain modules of the accounting system. The certified public accountants who reviewed their financial statements typically only used the general ledger that the controller provided them. The general ledger did not match the balance sheet and income statements. The bookkeeper was unable to make timely entries into the system because the software would close each period after each month. This compounded the problem as entries were not being made and amounts that were paid were left on the accounts payable ledgers. The Deltek system crashed during 2004. The company was able to recapture some of the lost information but [not] to recreate other information that was missing. Starting in 2006 we switched to Quickbooks accounting software to fix the problems.... The new accounting system worked better at being able to separate.. .allowable and unallowable costs by using the class tracking system. The 2004 incurred cost submissions were submitted by the former controller, Hank Taylor. He was inexperienced in the submissions required. Mr. Taylor also felt that he could submit everything and just be told by DCAA what was not acceptable, which demonstrates his lack of understanding of the FAR.

Readers, Inframat's story is a classic attempt to appeal to the "better angels" of the ACO. Unfortunately, it was never going to work. Indeed, in only exacerbated Inframat's problem—*since it clearly demonstrated that Inframat did not deserve a waiver*
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FAR 42.709-5 discusses when a contracting officer should consider waiving the penalties. It says—

(c) The contractor demonstrates, to the cognizant contracting officer's satisfaction, that—
(1) It has established policies and personnel training and an internal control and review system that provide assurance that unallowable costs subject to penalties are precluded from

being included in the contractor's final indirect cost rate proposals (*e.g.,* the types of controls required for satisfactory participation in the Department of Defense sponsored self-governance programs, specific accounting controls over indirect costs, compliance tests which demonstrate that the controls are effective, and Government audits which have not disclosed recurring instances of expressly unallowable costs); and <

(2) The unallowable costs subject to the penalty were inadvertently incorporated into the proposal; *i.e.,* their inclusion resulted from an unintentional error, notwithstanding the exercise of due care.

As you can see, Inframat admitted that it failed to properly maintain its Deltek accounting system and that the former Controller was intentionally negligent in preparing the company's *ce rtified*
final indirect rate submission. Unsurprisingly, the ACO declined to waive the imposition of penalties and interest.

Inframat appealed the ACO's decision to the ASBCA. As previously noted, the company did not invest in the cost of an experienced government contracts attorney. Instead, the company essentially reiterated its "sob story" to the Judge, writing—

While penalties such as the one imposed may act as incentives for 'bad' companies to take appropriate action to correct their behavior, in this situation, as corrective action had already taken place well before Mr. Galvagni's decision, we question the need for the Government to implement a significant (for us) financial penalty.

Like the ACO, the Judge was not moved by Inframat's plea. Judge James wrote—

Inframat failed to raise a genuine issue of material fact, however, that it met the requirements of FAR 42.709-5(c)(2). On 31 August 2006 it submitted its 2004 final incurred indirect cost rate proposal …. Prior thereto, it failed to exercise due care because its system support broke down for failure to make yearly maintenance payments, its Deltek system crashed, it lost cost information, its bookkeeper could not make timely cost entries, and its inexperienced controller included expressly unallowable costs in its 2004 final indirect cost rate proposal on the misunderstanding that DCAA later would tell him what costs were not acceptable …. Therefore, ACO Galvagni properly determined that Inframat failed to exercise due care in preparing its 2004 indirect cost rate proposal and properly denied its request to waive the penalties.

The Government's motion for summary judgment was granted as a matter of law, and Inframat's appeal was denied.

As we wrap-up this week of articles, the majority of which focused on the challenges of small business contracting, we need to remind contractors (large and small) that they ignore the administrative and accounting requirements of their flexibly priced contracts at their peril.