

# What Commercial Firms Must Know When Pursuing Stimulus Money

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Your firm has no choice. The commercial marketplace has dried up and it needs to generate revenue to survive. So it makes a strategic decision to pursue federal work (under the various Government Stimulus Packages) on a Commercial Items (CI) basis under Federal Acquisition Regulation (FAR) Part 12, "Acquisition of Commercial Items." Of course, your firm is aware of the many shocking stories of federal contractor fraud and abuse and you wonder how your firm can avoid these "pitfalls" of government contracting with all the recent laws creating layers of oversight and investigative bureaucracy. And, just like magic, this article appears and navigates you through "best practices" and key CI requirements when dealing with the federal government.

Before we get into recent legislation impacting all government contractors and key CI requirements, let's first consider the organizational structure of the entity pursuing the CI federal work. From a "best practices" perspective, firms should insulate the federal contract portion of the organization from the non-federal portion so that all potential post-award financial audit risks associated with federal contracting and the cumbersome government compliant infrastructure and systems requirements reside in one entity. More importantly, if a company is publicly traded, it should consider the potential impact on its stock price and investors if the government group is suspended or debarred from government work.

Usually, organizations achieve this insulation by establishing a separate legal entity whose sole mission is to sell goods and services to the federal government (and/or state and local governments). This federal entity should be a separate and distinct legal entity, both in substance and form (i.e., a wholly owned subsidiary of the firm). It will need an independent Board of Directors, executive team, Federal/Tax Identification number, D&B number, CAGE number and financial statements. If such a legal structure is not feasible, then the firm should at least establish a separate business unit for all of its government work that has its own set of financial statements and executive/senior management team.

## Recent Federal Procurement Regulations

### ***Ethics and Mandatory Disclosure Rule***

Recent legislation passed that involves two CI procurement areas: Contractor Business Ethics Compliance Programs and Disclosure Requirements. Effective December 12, 2008, FAR Clause 52.203-13, "Contractor Code of Business Ethics and Conduct" requires contractors, if receiving a federal award of \$5 million or more with a period of performance of at least 120 days, to ensure that:

1. Its employees understand that integrity and ethical values cannot be compromised. As such, from a "best practices" angle, your firm will need an integrity

and ethics program that, at a minimum, includes: (a) orientation and formal acknowledgment by employees, (b) ongoing ethics training for all employees, (c) written Codes of Conduct/Ethics Policies and Procedures (P&Ps); and (d) periodic reviews of company practices, procedures, and internal controls for compliance with standards of conduct.

2. Its self governance program results in timely reporting of procurement violations. Again, from a "best practices" perspective, your firm will need a self governance program that, at a minimum, includes: (a) internal audit program (see Point 3 below), (b) posting of DOD Hotline Poster by the Inspector General (IG) and/or internal hotline, and (c) written P&Ps for reporting violations that provide for the timely reporting to government officials (IG and Contracting Officer (CO)) of any suspected violation of law in connection with government contracts or any other irregularities. In addition, your firm's P&Ps must provide for cooperation with any government agencies responsible for investigations of suspected law violations. Also, your P&Ps must ensure no management intervention and/or overrides of suspected violations.
3. Its P&Ps require internal and/or external audits of its ethics/self governance programs and accounting systems. As such, your firm will need an internal/external audit program that, at a minimum, includes: (a) a description of who conducts these audits, (b) types of audits, (c) frequency of audits, and (d) what processes exist for taking corrective action.
4. This clause is flow-down to subcontractors meeting the \$5 million and 120 days criteria.

More importantly, under this recent rule a contractor can be suspended or debarred for a "principal's failure to timely disclose to the government in connection with an award, performance or closeout of a contract or a subcontract credible evidence of: (a) potential violations of certain federal criminal laws relating to procurement fraud, conflict of interest, bribery, or gratuities; (b) violations of the civil false claims act; or (c) the existence of significant overpayments on contracts." The Mandatory Disclosure obligations exist until three years after final payment on any government contract awarded to the contractor meeting the \$5 million and 120 days criteria.

As a vital point to consider, firms selling on a CI basis to the government will, at a minimum, need to evaluate the impact of this Mandatory Disclosure Rule on their financial statements (i.e., FASB #5, Contingencies) as well as implement an effective ethics compliance program. So in order to reduce risk

of noncompliance with this cumbersome Mandatory Disclosure rule, a firm should establish an internal control system with the purpose of maintaining integrity and efficiency of the processes related to these Disclosure/Reporting rules per FAR 3.10 and FAR 52.203-13. The factors the internal control environment must consider are integrity, ethical values, and competence of the employees and the degree they reflect your firm's Code of Business Ethics and Conduct (Code); the Senior Management's philosophy and operating style and how they reflect the values promoted in the Code; and the attention and direction provided by the Senior Management in conducting activities necessary to implement and carry out the policies and procedures in the Code.

### **American Recovery and Reinvestment Act of 2009**

Office of Management and Budget (OMB) made similar mandatory disclosure requirements applicable to cooperative agreements and grants funded under the American Recovery and Reinvestment Act of 2009 (Recovery Act). In a February 18, 2009 Memorandum to all Heads of Agencies and Departments, OMB states the following "include the requirement that each grantee or sub-grantee awarded funds made available under the Recovery Act shall promptly refer to an appropriate IG any credible evidence that a principal, employee, agent, contractor, sub-grantee, subcontractor, or other person has submitted a false claim under the False Claims Act or has committed a criminal or civil violation of laws pertaining to fraud, conflict of interest, bribery, gratuity, or similar misconduct involving those funds."

If that wasn't enough, the Recovery Act created a new Recovery Accountability and Transparency Board to coordinate and conduct oversight of covered funds to prevent fraud, waste, and abuse. The Board consists of numerous IGs and the Recovery Act appropriated \$84 million for this new Board as well as millions of dollars to various other Agency IGs. Also, the Recovery Act created a "Recovery Independent Advisory Panel" that is tasked with coming up with recommendations on how best to prevent fraud, waste and abuse. And if that oversight isn't enough, the Recovery Act issued some interim rules, effective March 31, 2009, that: (a) mandate quarterly reporting by contractors of their use of Recovery Act funds as well as for large contractors (i.e., \$25 million or more in annual gross revenues from federal contracts and 80% or more from Recovery Act funds), the names and total compensation received for each of the five most highly compensated officers for the year in which the contract was awarded; (b) establishes protections for whistleblowers of employers that receive Recovery Act funds and expands the definition of whistleblower actions to include gross mismanagement or waste of Recovery Act funds; and (c) broadens audit rights to records and access to personnel for contractors and subcontractors receiving Recovery Act funds

by the Government Accountability Office (GAO) and the IGs. Not to be overlooked during this period of extreme government oversight and contractor accountability, the Treasury Department enacted similar mandatory disclosure and anti-fraud, waste, and abuse rules under its TARP Conflicts of Interest Rule, effective January 21, 2009.

We do realize that the abundance of "stimulus money" is a great relief during a downward commercial economy but with all the "federal procurement strings" attached to government funds, we just wanted commercial firms to be aware of the complexity of government contract compliance and the increased level of government oversight.

### **Methods for Selling Commercial Items (CI) to the Government**

The most common methods for selling CI to the government are: (a) CI Firm Fixed Price (FFP) basis; (b) CI Time and Materials (T&M)/Labor Hour (LH) basis; or (c) GSA Schedule basis. If your firm plans to sell to the Government under a FFP proposal and it does have a Federal Acquisition Regulation (FAR) basis for an exception to cost or pricing data requirements (i.e., adequate price competition, Commercial Items/GSA Schedule pricing for its labor category hourly/daily rates, SF 1449 supporting its commercial hourly services sales for the past 12 months, prices set by law or regulation, etc.) as cited in FAR 15.403-1(b), "Exceptions to Cost or Pricing Data Requirements" for its services, then the Government's audit rights would be limited to: (a) examining the validity of your firm's basis of exception to cost or pricing data, (b) determining if your firm's labor category mix is realistic/reasonable for the Scope of Work (SOW) and, (c) determining if the level-of-effort/hours are sufficient to deliver the services. The government's audit rights do not extend to cost or profit information unless the firm's exception is found to be inaccurate, noncurrent or incomplete in some way.

Negotiating with the government on a CI FFP basis highly reduces the financial post-award audit risk for a firm and requires the least amount of back-office/infrastructure support for ensuring compliance with government procurement regulations. This would be the preferred method of negotiating service type contracts with the government assuming that the Scope of Work is well defined and the level of effort can be reasonably estimated.

If your firm plans to sell to the Government under a T&M proposal, then FAR 52.216-31 (FEB 2007) "directs the Prime Contractor to state in the proposal whether the fixed hour rates proposed apply to: the prime, subcontractors; and/or divisions, subsidiaries, or affiliates of the prime." The contractor is free to choose, all at prime's rates, separate rates, blended rates, or combination. In addition, for a T&M proposal based on an

exception to cost or pricing data as discussed above, the Government's audit rights would be limited to: (a) examining the validity of the firm's basis of exception to cost or pricing data; (b) reviewing Human Resource (HR) records to verify that employees invoiced under certain labor categories meet the contractual labor category qualifications (i.e., job functions/duties, work experience, and education); (c) verifying hours billed against actual hours worked through time sheets, labor distribution reports, and payroll records; and (d) the other specific audit rights listed under FAR 52.232-7, "Payments Under Time-and-Materials and Labor-Hour Contracts" clause. This T&M/LH clause is also included in GSA Schedule awards. Basically, this clause gives the government specific audit rights relating to:

### **Labor Invoice Documentation**

The firm will need to support its billings (including any subcontractor hours reimbursed at the hourly rate in the contract) by evidence of actual payment and by: (a) individual daily job timekeeping records; (b) records that verify the employees meet the qualifications for the labor categories specified in the contract; or (c) other substantiation approved by the CO. Also, as support for a T&M audit, the firm will need: (a) original timecards, (b) timekeeping policies, (c) labor distribution reports, and (d) employee access to verify proper charging through interviews. This invoice documentation requirement flows-down to subcontractors if they are being invoiced as labor hours.

### **Labor Hour Recording System**

From a best practices standpoint, the firm will need, at a minimum, a time reporting system (these guidelines apply to electronic timesheets, too) that:

1. Tracks and segregates direct versus indirect hours/labor
2. For direct hours/labor, tracks by project name, number, or other job specific identifier
3. Matches employee names/projects to billing rates and labor category classifications
4. Reconciles to the G/L (i.e., payroll) on a monthly basis
5. Tracks the date the labor charges were incurred
6. Posts transaction references so that original time sheets can be easily found
7. Is augmented by adequate time reporting policies and procedures that require: (a) daily posting of timesheets, (b) updates of job listings that provide descriptions and account numbers for direct and indirect efforts, (c) preparation by the employee and approval by a supervisor, and (d) employees to make corrections/changes to their timesheets only with written explanations, their initials, and re-submittal for supervisory approval and finance and accounting processing

### **Material Invoice Documentation**

Material means ... "subcontracts for supplies and incidental services for which there is not a labor category specified in the contract; and ODCs (e.g., incidental services for which there is not a labor category specified in the contract, computer usage charges, etc.)." For government audits of material, your firm will need copies of material invoices, agreements, and documents supporting payments of actual material costs. Under T&M contracts, the government does not pay profit or fee to the prime contractor on material costs.

Negotiating with the government on a CI T&M/LH basis reduces financial post-award risk for a firm but requires more back-office/infrastructure support for ensuring compliance with government procurement regulations as described above. Some would argue this point but this method would be preferred over GSA Schedule contracting if the commercial firm does not have adequate internal controls dealing with the price reductions clause discussed below.

### **GSA Schedule Awards**

The General Services Administration (GSA) describes its GSA Schedules Program (or Multiple Award Schedules and Federal Supply Schedules) as one that establishes long-term (up to 20 years) government-wide contracts for goods and/or services with commercial firms. GSA Schedules offer government agencies direct delivery of millions of state-of-the-art, high quality commercial supplies and services at volume discount pricing. Currently, there are 48 types of GSA Schedules and some of the services GSA Schedules include are financial and business solutions (FABS), advertising and integrated marketing solutions (AIMS), language services, human resources, professional engineering services (PES), mission oriented business integrated services (MOBIS), and environmental services.

According to GSA, getting on a GSA Schedule is simple and fast, and commercial firms can quickly begin selling to the federal government. This is true as long as the contractor understands a few risk areas in the GSA Schedule Program, the key one being the Price Reductions Clause. The "Price Reductions Clause (PRC) requires a commercial firm to agree to the: (a) basis of award customer(s), (b) Government's price or discount relationship to the basis of award customer(s), and (c) fact that this relationship shall be maintained throughout the contract period." Thus, any change in a firm's commercial pricing or discount arrangement applicable to the identified basis of award customer(s) that disturbs this relationship shall constitute a price reduction. Basis of award customers are classes of customers such as: (a) commercial end users, (b) national accounts, (c) educational institutions, (d) state and local governments, (e) value added resellers, (f) dealers/distributors, and so on.

A price reduction by a commercial firm applies to GSA purchases if the firm: (a) revises its commercial pricelist downward and this pricelist was the basis for GSA Schedule award, (b) grants more favorable discounts or terms/conditions than those used as the basis for GSA Schedule award, or (c) grants special discounts that disturbs the price/discount relationship of the government to the “basis of award” customer(s). If any of these situations occur, a firm has 15 days to notify the government and reduce its GSA pricelist and refund the government customers back to the same effective date as extended to the basis of award customer(s). Failure to comply with the PRC clause results in monetary damages as well as civil and criminal prosecution.

GSA clearly states that there shall be no price reduction for sales: (a) to commercial/basis of award customer(s) under firm, fixed-price definite quantity contracts with specified delivery in excess of the maximum order threshold specified in this contract; (b) to eligible ordering activities under this contract, or (c) caused by an error in quoting or billing, provided adequate documentation is furnished by the firm to the Contracting Officer.

Looking at the GSA Schedule Department of Justice (DOJ) cases, one notes that most of the DOJ settlements or court wins are related to PRC noncompliance. If a commercial firm is international and has decentralized sales and marketing operations, the PRC becomes extremely complicated to comply with and requires internal controls starting from the sales quote process all the way through the invoicing/payment process.

Another risk area when dealing with GSA Schedules is the “Price Adjustment-Failure to Provide Accurate Information” clause. This clause requires commercial firms to disclose “current, accurate, and complete” pricing information when negotiating any GSA Schedule pricing. This includes a firm’s: (a) response to the GSA Schedule Solicitation, contract, or otherwise requested data by the government during negotiations and, (b) commercial pricelists, discounts, customers, etc. disclosed in their Commercial Sales Practices Format. Under this clause, “the offeror and/or contractor grants the CO or an authorized representative the right to examine, at any time, before award (can be extended to two (2) years after award or modification); books, records, documents, papers, and other directly pertinent records to verify any request for and exception to the requirement for cost or pricing data and the reasonableness of prices.”

What all this means is that any information relied upon by GSA to establish Schedule pricing that is “defective” will result in reductions to prices on the Schedule and more importantly, the contractor shall be liable to the government for any overpayments and simple interest. In addition, under this clause, the government also has the right to terminate the

contractor for default. Again, if a commercial firm is international and has decentralized sales and marketing operations, this clause becomes extremely complicated to comply with and requires adequate internal controls relating to sales/pricing information.

One final “gotcha” point when dealing with GSA Schedules: be fully aware of the post-award audit rights by the GSA IG found under the “Examination of Records by GSA Multiple Award Schedule” clause. According to this clause, “the contractor agrees that the Administrator of GSA or any duly authorized representative shall have access to and the right to examine any books, documents, papers, and records of the Contractor involving transactions relating to this contract for over billings, billing errors, compliance with the Price Reductions clause, and the Industrial Funding Fee and Sales Reporting clause of this contract. This authority shall expire three (3) years after final payment. The basis contract and each option shall be treated as separate contracts for purposes of applying this clause.”

We have known many companies who thought the GSA Schedule was identical or very similar to a real commercial contract. To be honest, that is the way GSA and others in the government sell this Program to commercial firms. But we wanted you to know that is not 100% true and there could be some financial post-award risk associated with any GSA Schedule contract.

We hope this article provides informative guidance and some best practices for Commercial Items acquisitions related to Government Stimulus programs and funds.

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