DCAA Updates “Information for Contractors” Guide

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Redstone Government Consulting, Inc.

The Defense Contract Audit Agency (DCAA) issued a June 2012 version of its on-line “Information for Contractors” guidebook, a publication designed to educate the government contractor as to DCAA audit expectations during cost and pricing audits.

The new release comes more than seven years after the last update (January 2005). Primary changes include implementation of more recent DCAA policies; changes, additions, or deletions to the dialogue to either emphasize or de-emphasize certain contractor responsibilities, and verbiage clarifications as well as content reorganization.

The new pamphlet includes six “Enclosures” (replacing the former “Chapter” content identification), and topics covered by the first six enclosures parallel the narrative in the 2005 manual, except that Chapters 7 & 8, “Contract Types” and “Forms”, respectively, have been removed from this updated edition.

No significant changes worthy of discussion are noted in Enclosures 2 and 4; hence the revisions we believe are most important to government contractors are included within the other Enclosures, and are discussed as follows:

Enclosure 1—Introduction to DCAA

DCAA eliminated previous verbiage stating that its professional standards are those of the AICPA incorporated into the Government Auditing Standards; in place of that verbiage, the pamphlet clearly holds the General Accepted Government Auditing Standards (GAGAS), which incorporates selected AICPA guidelines, as the professional standards under which it performs its duties.
Added sections to this enclosure including specific regulatory criteria for “Records Retention” with emphasis on contractor responsibilities for making that data available to the government regardless of form (written vs. electronic). In addition, revised narrative implicitly mandates the submission of audit documentation and cost presentations in electronic form, although not required by regulation; principal reason for requiring contractor electronic data is that the DOD has mandated DCAA “move toward a paperless environment”. To DCAA’s credit, Enclosure 1 also adds DCAA Regional contacts if and when contractors have issues with the audit process, and encourages resolution of problems at the local level. Strangely enough, the emphasis on electronic data is at odds with ongoing DCAA audits where the auditor documentation requests are insisting upon “originals” (hardcopy) and rejecting scanned (electronic) copies.

Enclosure 3—Price Proposals

DCAA significantly overhauled this section by expanding the “DCAA Audit” and “Examples of That DCAA May Request” discussion, while removing the FAR 15.408, Table 15-2 proposal submission criteria (now is simply referenced in “Requirements for Submission” paragraph), and largely eliminating types of forward pricing audits offered as well as audit responsibilities in the Integrated Product Teams (IPTs).

The “DCAA Audit” discussion is amended to implement current DCAA policy for conducting the audit, such as performing a proposal walk-through and a formal adequacy review before audit commences. One glaring addition to this section is a paragraph stating that the contractor is solely responsible for providing adequate supporting data to justify reasonableness, thus a challenge to contractors to have their support ready before the audit.

The access to records discussion has been expanded from a couple of lines to two paragraphs. The revised access to records dialogue stipulates that audit requested documentation, as well as access to contractor personnel, must be provided in a “reasonable” period of time, or DCAA will expeditiously notify the responsible Government personnel that a formal denial of access to records exists. DCAA still believes that the access to records clause includes contractor personnel in spite of the fact that no regulation includes contractor personnel within the definition of “a record”. Finally, within the examples of data request monologue, DCAA expands audit expectations and contractor responsibilities for supporting out-year indirect rates to include an “analysis of the impact on its rates based on its long range forecast/strategic plan”. Translated, DCAA expectations for some type of long range planning which is then utilized to create the forecasted rates ignoring the fact that nothing in FAR Part 15 has this explicit requirement.

Enclosure 5—Contract Financing and Interim and Final Vouchers

Major revisions include the removal of the detailed criteria for direct billing privileges and an expansion of the introduction to include added FAR 52.216-7 (Allowable Cost and Payment clause) criteria for billing on an interim basis, e.g., accrued direct costs, pension plan contributions, etc.

Enclosure 6—Incurred Cost Proposals

Principal changes include the replacement of previous “Model Incurred Cost Proposal” mandatory and supplemental schedules with those schedules explicitly required (as of May 31, 2011) within FAR 52.216-7(d); revisions to reflect current policies on coordination with contractor, and; addition of verbiage regarding supporting documentation, subcontract management, and changing cost accounting practices.

Within the “Audit Evaluation” narrative, DCAA has included a statement that continuous coordination between auditor and contractor will ensure timely resolution of issues, and upon completion of the audit, DCAA will provide the results to the contractor in writing—previous pamphlet stated a copy of the draft report would be handed to the contractor. Further, DCAA added verbiage stating that significant audit findings will have been discussed during the audit process, hence the exit meeting should be short and sweet—although on-going incurred cost proposal audit findings should be provided during the audit, in actual practice that is rarely the case.

The revised guidebook also includes new paragraphs that discuss the FAR 31.201-2(d) contractor responsibility for maintaining adequate data to demonstrate that costs were incurred, and are allocable and allowable; requirement for contractors to continually evaluate its indirect cost allocation practices to determine if changes are required (FAR 31.203(e)) and notify the CO and DCAA of planned changes prior to implementation (correction here—notification of
changes in cost accounting practices are not required under regulations unless CAS (Cost Accounting Standards) are applicable), and; the prime contractor’s responsibilities for sufficient subcontractor management, which is a separate and new section entitled “Responsibility of Prime Contractors Over Subcontracts”.

Because this updated publication is not yet available in Barnes and Nobles book stores, nor can you order through Amazon.com, government contractor compliance geeks interested in absorbing this mind-tingling edition will have to pull up the DCAA website, www.dcaa.mil.

The New Challenges Coming from DCAA’s Restarting Audits of Indirect Cost Rates for ICPs

By Michael E. Steen, CPA Technical Director at Redstone Government Consulting, Inc.

The DCAA’s (Defense Contract Audit Agency) annual program plan for its fiscal year (FY) 2012 included the long-awaited announcement that DCAA would be restarting its incurred cost audits (audits of contractor Incurred Cost Proposals or ICPs submitted by contractors six months after the end of a contractor fiscal year (FY) as required by FAR 52.216-7). DCAA’s initiative to reduce this incurred cost audit backlog is to be accomplished through virtual audit teams which are nothing more than dedicated resources or teams whose audit assignments will not be limited to any particular contractor or geographical area (“virtual” audit teams somehow gives this a high tech sound although it is a very basic and long-standing operational strategy deployed by everyone except DCAA until now).

As with all good news coming from DCAA, there is the “bad” which comes with the good. The “good” is that ICP audits will ultimately yield final rates for a contractor FY, thus allowing the cost and other flexibly-priced contracts to be closed (finally). The “bad” is that contractors, many with “old” years going back to the 2004-2005 timeframes, will find themselves with new and unexpected challenges including the following:

- DCAA requests for contractor “data dumps” (e.g. all general ledger transactions for all expense accounts, with subsets for direct costs and indirect costs). DCAA may also request that contractors filter out certain transactions (offsetting debits and credits, such as accruals and the reversing entry) as well as providing the data in a spreadsheet (specifically, Excel). These requests are to facilitate DCAA’s use of statistical sampling (variable sampling discussed in DCAA open audit guidance, 11-OTS-001, January 3, 2011, available at www.dcaa.mil). Although most contractors will not have a problem generating the data dump, providing the actual source documentation going back several years will be the challenge (as discussed in the following subparagraphs).

- DCAA, in its excessive-compulsive desires to absolutely comply with government auditing standards (GAGAS), now requires its auditors to test massive numbers of transactions wherein the auditor must drill-down from job cost ledger, to subsidiary ledgers (e.g. labor distribution reports), to labor entry documentation (e.g. timesheets), to payroll registers and ultimately to cancelled checks. Additionally, DCAA may or more likely will be requesting personnel files or employment contracts asserting that the absence of “all of the above” results in a risk that the employees did not exist (AKA “phantom employees”). Oddly enough, there is nothing in FAR 31.205-6 (compensation) which requires or even alludes to such detailed and specific wage or salary documentation requirements, but nothing in FAR deters DCAA auditors from their requests for multiple forms of documentation to support “a” cost. When contractors lack or cannot locate DCAA’s interpretation of the required documentation, the result is significant amounts of direct and indirect labor costs being categorized as unallowable. In many reports, DCAA’s assertion is based upon the identical FAR reference, 31.201-2(d) “a contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation adequate to demonstrate that costs claimed have been incurred, are allocable to the contract and comply with applicable cost principles” (DCAA auditors with sleep disorders have in fact been heard muttering this statement while asleep). Contractors who have never experienced significant cost disallowance issues will now join the fray thanks to DCAA’s misapplication of FAR 31.201-2(d).

- As a subset of DCAA’s demands for multiple forms of documentation supporting “a” cost, DCAA is now challenging incentive or bonus compensation on the basis that the “basis for the award is not supported” (FAR 31.205-6(f)(2)). As with all other documentation challenges, DCAA is greatly expanding the terminology insisting that contractors provide
employee performance evaluations as if the performance evaluation is mathematically tied to the basis for the individual employee bonus compensation (in most cases, the incentive compensation is a flexible plan which has certain measurable parameters coupled with the statement that the company reserves the right to determine the amount of the overall funding for incentive compensation and to determine the amounts payable/paid to employees). Noting that DCAA has been less than timely within initiating or completing its incurred cost audits and also noting that DCAA never requested the level of detail as now required, few contractors can now provide all documentation for “old years” for all employees leading DCAA to question incentive compensation for specific employees or in the most severe cases, to question incentive compensation in its entirety.

- DCAA is also ignoring FAR Subpart 4.7 Contractor Records Retention, within DCAA’s demands for access to records such as employee time sheets and cancelled payroll checks. Although the records retention generally requires contractor records to be retained for three years after final contract payment, subpart 4.705 stipulates more limited retention periods for specified records. For example, clock cards or other time and attendance cards need only be retained for 2 years after the end of the year of the transaction. Hence, FY2005 clock cards or time sheets need only be retained until the end of FY2007. As a matter of policy, DCAA ignores the records retention clause because in DCAA’s view, compliance with GAGAS apparently requires certain documentation although FAR subpart 4.705 explicitly does not require such information be retained. Historically (prior to DCAA FY2009), DCAA adhered to the records retention FAR clause, but apparently FAR is now viewed as merely a guideline and not a regulation.

Although DCAA’s aggressive policies are purportedly to protect the taxpayer, we believe that DCAA’s primary objective is to protect DCAA by over-reporting audit exceptions and reporting those “cost questioned” statistics in annual reports to Congress (DCAA’s first annual report to Congress was issued on March 31, 2012). As is already an ongoing process, DCAA’s failure to accurately read or apply the FAR has resulted in an increase in contractor actions invoking the CDA (Contract Disputes Act) and thereby delaying final rates for years while issues are resolved in litigation. By all measures, DCAA simply ignores the “collateral damage” caused by its misreading the regulations and overly expansive and administratively expensive audits as long as DCAA is never found to have issued an audit which fails to comply with GAGAS.

**CBCA Renders Surety Bond Costs Directly Allocable to DOE Contract**

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Redstone Government Consulting, Inc.

The Civilian Board of Contract Appeals (CBCA 2260) rejected the Department of Energy’s (DOE) argument that the prime contractor (URS) payment of $7.8 in settlement costs to a subcontractor (GIT), resulting from a U.S. District Court judgment, were unallowable and not allocable as a direct cost to the URS contract which gave rise to the prime contractor/subcontractor litigation. In addition the CBCA also deemed the litigation costs incurred by URS for defending itself against the GIT counterclaim for breach of contract as well as costs for appealing the adverse judgment as allowable.

URS terminated for default a subcontract with GIT because it was dissatisfied with the subcontractor’s performance, and GIT sued the prime contractor for damages, after which a judgment was determined in favor of the subcontractor in the amount of $5.6 million. URS, with the approval of DOE, sought to stay judgment pending an appeal of the initial ruling, but in order to secure a stay until the appeal, URS had to obtain a $7 million surety bond which guaranteed payment of that amount by the Surety to the subcontractor in the event of a final judgment against URS.

Upon conclusion of the new trial, the Court’s decision went against URS with a $15.6 million judgment to GIT, but the value was later reduced in an appeal to an undisclosed amount by the U.S. Court of Appeals for the Tenth Circuit Court. The Surety subsequently paid to GIT a portion of the final judgment, equal to $7.8 million which included the original bond value plus interest. In reducing the judgment amount, the Tenth Circuit in its 2008 decision stated that costs awarded to GIT were reasonable, allowable and allocable under the Federal Acquisition Regulations.

In accordance with the indemnity agreements with the Surety, URS reimbursed the Surety for the total $7.8 million. In turn, URS submitted an invoice to the contracting officer for
payment of $7.8 million under the prime DOE contract in which
the court action arose; the CO rejected payment first on the
basis that no specific contract clause authorized
reimbursement of the indemnity obligation, and later that costs
were unallowable because bankruptcy proceeding initiated by
URS earlier terminated the URS’s obligation for payment to
GIT. URS subsequently filed a claim and appealed the CO
decision.

The CBCA disagreed with DOE and stated that costs pursuant
to its indemnity obligation were allowable under the terms of
the DOE-URS contract; the settlement/indemnity costs are
allocable as direct costs to the specific DOE prime contract
under FAR 31.201-4 inasmuch as there is an indisputable
nexis between the costs and the specific work of one contract,
and; costs are allowable within FAR Part Cost Principles.

In determining if settlement costs were allowable, the CBCA
decision brought in dialogue from an earlier ASBCA case,
Hirsh Tyler Co, ASBCA 20962, 76-2, which affirms concepts of
operating in a commercial market place where defense of
lawsuits by third parties are often an ordinary and necessary
function of a business, meaning that legal costs incurred to
defend itself, including settlement costs, are reasonable and
therefore allowable, as long as such actions are not expressly
prohibited within an “exclusionary cost principle” and the
contractor acted responsibly.

The court stated, “legal defense and settlement costs are
unallowable only when the FAR expressly disallows such
costs” or when such costs were similar or related to an
unallowable activity. Essentially, the court recognized that
third party civil law suits are not addressed by FAR 31.205-47,
Legal Costs, notwithstanding other decisions where the courts
have rendered legal costs unallowable related to a civil action
when contract terms bringing in federal statutes were deemed
to have been violated. The decision of allowability thus falls
back to the “reasonableness” concept.

The court explicitly noted that URS legal expenses incurred in
defending itself against the GIT’s counterclaim and appealing
the adverse jury verdict, at the direction/approval of the
Government, are allowable (reasonable).

DFARS Rule Makes it Tougher to
Justify One Bid as Competition

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at
Redstone Government Consulting, Inc.

The Department of Defense issued a DFARS rule effective
June 29 which essentially overrides the FAR Part 15.403
provision that allows rendering a single bid as “competitive”
under certain circumstances without explicitly requiring a cost
or price analysis of that single offer. The proposed rule could
significantly impact the manner in which government
contracting officers or contractor procurement departments (for
subcontracts) categorize proposals as competitive or non-
competitive, and the most obvious impact to contractors will
be:

- For prime contracts, unanticipated DOD contracting
  officer requests for cost or pricing data in situations
  wherein the contractor had assumed to be in a
  competitive bid with minimal data requirements
- For subcontracts, more extensive documented cost
  and price analyses for sole-source offers even if
  contractor RFPs were meant to be competitive.

The DFARS change was implemented as part of the DOD’s
“Better Buying Power” initiative to bolster competition, and in
planting regulatory seeds for promoting competition, it also
recognized that a single offer could not “constitute adequate
price competition” without certain due diligence processes.
The provisions of FAR 15.403-1((c)(1)(ii) allow the definition of
“adequate price competition” to include a single bid as long as
the offer was submitted with the expectation of competition,
the determination that the price was based on competition is
reasonable, and that the decision to accept the sole bid as
“competitive” is approved at a level above the contracting
officer. Within the context of this one parameter for deeming a
single bid as “competitive”, there is no explicit FAR Part 15
requirement for any further cost or price evaluation.

The DOD/DFARS, however, makes it clear in DFARS
215.371-3(a) & (b) that the FAR Part 15 one-bid scenario is
not adequate competition unless cost or price analysis is
performed and an official at one level above the contracting
officer “approves that the price is reasonable”; DFARS 215-
371-3(b) specifically states that assuming there is no decision
to re-solicit the bid (due to lack of sufficient time for offerors to
reply, e.g., less than 30 days, the contracting officer must
either (1) conduct a cost or price analysis of the single offer price to prove the price equates to a value that would justify that adequate price competition exists as to that offer, or (2) obtain cost or pricing data for evaluation.

Contractors most susceptible to being governed by this provision and blending the impact of this new rule within its procurement practices are those highest at risk for a purchasing system review (e.g., CPSR). Nonetheless, we encourage any government (DOD) contractor that frequently deems the one-bid scenario as competition to revise its practices to include that any sole vendor bid be subjected to a cost or price analysis even when solicitations were issued to many vendors with competition as the objective.

**DPAP Memo Limiting Labor and Overhead Rates on Contracted Services**

*By Michael E. Steen, CPA Technical Director at Redstone Government Consulting, Inc.*

In its June 6, 2012 Memorandum to DOD agencies, DPAP (Defense Procurement Acquisition and Policy) issued a class deviation limiting negotiation objectives for labor rates and overhead rates for contracted services. The limit, which will be reflected in contracting officer pre-negotiation memorandums, states that for contracts or task or delivery orders awarded to a contractor in (government) fiscal year (FY) 2012 or 2013, the labor rates and overhead rates shall not exceed those paid the contractor for the same or similar contract services performed under contract with the procuring DOD component in FY 2010.

The DPAP class deviation also provides for written approval by the Secretary of the Military Department or Head of the Defense Agency for contracts, task or delivery orders awarded in FY 2012 or 2013 that calls for continuing services at an annual price that exceeds the annual price paid for the same or similar services in FY 2010.

These limitations were required by section 808 of the National Defense Authorization Act for FY2012 and may appear to be driven by cost reduction initiatives; however, a full reading of section 808 would suggest that the sponsors are more directly attacking outsourcing (services performed by contractors as opposed to government employees). In particular section 808 also requires the elimination of contracted services for inherently governmental services and the reduction by 10 percent per fiscal year (in each of FY 2012 and 2013) the funding for staff augmentation contracts and contracts for the performance of functions closely associated with inherently governmental functions.

It is all too obvious that the sponsors of section 808 are intent on making it difficult to outsource regardless of any factors which would justify outsourcing. It will be difficult for contractors to continue these service contracts at FY2010 rates when normal inflationary increases will have caused labor rates to increase by five to ten percent from 2010 to 2012/2013. Overhead rates, which are a function of increasing prices/inflation and a contractor’s business base volatility, may or may not have increased; hence, limiting overhead rates to FY2010 rates may serve no real purpose if a particular contractor has experienced sufficient growth in its business base. For example, if a contractor has doubled its business base, thus its overhead allocation bases, the overhead rates will most likely have substantially decreased making the section 808 overhead rate limitations somewhat meaningless. Unfortunately, the opposite occurs when a contractor’s business base shrinks, making it fiscally impossible for a contractor to avoid financial losses if it were to accept labor and overhead rates limited to FY 2010.

Slightly confusing the issue, the section 808 requires high level approval when the negotiation of FY2012 or 2013 contract price will exceed the FY2010 price which implies that a contracting officer can negotiate a reduced level of services (i.e. lower contractor hours in FY2012 vs. FY2010) at higher rates (than FY2010) to yield a total price which does not exceed FY2010. In other words, start with a pre-negotiation position which complies with that section 808 limitation (labor and overhead rates at FY2010 or below), but negotiate higher and presumably fair and reasonable rates that would be applied to fewer contractor hours.

As with too many cases, the sponsors of a public law, by treating overhead rates the same as labor rates (i.e. increase solely as a result of inflation), tend to oversimplify the economic factors which ultimately impact overhead rates. This continuously displays itself when Congress stretches a weapon system and/or reduces the number of units (e.g. aircraft) and Congress cannot comprehend why the unit prices increase. In the case of section 808, its sponsors really don’t care about the “math”, the objective is to make it more difficult, or in some cases impossible, to outsource.
DOD Considers Redefining “Commercial Items”

By Darryl L. Walker, CPA, CFE, CGFM, Technical Director at Redstone Government Consulting, Inc.

The Department of Defense is floating a proposal that the definition of “commercial item” be more narrowly defined and limited to existing products or services that are actually sold, leased, or licensed in the commercial marketplace, which would effectively limit that definition to commercial off-the-shelf items, services or supplies that are clearly based on competitive prices, or sold through traditional commercial catalogue avenues. The notion being discussed is effectively eliminating the “of a type” verbiage from the definition in FAR 2.101, thus closing loopholes that allow broad interpretations of items that could be commercial using a vast array of presumptions and qualifications.

Although the proposed change has not been included within the 2013 National Defense Authorization Act (NDAA) for Senate or Congressional consideration, the fear is that DOD and legislators may nonetheless entertain a change in the definition at a later time.

If the definition is narrowly defined as discussed above, concerns arise that certain services or products offered in the future, which are currently categorized as commercial, would lose that barrier from having to produce cost information to support their price. For example, the definition encompasses items for which “minor modifications” have been made to hardware of software ordinarily of a commercial nature, where such modifications do not “significantly alter the nongovernmental function or essential physical characteristics” of the original commercial product. Were the definition to be more restrictive, “altered” items may lose the commercial item classification.

Critics are quick to point out that technology advances occur so quickly that products are sometimes obsolete by the time they are available to the commercial market place. Should such items be rendered noncommercial, thus requiring added contracts administrative effort for selling to the government (e.g., added regulations, submission of cost or pricing data, audit oversight, etc.), the added administrative burden required to administer government contracts for those items may be cost prohibitive.

Reducing the portal through which government contractors are able to sell their “commercial items”, if executed via revised regulations, will create a lot of grief for companies who were formerly able to broaden their business base and increase contributions for government spending. Equally troublesome, prime contractors will be forced to attempt to obtain cost or pricing data from subcontractors who have never provided anything other than a commercial price.

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Instructors
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- Darryl Walker
- Scott Butler
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