Technology Systems, Inc. (TSI) was a small business. (We say “was” because the company is no longer operating.) It had been a government contractor since 1987. It received and performed cost-type contracts. Accordingly, it was required to invoice only allowable direct and indirect costs. Further, TSI was required to calculate its invoices using provisional billing rates that were intended to approximate the billing rates it would calculate at year end, when the books closed. Additionally, TSI was required to submit a proposal to establish final billing rates; that proposal would be audited by DCAA and eventually DCMA would negotiate the final billing rates based on the audited proposal.

(This is all rather humdrum. It’s how these things work. But we note them because some small businesses simply do not have a clue about it. For them, the foregoing may well be a revelation.)

The DCAA audit history of TSI’s annual proposal to establish final billing rates is interesting. DCAA conducted a “full audit” of Fiscal Years 1998, 1999, 2000, 2001, 2002, and 2003. With respect to FY 2001, DCAA questioned some claimed consultants’ costs because TSI failed to provide the auditors with “actual work product.” However, no costs were questioned—none at all—with respect to TSI’s FY 2002 and 2003 proposals. Based on the lack of questioned costs (which meant that TSI was considered to be a low-risk contractor), DCAA performed a “desk review” of TSI’s FY 2004 and 2005 proposals instead of a full audit. (We have voiced our opinion regarding this innovative DCAA audit approach several times on this blog.) With respect to FY 2006, DCAA performed another “full” audit and, again, found no questioned costs.

Which brings us to FY 2007.

TSI submitted its proposal to establish final billing rates on time, in June, 2008. The DCAA audit began a couple of months later. (This was back in the time when DCAA performed timely audits of such proposals; within a year from TSI's submission date, DCAA would make a management decision to stop performing “incurred cost” audits for several years, resulting in an embarrassingly large audit backlog. Again: something we’ve discussed many times on this blog.) Apparently one of the two auditors assigned to TSI was difficult to work with and TSI requested that she be replaced with somebody more “objective.” The request was declined. (This was back in the time when a contractor complaint about an auditor was considered to be somewhat of a merit badge. See our discussion of that situation—and how it has evolved— **here** .

) Which is neither here nor there, because the audit was completed and a draft report was submitted in April, 2009, for a "peer review." It had been less than one year since TSI had submitted its proposal. That's how quickly DCAA worked back then.

The draft report, as submitted, questioned more than $360,000 in direct and indirect costs. TSI's claimed overhead rate had been reduced by more than one-third. TSI's claimed G&A rate had been reduced by more than one-third. And TSI's claimed Material Overhead rate had been reduced to zero. *Yes, that's correct. 100 percent of the claimed Material Overhead indirect costs had been questioned by DCAA.* That seems *unusual*. It would be interesting to see how the draft audit report fared in its "peer review."

But by that time, DCAA had stopped performing such audits and the "peer review" was never completed. The draft audit report languished in limbo for a full four years, until April, 2013. Another auditor was assigned at that time, and spent another four months reviewing the work papers, before concluding that more information was required.

Then another DCAA auditor was assigned. (For those keeping count, this would now make four individual auditors assigned to this single ICP audit of a small business.) Another eight months passed.

Finally, in March 2014—five years and nine months after TSI had submitted its original proposal—DCAA formally notified DCMA that it was withdrawing from the audit, primarily because it was unable to complete additional transaction testing of TSI's direct labor rates by the agreed-upon audit due date. The expanded testing was a result of TSI's complaint to its Congressional Representative and/or Senator about DCAA's conduct. This would seem to be a rather punitive response. Regardless, the testing was expanded but that meant that the audit would not be completed in time, so DCCA admitted failure and handed the resolution over to DCMA.

As part of its hand-off, DCAA provided the DCMA contracting officer with a "Decrement Memo" that expressly was not based on anything that complied with Generally Accepted Government Auditing Standards (GAGAS). Apparently that was an okay thing to do: once DCAA had withdrawn from its audit assignment it was (apparently) no longer required to comply with GAGAS.

The Decrement Memo that was not compliant with GAGAS requirements recommended indirect rates that DCMA should use to negotiate TSI's FY 2007 final billing rates. The recommended rates were higher than those in the draft audit report. Among other things, no costs were questioned with respect to TSI's claimed Material Overhead rate. *Yes, that's correct. Instead of questioning 100 percent of the claimed indirect costs, DCAA was now questioning zero percent.*
Almost as if the draft audit report had been wrong. Indeed, the fourth auditor explained to DCMA that he was not taking the same "hard line" that the original auditor had taken. Almost as if the original auditor had been less than objective, as TSI had feared she might be.

DCMA opened negotiations by offering not to assess any penalties on TSI if it would accept DCAA's decremented rates. TSI declined and attempted to rebut DCAA's position by claiming, among other things, that DCAA was questioning costs that had never been questioned in the past. DCMA's position was established as follows:

We understand your argument that DCAA has historically not questioned these costs; however, that does not mean DCAA deems those costs to be allowable. We here at DCMA cannot speak for the DCAA auditor(s) that performed the reviews, nor can we speak for the sampling methodology used by DCAA. *Our job will be to address the audit as written.* If you are able to substantiate the costs with the required documentation, we will reinstate the costs. If not, we have to sustain the costs.

(Emphasis added.)

See that part in italics above? See how DCAA's "Decrement Memo" that was expressly not an audit nor an attestation opinion, and expressly did not comply with GAGAS, became an audit in the mind of the DCMA contracting officer? That right there is one of the big problems in this business. Contracting officers aren't trained to know the difference between an audit and a non-audit, and so they treat all opinions by DCAA as being of equal weight. To be sure, it was incumbent on TSI to point that out to the CO, but it was also the CO's responsibility to understand that the recommended rates in that Decrement Memo had about as much substance behind them as a Potemkin village. (Go look up that reference.)

Negotiations ensued but the parties could not reach agreement. Finally, in late June, 2014—literally five days before the CDA Statute of Limitations would come into play—the contracting officer issued a COFD and asserted a government claim for $159,303. TSI appealed to the **ASBCA** .

What makes this story so interesting is that there was a dissenting opinion at the Board. Judge Clarke—the individual who actually heard the appeal—dissented from the majority decision. We'll discuss the different viewpoints in the remainder of this article.

There were many elements of cost questioned by DCAA and, ultimately, sustained by the DCMA contracting officer. We are not going to recite all of them; instead, we are going to focus on the ones that may present lessons to our readership.

Consultants

Expenses for two marketing consultants were disallowed because of a lack of work product. (See FAR 31.205-33(f). This is a common finding that requires some good audit support tactics to overcome.) To be clear, there was an agreement in place and there were detailed invoices. However, the third prong of the requirements was allegedly missing. The majority decision found that the work was performed via telephone and no work product should have been required. (In fairness, had the executive receiving the marketing support kept notes from the conversations, this never would have been an issue in the first place.) The majority also found that "the details contained in the … invoices are adequate to support a finding that [the consultant] worked the hours charged." The questioned costs were found to be allowable by the majority because the FAR requirements were complied with.

In his dissent, Judge Clarke stated that he would have sustained TSI's appeal, based on a "course of conduct" between DCAA and TSI that had been established in the previous audits. Suddenly, DCAA changed its mind with respect to the required transaction support, without giving TSI adequate notice. This sudden change, he found, was equivalent to a prohibited retroactive disallowance. On the other hand, the majority rejected that finding, and stated that the retroactive disallowance prohibition was based on an estoppel argument that required evidence of bad faith on the government's part. (Apparently the documented animus exhibited by the first DCAA auditor was insufficient to show bad faith.)

We think that contractors who engage consultants need to be aware of the FAR requirements in that area, and be prepared to show a government auditor how they are complying with those requirements. Indeed, we've **written** about those requirements.

Executive Bonuses

Three TSI executives were paid bonuses in FY 2007, pursuant to a one-page incentive compensation plan. However, the company failed to track the metrics discussed in the plan, and thus the awards lacked support. The majority decision found that the executive bonuses were unallowable. The majority wrote—"We agree with the government that TSI's executive bonus plan was too amorphous in its criteria for bonus award and subject to too unfettered discretion in its application to permit the inclusion of its costs in the ICP. … when an executive bonus plan lacks measurable metrics and is essentially subject to the unfettered discretion of those who would benefit from it … its costs are not compensable."

The dissent by Judge Clarke would have allowed the bonuses. He found that there was a bona fide bonus plan—albeit of one page—and that it was reasonably followed. He found that TSI's course of conduct with respect to its executive bonuses was reasonable for a company of less than 20 employees.

Unfortunately, the lesson to be learned here is that the requirements of the compensation cost principle at 31.205-6(f) will be strictly enforced, even as applied to small businesses. Companies that have incentive compensation should have a written plan that is consistently followed. Incentive compensation awards should be documented and supported. There should be no question as to why Employee A received the award she did and why Employee B received a different amount. This is a hard thing to understand and to do, because it's such a closely-guarded process at most companies. How much IC is given to any individual is something that is simply not shared, except within the smallest possible group. That fact being acknowledged, somebody within that group needs to document and support the actual award amounts.

Subcontract Costs

TSI awarded several T&M subcontracts without first obtaining consent from the contracting officer, as required by the FAR contract clause 52.244-2. Because advance consent was never obtained, and because the information supporting TSI's determination that the prices it was paying to its subcontractors was fair and reasonable was not available, the costs were disallowed by the majority.

As was the case with the consultant costs, Judge Clarke would have allowed the subcontractor costs because of the parties' prior course of dealing, in which such costs had never been disallowed even though TSI had similarly failed to obtain advance consent for them.

The majority decision is a bit murky in this area, but apparently a failure to obtain consent was equated by DCAA, DCMA, and the Board as being equal to a CO challenge that the awarded price was not fair and reasonable. We don't really understand that equivalence; to us it seems to be conflating two separate concepts. Can the costs be questioned solely on the basis that the contractor failed to comply with the advance consent requirements? We don't see why not (though there may be a *quantum meruit* defense available). In other words, a contractor can have airtight documentation regarding price reasonableness, but if it fails to obtain advance consent when required to do so, it may be putting those costs at risk. We do not understand how the majority got from consent to price reasonableness—though that could just be our lack of understanding, since we lack legal training. Regardless, we have warned our readers that DCAA will challenge subcontractor costs when the price reasonableness is not supported—and here is another example of that principle in action.

Statute of Limitations

There was some discussion about the CDA Statute of Limitations. As noted above, the COFD was within the six-year clock—assuming the clock started when the FY 2007 final billing rate proposal was submitted. In fact, many recent ASBCA decisions tend to elide that date in favor of the date when the government had notification that disputed indirect costs were actually incurred and claimed as allowable indirect costs—i.e., when transaction detail is provided. That does not need to be the date of the audit commencement. For instance, if the contractor submits general ledger transaction detail along with the proposal, that would seem to be sufficient to start the SoL clock. That being said, both the majority and the dissent found that the COFD was issued within the CDA Statute of Limitations.

What was *not* discussed was whether the disallowance of the subcontractor costs was time-barred. This is a curious omission, because recent ASBCA decisions have distinguished direct from indirect costs with respect to the start of the Statute of Limitations. See, e.g., **Sparton deLeon Springs**

. That appeal involved a disallowance of intra-organizational transfer costs (i.e., direct costs) that were insufficiently supported. Judge McIlmail, writing for the Board with no dissent, found that the SoL clock started running when the government paid the interim vouchers that included the disputed direct costs. He wrote: "
… the government's overpayment claim is based upon the contention that Jackson costs were 'insufficiently supported', and that, according to the contracting officer, there is no proof that [the contractor] paid those costs in connection with any government contract. However, if that is true, it was no less so … when the government paid those costs pursuant to the interim vouchers.
"

It is puzzling, if not disturbing, to see that line of reasoning not being addressed by either the majority or the dissenting opinion.

To wrap this article up, there is much to criticize about the story of the DCAA, DCMA, and TSI. The approach taken by DCAA was, to our eyes, unprofessional at best. DCMA's reliance on a non-GAGAS non-opinion as a Bible-solid position that could not be ignored without irrefutable evidence from the contractor was, in our view, misplaced. The DCMA contracting officer had much more discretion available; though of course many contracting officers are afraid to use their discretion these days, since DCAA has a tendency to whine to the DoD Inspector General when their positions are not sustained. Finally, this decision may really undercut the previously solid doctrine that the government cannot engage in retroactive disallowance.

This is another important ASBCA decision that merits close scrutiny by those engaged in the practice of government contract compliance.