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THE NEWSLETTER FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

BDO KNOWS: GOVERNMENT CONTRACTING

BDO'S EXECUTIVE CONFERENCE: CURRENT STATE OF DCAA AUDITS

By William Keating

On April 30, over 200 people attended BDO's inaugural Executive Conference on the Defense Contract Audit Agency (DCAA) to discuss the unique challenges and opportunities when it comes to government procurement. BDO's Government Contracting practice invited industry professionals engaging with the DCAA in a variety of capacities to provide their perspectives on DCAA audits as well as the current government contracting environment.

The following overarching themes emerged from the conference to drive the day's discussion:

The State of the Government Contracting Industry

Speakers addressed the current trends they are observing in today's government contracting environment, focusing on the opportunities in this space. Despite sequestration and the fluctuating priorities of federal agencies, government contracting professionals feel the industry is poised for continued growth. One thing that has remained constant is the fierce competition over defense contracts as the Pentagon tightens its belt, especially around weapons systems, force posture reconfigurations and redeployments of troops abroad.

While the defense industry remains a reliable customer for contractors, professional services and information technology (IT) are two sectors also seeing formidable growth. Technological advancements have also been shaping federal contracts, with innovation bringing new solutions and services to the marketplace and forcing the government to put a higher value on IT procurement.

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According to The ***New York Times***, in fiscal year (FY) 2013, federal agencies used FedBid, an online marketplace for government contracts, to award about $1.8 billion in contracts.

A government investigation has found that the State Department has incomplete files or is missing files for more than $6 billion in contracts over the last six years, reports the ***Associated Press***.

According to a survey by ***Lohfeld Consulting and Market Connections***, 31 percent of government contractors said their revenue declined more than 10 percent in 2013 because of sequestration and the federal shutdown.

In FY 2013, all federal agencies met their small business contracting goals for the first time in seven years, according to ***Government Executive***.

Overall federal contracting fell from $516.3 billion in FY 2012 to $462.1 billion in FY 2013 cites a recent ***Bloomberg Government*** study of top contractors at 24 agencies.

Federal travel spending in FY 2014 through March reached about $2.8 billion, compared to almost $3.4 billion through March of FY 2013, according to data from the ***General Services Administration***.

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DCAA AUDITS

However, the government IT space currently lacks skilled technology personnel to adapt to the rapid pace of change in the industry. Right now, the IT workforce is comprised of 10 times as many employees over the age of 50 as under the age of 30, which may lead to a skills gap as older employees work to adapt to new technologies and keep pace with their younger counterparts. In addition, college graduates with the desired technology skill sets continue to pursue private sector opportunities instead of public service, creating talent shortages and fierce competition for recruitment.

Best Practices for DCAA Audits

As DCAA audits are unique to the government contracting industry, it is important for businesses—large and small—to know how to develop working relationships that lead to successful outcomes for both parties.

Before the audit even begins, businesses should prepare by doing their homework and reading all the necessary materials, such as the DCAA Audit Program, Contract Audit Manual and Memorandum for Regional Director's Audit Guidance Memos, to understand all aspects of the process upon which they are embarking. This preparation helps businesses to be better equipped to know what questions to ask and what guidelines to follow throughout what is a highly complex process. For example, before an audit, companies can ask the auditor to provide a detailed entrance conference that addresses the planned scope and duration of the audit. Companies can even request more senior DCAA personnel, such as a supervisory auditor or technical specialist, to provide guidance on more complicated audits.

During the audit process, contractors shouldn't be afraid to ask questions. If the auditor is asking for irrelevant materials, companies should request that they lay out what audit steps they are trying to complete. In doing so, the company can not only better understand their auditor's thinking, but also help direct the auditor toward more suitable and illuminating materials. Less experienced auditors, or those who are unfamiliar with certain business systems, may need this additional assistance and information to better guide their audit process. In turn, auditors should communicate their findings throughout the process to avoid surprises at the end.

Cooperation between a contractor and their DCAA auditor is key. If an auditor requests access to certain information, businesses should respond in a timely manner and have supporting documents for cost claims and estimates readily available. But auditors should also allow adequate time for businesses to respond to those requests, as they may take some time to put together. Contractors also need to remain alert throughout the process and make sure they appropriately manage access to their key personnel.

When the audit is complete, the exit conference is crucial. If businesses disagree with the outcome, they shouldn't hesitate to ask for a rebuttal and escalate any issues. However, they should understand the reasons behind the assessment to inform their response. If necessary, contractors should bring in outside help. Although outside consultation can be expensive for small businesses, it's far less expensive than losing a contract.

Statute of Limitations – DCAA Audit Issues

If contractors do decide to escalate any issues from their audit outcome, it's important they understand the Statute of Limitations (SOL). According to the SOL, a party has a limited amount of time to bring up a claim. Prior to the enactment of the Federal Acquisition Streamlining Act of 1994, the government contracting industry lacked a clear, consistent framework for statutes of limitations. While the passage of the legislation has helped lend clarity to the process, case law in this area is still developing and contractors must navigate the claims process cautiously.

The statute of limitations for government contracts is six years from the claim accrual date, or the date when all events associated with liability are officially known. Some degree of monetary damage must have been incurred before the liability can be fixed and a claim accrued, but claimants are not required to have affixed a specific sum to those costs. However, determining when an injury is officially known requires more precision. A contractor's (or, in some cases, the government's) first hurdle is determining the date of accrual by examining the legal basis of the claim, and then determining when a reasonable party should have known it had a claim (as opposed to making a subjective judgment as to when it *actually* knew it had a claim).

Contractors must carefully understand how DCAA touchpoints impact the date of accrual for any claims they may make. For example, waiting until you have a DCAA audit report in hand should not be the guide for determining the date of accrual, as a contractor may reasonably know that some injury occurred before the report is issued, even if it is not clear how much that injury cost. Contractors should also be aware that the date of accrual is not contingent upon the Contracting Officer's actual knowledge, and that various intervening events, such as settlement negotiations, do not delay claim accrual.

Similarly, contractors need to be aware how the SOL affects the government's ability to assert a claim. Many incurred cost proposals (due six months after a contractor's fiscal year end) have been submitted more than six years ago and have yet to be audited by DCAA. In such circumstances the government's ability to question these old incurred costs may be limited by the SOL.

Given the complexity of assessing the claim accrual date and the evolution of legal precedent related to SOLs for government contracting, contractors are well-advised to retain experienced legal counsel as soon as they suspect they may have a claim.

Overall, the government contracting industry continues to provide opportunities for businesses as federal agencies will always be in need of services and products. However, first-time contractors should be prepared for the eventuality that they will be subject to the complex and time-consuming process of a DCAA audit. As long as contractors think of the government as their customer *and* their partner, *and* manage company interaction with DCAA oversight, they will be poised for success.

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I'LL SELL YOU MY BUSINESS TODAY IF YOU PAY ME TOMORROW: THE BENEFITS OF A ONE-DAY NOTE IN A SALE TRANSACTION

By Meredith Pilaro, tax senior director and Jeffrey Schragg, tax partner, BDO USA

WHEN OWNERS AND THEIR CLOSELY HELD BUSINESSES LOOK TO COMPLETE A SALE TRANSACTION, THEY FACE AN ENORMOUS BALANCING ACT.

They must complete due diligence and construct agreements to benefit their business and employees' welfare, while trying to ensure they are fairly compensated for their own work in making the business successful. Tax planning often becomes a late consideration for many sellers as they assume that while maximizing their top line may result in higher taxes, it will also provide a better outcome at the end of the day. Although there is some truth to this, the devil is often in the details, and a stock purchase agreement is no exception.

Let's take a look at a typical Section 338(h)(10) transaction for an S corporation. The initial Letter of Intent (LOI) specified that the corporate stock would be purchased for an estimated price contingent upon results of due diligence, and this was agreeable enough that the parties moved forward. Now that the draft stock purchase agreement is circulating for review among the parties, there is a small section about halfway through the document that states the seller will consent to a Section 338(h)(10) election. By agreeing to this election, the seller is taking a part of the capital gain that the LOI contemplated and turning it into ordinary income. This will double the tax rate on a portion of the income to be reported by the seller and could eliminate a big chunk of the projected net proceeds from the sale.

Fortunately, this type of arrangement has been around long enough that most sellers and advisors know to look out for it. However, let's take the scenario a step further and look at a possible planning idea. Sellers are typically looking to maximize the cash received at closing and minimize escrow holdbacks and earnouts, particularly if their control over the company's operations will be reduced post-transaction. In a Section 338(h)(10) transaction, a deemed sale of assets is followed by an immediate liquidation of the company, which occurs at the end of the day of the sale for tax purposes. As such, any proceeds received on the day of the sale will result in the gain being part of the final S corporation return, and the gain will flow through to the shareholders on their Schedule K-1. For many multistate government contractors, the gain will also go to all of the state returns where they do business and could result in additional entity-level taxes or pass-through income (particularly if the state has a higher individual rate than the shareholder's resident state).

Shareholder basis is another tax consequence of gain flowing through on the Schedule K-1. When a shareholder recognizes income from the company that passed through on the Schedule K-1, the income increases their

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ONE-DAY NOTE

basis. Basis is important in the sale transaction because it is a major factor in computing capital gain. If the cash payment at closing is high and the gain passes through, you now have a significant increase to basis, which will offset proceeds received in the future and, in the case of escrows and earnouts, that is typically between one to three years after closing. In installment reporting for federal tax purposes, you prorate your basis across the payments as they are received. If your later earnout payments are never received, you need to wait until the end of the earnout period to write off any remaining basis, which now results in a capital loss to the extent there are no capital gains to offset. Excess capital losses will be deducted at $3,000 per year.

To avoid this result, it may be beneficial to introduce a one-day note to the transaction. With a one-day note, no cash is paid at closing. Rather, the one-day note is retired the day after closing, and therefore is not part of the final S corporation tax return. Consequently, the shareholder's basis is lower, and the risk of "lost" capital losses is lower. Often sellers are skeptical of this approach, as they think this type of treatment must be scrutinized by the Internal Revenue Service. However, neither the total amount nor character of gain recognized changes. However, what *does* change is the timing of recognition. This type of arrangement was addressed by the Tax Court in Rushing v. Commissioner (441 F2d 593(1971)).

EXAMPLE:

Assume seller A owns 100 percent of cash basis corporation T and enters into an agreement to sell her stock to P and make a Section 338(h)(10) election. The sale occurs on May 31, and P pays A $1 million in cash at closing and $2 million subject to earnout provisions to be payable in Year Two if earned. Corporation T's assets consist of Accounts Receivable of $200,000.

Result: T reports $200,000 of ordinary income and $800,000 of capital gain income on Schedule K-1 to A. A's basis, previously zero, is now $1 million. She reports the sale of her stock on the installment method and picks up an additional $666,600 of capital gain. In Year Two, assuming the full $2 million is earned, $1,333,400 in capital gain is reported on A's individual return.

However, if the earnout is not earned, $666,600 of basis is still available to offset capital gain income that is not earned. Therefore, A has a capital loss of this same amount and may have to take that as $3,000 each year –over 222 years!

Here are the results if the $1 million was paid the day after closing instead: the $200,000 of ordinary income still comes through on the Schedule K-1, but without capital gain, resulting in basis of $200,000. A still reports using the installment method, and picks up $933,300 of capital gain. In Year Two, if the earnout is earned, $1,866,700 of capital gain is reported. If it is not, $133,300 is the remaining basis and capital loss; an amount that is far more likely to be able to be used by the taxpayer.

Again, the total income and character in each situation is the same: $200,000 of ordinary income and either $2.8 million of capital gain (if the earnout is earned) or $800,000 of capital gain if it is not.

Naturally, it is a concern to hand someone your company without any payment whatsoever. It is common to ask for assurances, such as a standby letter of credit or some other guarantee from an independent third party. Care must be taken in the form of the arrangement in order to avoid constructive receipt. The value and benefit of the one-day note should be discussed in detail with your tax advisors.

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REGULATORY UPDATES

Report to Congress on Fiscal Year (FY) 2013 Activities at the Defense Contract Audit Agency (DCAA)

DCAA published its 2013 annual report to Congress on March 24, 2014. In the report, DCAA discusses its audit performance, the challenges it faces and other audit issues.

In 2013, DCAA completed a total of 6,259 audits examining $163.1 billion in contract costs. The table below shows the breakdown of completed audits by type and amount of questioned or unsupported costs.

In order to prioritize its audit efforts, DCAA focused on the "highest-payback areas to DoD: the war fighter and the taxpayer." It decided to focus on audits related to Overseas Contingency Operations (OCO) and Forward Pricing. DCAA was able to audit $30.2 billion for OCO and made a recommendation of about $1.4 billion in reductions.

Incurred Cost audits were still a primary area of focus in FY 2013. In FY 2012, DCAA established Incurred Cost audit teams. DCAA reflects in the report that these teams were highly active in FY 2013 and, as a result, reduced the incurred cost backlog. The report states that the number of Incurred Cost audits completed in FY 2012 and FY 2013 totaled 12,724. It is still unclear if this amount includes inadequate proposals that were sent back to contractors. DCAA auditors will review initial Incurred Cost submissions received to determine if the submission is adequate and in accordance with FAR 52.216-7. If the submission is deemed not adequate, it is returned to the contractor for correction and resubmission.

DCAA notes a few areas where it has experienced challenges during the audit process, in particular:

- Difficulty in obtaining sufficient commercial pricing documentation from prime contractors for its subcontracts
- Denial of access to contractor internal audit reports, contractor employees and online data in contractors' systems

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REGULATORY UPDATES

While DCAA does note that Forward Pricing Rate Proposal Adequacy was an issue, the recent implementation of the proposal adequacy checklist into DFARS 215.408 with a solicitation provision at DFARS 252.215-7009 has resulted in improvement, and DCAA believes that the checklist will continue to provide efficiency in this area.

The Inspector General has begun conducting an external peer review of DCAA. This report will provide an independent assessment of the current quality level of DCAA audits and is expected to be completed in Q3 or Q4 of this year.

DCAA Audit Guidance Memorandum – Treatment of Delinquent Final Indirect Rate Proposals

On Feb. 3, 2014, DCAA issued a memorandum instructing audit teams to immediately discontinue the practice of sending late notification letters to the contracting officer, except for the 30-day overdue notification letter.

As part of actions for calendar year 2014, headquarters policy will furnish a memorandum to DCMA with a list of contract fiscal years (CFYs) ending in 2011 or earlier for which it has not received a final indirect rate proposal (>18 months over). DCMA plans to either:

- Obtain an adequate proposal, or
- Unilaterally establish contract costs as authorized in FAR 42.703-2(c)(1) and FAR 42.705(c)(1).

Policy will coordinate with various Field Audit Offices to determine a reasonable method for identifying and including proposals that DCAA considers inadequate for audit on the annual list furnished to the responsible contract administrative agencies.

DCAA Audit Alert – Risk Factors Associated with Grouping, Pegging and Distribution within SAP Software

On Jan. 30, 2014, DCAA issued a memorandum to provide increased awareness of risk factors associated with Grouping, Pegging and Distribution (GPD). GPD is a component of SAP software, and therefore, is only applicable at contractors that have implemented SAP.

Audit teams have identified weaknesses/risk factors in the SAP system GPD performance to include:

1. Premature Billing of Material Costs
2. Billing Material in Excess of Contract Requirements
3. Material Title Passed to Government
4. Audit Trail
5. Costs Assigned to Closed Work Orders

GPD could affect specific audit assignments:

- **Material Management Accounting System (MMAS)** – prescribed in DFARS 252.242-7004(d).
- **Progress Payments and Cost Vouchers** – There is a potential for material and associated costs to move from one cost objective to another cost objective within the same group.
- **Forward Pricing** – Configuration of the contractor's GPD could result in the redistribution of material and labor costs to open and closed work orders (items shipped and completed).

After coordination with the DCMA and DCAA Legal, it was determined that GPD reallocation of material parts is CAS 411-compliant. It was determined that the reallocation is a material transfer issue. The preamble to CAS 411 recognizes that CAS 411 should not govern costs of material transfers; therefore, the CAS Board removed the provision concerning cost of transfers of material between cost objectives.

Proposed FAR Rules

Case 2013-022: Extension of Limitations on Contractor Employee Personal Conflicts of Interest; DoD, GSA and NASA are proposing to amend the FAR to implement a section of the National Defense Authorization Act (NDAA) for FY 2013 to extend the limitations on contractor employee personal conflicts of interest to apply to the performance of all functions that are closely associated with inherently governmental functions and contracts for personal services. By extending contractor employee personal conflict of interest limitations, the proposed rule further enforces government policy that requires contractors and subcontractors to:

- identify and prevent personal conflicts of interest of their covered employees; and
- prohibit covered employees who have access to non-public information by reason of performance on a government contract from using such information for personal gain.

Type of Audit	Number of Audit Reports	Questioned Cost (Millions)	Unsupported Costs (Millions)
Forward Pricing	1,316	$11,731	$20,477
Special Audits	1,898	$791	N/A
Incurred Cost	1,899	$3,214	N/A
Other Audits	1,146	$299	N/A
Total	6,259	$16,035	20,477

Note: Any potential cost discrepancies identified by DCAA in the case of Incurred Cost Audits, Special Audits and Other Audits are classified as "Questioned Costs," where the contractor has not provided adequate documentation to support a claim about the actual costs it has incurred.

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REGULATORY UPDATES

Final DFARS Rules

Case 2013-D010: Enhancement of Contractor Employee Whistleblower Protection; effective Feb. 28, 2014. DoD has implemented statutory amendments to whistleblower protections for contractor and subcontractor employees. The rule applies to all entities, small and large, at the prime and subcontract level. Regardless of the size of the business, a whistleblower employee must be protected from retaliation by his/her employer.

Case 2013-D009: Acquisitions in support of Operations in Afghanistan; effective Feb. 28, 2014. The DoD implemented two sections of the NDAA, sections 826 and 842. Section 826 requires compliance with 10 U.S.C. 2533a for the purpose of production of uniforms components supplied by DoD to the Afghan National Army or the Afghan National Police. Section 842 eliminates the applicability of acquisition of products and services from Iraq that were required in section 886 of the NDAA for FY 2008. The impact of this ruling will directly benefit domestic sources.

Case 2011-D045: Performance Based Payments; effective March 31, 2014. The rule amends the DFAS to provide requirements for the use of the performance-based payments (PBP) analysis tool. The PBP analysis tool is a cash-flow model for evaluating alternative financing arrangements and is required to be used by all contracting officers contemplating the use of performance-based payments on new fixed-price type contract awards. Requests for a PBP should not be administratively difficult. Information requested should be readily available via the contractor's accounting system. In addition to requests for cumulative value and total cost incurred to date, the contracting officer can request access to the contractor's books and records in order to administer this clause. Contracting officers must consider the adequacy of the contractor's accounting system for providing reliable cost data to support the performance-based payments.

Interim DFARS Rules

Case 2012-D029: Disclosure to Litigation Support Contractors; effective Feb. 28, 2014. DoD is amending the DFARS to implement authority for DoD to allow its litigation support contractors to have access to "sensitive information." The intent of the rule is to allow litigation support contractors, with DoD authorization, access to information that may be considered sensitive or non-public. The provided information would solely be used for the purpose of providing litigation support services to DoD.

Other

Executive Order 13658 of Feb. 12, 2014
The President of the United States has established a minimum wage for contractors. Beginning Jan. 1, 2015, the hourly minimum wage paid by contractors will be $10.10. Annually, the minimum wage will be reviewed and either remain unchanged or increase by the annual percentage described in the Consumer Price Index for Urban wage earners and Clerical Workers.

The Secretary of Labor shall issue regulations by Oct. 1, 2014. Once regulations are in place, the Secretary shall have the authority for investigating potential violations and obtaining compliance.

PErspective in Government Contracting

The government contracting industry is in a state of recovery. While the federal budget was approved in late 2013, the industry is still healing from 2013's budget uncertainties and sequestration. One sector particularly affected is the U.S. defense industry. According to the National Law Review, in Q1 2014, a number of major U.S. defense contractors reported earnings declines tied not only to sequestration and budget cuts, but also to the withdrawal of U.S. military forces from Iraq and Afghanistan.

Historically, private equity has played a significant role in the defense industry. From 2004 to 2013, the private equity sector invested more than $30 million in 358 U.S. aerospace and defense companies, according to PitchBook. However, the pace of private equity spending has slowed over the past year. Given the industry's declining earnings, many private equity firms who invested in defense contractors years ago are holding off on exiting their investments in the hope that valuations will increase, reports the Washington Post.

As the federal budget solidifies, the question remains whether private equity funds will continue to pursue new investments in the U.S. defense industry.

For the optimistic, several emerging trends may lead to industry recovery in the next few years. International expansion into new regions, although requiring significant capital and time commitments, could ultimately lead to new opportunities. The development of "next generation" defense technology, such as data analytics and unmanned combat vehicles, could lead to industry growth. Finally, acquisition and consolidation of weaker companies could be an opportunity for new investment. Additionally, for private equity funds that focus on distress, the current environment provides a significant opportunity to buy in at lower multiples and to potentially reap the reward when valuations begin to rise again.

PErspective in Government Contracting is a feature examining the role of private equity in the government contracting industry.

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JUNE 2014

June 4-6
12th Annual Emerging Infectious Diseases + Biodefense*
Almas Temple Club
Washington, D.C.

June 5
2014 Akamai Government Forum: The Next Generation of Cloud and Security
Renaissance Hotel
Washington, D.C.

June 9
Masters Academy: Best Practices in Government Contracting
Nash & Cibinic Center for Excellence in Government Contracting
Washington, D.C.

June 24
Northern Virginia Technology Council's 2014 Hot Ticket Awards*
Redskins Park
Ashburn, Va.

* Indicates that BDO is sponsoring and/or speaking at this event.

JULY 2014

July 21-22
National Association of Government Contractors' DCAA Audit & Compliance Boot Camp
InterContinental Chicago
Chicago, Ill.

July 29-31
InsideNGO's 2014 Annual Conference "Sustaining Excellence in a Changing World"*
Walter E. Washington Convention Center
Washington, D.C.

AUGUST 2014

August 7
ChallengeHER – Opportunities for Women in Federal Contracting
GSA Conference Center
Chicago, Ill.

August 13
Public Contracting Institute's Price & Cost Realism
Nash & Cibinic Center for Excellence in Government Contracting
Washington, D.C.

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