It's correct to note that Apogee Consulting, Inc., is in the business of assisting government contractors in the back-office administrivia associated with government contracts. It's also correct to note that there is a certain amount of "we-told-you-so" in this article.

Yet, further note the maxim that every consultant in this business knows to be true: "*It's harder to sell services that prevent problems; whereas it's much easier to sell services that fix the problems into which the contractor has got itself.*
" Nobody is a hero when problems are prevented; but lots of people can be heroes when confronted with preventable problems that "suddenly" need to get fixed.

If one were of a mind to peruse previous articles found on this blogsite, one might note a certain amount of repetition on the above statements, particularly with regard to small businesses that simply do not know what they don't know. They often don't understand the intricacies associated with their government contracts and thus fail to make accurate risk assessments. They don't invest in their back-office controls because they don't really understand the probabilities and consequences associated with their contract risks. They do not understand that those investments have a quantifiable return on investment, in terms of disputes avoided.

In September, I will be presenting at the Society of Corporate Compliance and Ethics (SCCE) 18th Annual Compliance & Ethics Institute. (If you are interested: link **here** .) The catchy title of my presentation is "Taking a Dynamic Approach to Compliance Risk Assessments for U.S. Government Contractors." My presentation is described as follows:

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Learn how to manage a changing risk profile as your business evolves in size and transitions from sub to prime contractor and contracts change from fixed-price to cost-reimbursable

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Increase your organization's ability to identify and assess risks associated with organizational and contractor evolution using revenue, contract-type and acquiring agency as key differentiators

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Better understand Federal Acquisition Regulation contract clauses and changing non-compliance risk

So, yeah. This is a topic that's on my mind. When you couple a small business' inability to properly identify and assess risks with an evolving environment, you often get problems. For example, when a small business moves from FFP contracts to its first Cost-Type contract—as is often the case when a SBIR Phase 2 contract is awarded—then that small business really needs to be prepared for its new risk environment. However, such is not always the case.

With all that in mind, let's discuss the situation faced by Falmouth Scientific, Inc., a successful small business that performed on a four-year Cost-Type SBIR contract for SPAWAR. Falmouth's problems stared with its initial proposal, in which Falmouth failed to apply G&A expenses to its three project subcontractors. In the first year of contract performance, DCAA "informed the company that it was required to apply G&A to its subcontractors and it would have to redo the invoices it had submitted on the contract to that point. Falmouth worked with DCAA to revise its prior payment requests." (Internal citations omitted.)

Why would DCAA tell Falmouth that it had to apply G&A to its subcontractors? It's not particularly clear. The notion that government contractors are required to use a Total Cost Input allocation base for G&A expenses has been dead for more than 30 years. Of course, perhaps Falmouth had an accounting policy or procedure, or practice, that described its G&A expense allocation base—and perhaps that G&A expense allocation base *was* TCI. But there was nothing that required Falmouth to apply G&A expense to its subcontractors unless it had *chosen*
to do so. Nonetheless, apparently Falmouth agreed with DCAA that G&A expenses should be applied to its subcontractors, because it subsequently revised its previously submitted invoices. Thus, Falmouth was committed to applying G&A on a TCI allocation base (even though, presumably, its SBIR proposal had been priced without such an application and was therefore going to burn through contract funding faster than the parties had anticipated.)

But just two years later, Falmouth and the government reached a deal that *retroactively approved use of a G&A expense allocation base that excluded subcontractor costs*
, and also capped the allowable G&A expense rate. At that point, presumably, the past two

years of invoices needed to be revised once again.

At that point, one might well wonder exactly what Falmouth's G&A expense allocation base was. Was it Total Cost Input, or Value-Added, or perhaps even Single Element? We don't know but we hazard a guess that Falmouth didn't really know, either. In the first two years of contract performance the company had *three separate G&A expense allocation bases*, which of course meant three separate G&A expense rates. And that third rate (whatever it was) had been capped by mutual agreement. It must have been a nightmare for the Program Manager to get a handle on the budget and to comply with the Limitation of Cost and/or Limitation of Funds clauses in that SPAWAR SBIR contract.

Let's agree that there was a big red flag that Falmouth had indirect rate calculation problems.

At some point the company hired a former DCAA auditor to assist it with its problems. The results of that hiring decision were a bit mixed, in our view.

Between 2009 and 2011, Falmouth submitted five years' worth of proposals to establish final indirect cost rates (commonly known as "Incurred Cost Proposals"). This tells us that they didn't submit their proposals when they were required to do so (in accordance with the 52.216-7 clause in their contract). Perhaps the company didn't know that such a proposal was required until DCAA (or their ex-DCAA auditor consultant) told them. Evidence once again that the small business didn't know what it didn't know.

Further, it's a bit unclear what G&A expense allocation base Falmouth used in those proposals, since two of them were submitted prior to the contract modification that established a G&A expense allocation base that excluded subcontractor costs. If they used an allocation base that was subsequently revised by mutual agreement, they may have been required to withdraw and resubmit their final billing rate proposals using a different G&A allocation base. Or not. We really don't know; but if you're thinking the whole situation sounds chaotic, you're on the same page as we are.

Surprising nobody who has experience with the back-office administrivia associated with government contracts, "DCAA's evaluation … identified numerous problems with Falmouth's financial management of its G&A and subcontract costs. After a second iteration, DCAA's

analysis concluded that Falmouth received overpayment of $118,810 for its indirect costs for the contract. … Further DCAA analysis of the allowable cost limits in Falmouth's contract reduced its allegation of overpayment to $100,611.88." (Internal citations omitted.)

Importantly, the foregoing was communicated to the DCMA Administrative Contracting Officer (ACO) via a Memorandum and not a formal audit report that would have been subject to GAGAS. Apparently, DCAA found Falmouth's proposals to be inadequate for audit. That finding, if it was made, would be consistent with the situation as we are picturing it, years later and miles away from Falmouth's headquarters.

Apparently, the DCAA finding was not the result of performing audit procedures; the finding came from application of a 20 percent decrement factor to both direct and indirect costs. (This is a thing that DCAA can do, though we believe that the audit agency currently applies a 16 percent factor, which is really not significantly better.) Readers may be interested to note that when DCAA applied such a factor in an audit report subject to GAGAS, the DOD Office of Inspector General found such a factor to be a violation of GAGAS. (See **this article** , in which we quoted the OIG as writing, "The auditor did not obtain sufficient evidence to conclude that the subcontract costs were unsupported … [and] the field audit office applied an arbitrary and unsupported 20-percent decrement factor to calculate the questioned costs.") But while asserting an arbitrary decrement factor is a GAGAS violation if included in an audit report, apparently it's just fine to include such a factor in a Memo to a Contracting Officer, which is not subject to GAGAS. We're willing to bet the small business didn't really understand the nuances of GAGAS compliance.

Let's talk about the DCAA assertion. $100,000 may not seem like a lot of money to a bigger business, but to a small business that's a huge amount. Thus, the parties negotiated and, eventually, agreed that Falmouth owed the government $83,295, which was a decent reduction but still quite a lot for a small business to swallow.

The agreement that Falmouth owed $83.3K was duly executed but, apparently, Falmouth was still a bit confused about next steps. There was some back-and-forth correspondence that including the following bit:

As you know FSI is a small company and cash flow is a significant issue for us. In previous discussion [sic] between you and I when I agreed to accept the rate settlement you indicated that a long term penalty and interest free payment plan was possible in this kind of situation.

This was one of the main reasons I agreed to accept the settlement and not contest it further. [Falmouth] requests that the payment be amortized over 5 years. Please call me to discuss or let me know what we need to do.

Thus, Falmouth sought to pay the $83.3K over five years, interest free. That goal was not attained.

In May, 2016, Falmouth received a Contracting Officer Final Decision (COFD) and a demand for payment in full. Falmouth reacted by undertaking the following actions: (1) submitted a deferral request, (2) submitted a request for an installment payment plan, and (3) filed **an appeal** with the ASBCA.

With respect to the appeal, Falmouth alleged that the dispute stemmed from a DCAA assertion that Falmouth's accounting system was inadequate plus "untimely, inconsistent and erroneous guidance from DCAA auditors during the contract performance periods." Okay. As we've stated publicly, getting guidance from DCAA regarding your contract costs is a lot like getting guidance from the IRS regarding how much taxes you owe. You certainly *can* rely on such guidance, but we suspect one does better by consulting tax preparation professionals. In addition, DCAA auditors are not supposed to actually provide guidance to the contractors under audit. Something about independence ….

With respect to Item #2 (the installment plan), Falmouth did receive a three-year payment plan from DFAS. Along with the payment plan came a promissory note stating "that Falmouth 'will pay' DFAS $83,294.88 plus interest at 1.875% and a penalty on its 'indebtedness under' the contract." (Internal citations omitted.) The interest-free and penalty-free goal was not part of that installment plan. Falmouth signed the promissory note anyway.

With respect to Item #1 (the request for payment deferral), it appears that Falmouth thought that signing the promissory note was a part of the deferral request. Spoiler: it wasn't.

With all that, the Board granted summary judgment in favor of the government. The decision did not give the government victory because Falmouth had signed the promissory note (as the government first argued), but the decision was for the government on the basis that the parties had entered into a bilateral agreement "which effectively established an agreed-upon figure

owed to the government." In other words, when Falmouth negotiated and agreed upon final rates that led to a situation where it owed the government money on its cost-type SBIR contract (based on application of the agreed-upon rates and the agreed-upon contract rate caps), and when Falmouth actually executed that agreement, at that point Falmouth had effectively agreed with the government's position—and all the complaints about bad DCAA auditor advice were simply irrelevant.

Though the negotiations began because of the DCAA audits and were informed by them, the agreements do not rest upon them. Instead, they are a product of the negotiations of the parties as contemplated by FAR 52.216-7, which is incorporated into the contract. … Falmouth's generalized argument that there was no meeting of the minds between the parties because the rate agreements did not include the bottom-line number of the amount owed fails because the agreements specified what was required (the rates) and Falmouth well knew what the exact consequences of agreeing to those rates would be.

(Citations and footnotes omitted.)

Falmouth is a small business and it learned a hard lesson. When it signed its SBIR contract, it should have realized the back-office compliance requirements associated with cost-type contracting. But it didn't realize what was required; we continue to believe the company simply didn't know what it didn't know.

A hard lesson, and also an expensive one.