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# GCA DIGEST

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## GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

*(Editor's Note. With the cessation of the Wind2 survey we used to summarize each year we were very happy to find a few years ago Grant Thorton's Annual Government Contractor Industry Survey that benchmarks primarily professional services firms. The 15<sup>th</sup> Annual GT survey for 2009 provides a variety of very useful information. You can contact the firm at 703-847-7515 to purchase a copy of the survey.)*

### ◆ Company Profile

83% of the approximately 120 surveyed firms are privately owned, 9% are publicly traded and 8% are not-for-profit concerns. 48% of the companies are classified as large and 52% as small where 24% had sales less than \$10M, 12% between \$10M-20M, 24% between \$20M-50M, 18% between \$50M-100M and 22% over \$100M. 34% of respondents have been in business between 1-10 years, 28% for 11-20 years, 19% for 21-30 years and 19% over 30 years. The vast majority of surveyed companies sell professional services – consulting, IT, research, engineering, general business services, science and technology, training and education, other services - while less than 5% sell products. The primary customer of the respondents is the federal government where 90% of their revenue comes from that source. 63% of their revenue came from the Defense Department, 28% from other federal agencies, 5% came from state and local government and 4% was commercial. The results confirm the truism that though the commercial sector has experienced major business disruptions government contracting remains a growth industry where 50% of respondents had increased revenue over the prior year, 30% had no significant change while 20% had reductions. Surveyed companies are very optimistic about business prospects over the next three years where 69% anticipated increased revenue from the federal government. 69% see their increases coming from prime contracts, 61% from subcontract federal business, 23% from state and local government, 26% from the domestic private sector and 12% from the international private sector. Interestingly, 65% expect no significant revenue increase from the impact of the stimulus program over the next 18 months, 33% expect a modest increase while only 4% expect a significant revenue increase.

### ◆ Indirect Headcount Breakdown

14.6% of total headcount is represented by management and support functions with the following breakdown of functions: finance and accounting (2.9%), human resources (1.3%), IT support (2.0%), contract and procurement administration (2.2%), legal (.7%), pricing (.7%), procurement (1.35%), sales and marketing (2.2%) and other indirect (7.3%).

### ◆ Government Contracts

*Breakdown of Revenue by Contract Type.* 46% of revenue from federal contracts come from cost type contracts, 20% are fixed price and 34% are time and material, all about the same as last year. The percent of cost type contracts has substantially increased over the last few years apparently putting to rest the impression that the government is moving more toward commercial practices where fixed price or T&M contracts predominate.

*Fees.* Average negotiated fees for cost type contracts averaged 6-7%, T&M contracts had an average of 7-8% (compared to 9-10% last year) while firm fixed contracts had 9-10% (compared to 10-11% last year). It should be noted that these negotiated profit rates are computed after deducting unallowable costs and before income taxes so actual profit rates are lower than negotiated rates.

*Proposal Win Rates.* Surveyed companies stated their win rate on non-sole source proposals was 30%. Reasons stated for losing competitions was a combination of price and technical – 51%, price only – 23% and technical only – 16%.

*Bid and Proposal costs.* 75% of respondents reported spending less than \$1 million while 19% spent between \$1-2 Million.

*Claims and Identifying Out-of-Scope Work.* Identifying out of scope work, whether it comes from an easy to recognize direct change or sometime difficult to recognize constructive changes, provides an important opportunity to receive additional entitled revenue. 44% of the respondents said their procedures for recognizing out of scope work are very effective, 39% said somewhat effective and 17% said not effective. 78% of respondents said the government requests out-of-scope work either occasionally or frequently without issuing contract mods. Typical responses when asked to perform out-of-scope work is 15% always perform the work, 19% refuse while 66% sometimes performs and sometimes refuses without a price adjustment.

*GSA Schedules and ID/IQ Contracts.* The use of IDIQ contracts and GSA Schedule contracts have increased substantially. When the GSA schedule is based on commercial pricing (as opposed to a cost buildup) companies must designate a target customer or category of customers required under the Price Reductions Clause (PRC) where contractors must notify the GSA of all special discounts offered to the targets where either they must offer the same discounts or justify why the special discounts are not offered to the GSA (contrary to popular belief, offering of a discount to a non-target client is not covered by the PRC.). 27% of respondents do not generate any revenue from such contracts while 20% generate 1-10% from GSA or other IDIQ contracts while the remaining 53% generate, on average, 50% of their revenue from them. 36% of the companies said their GSA contracts were priced on a cost basis (compared to 47% last year) while 65% used commercial pricing (compared to 53% last year). As for who their target customers were, 45% said all commercial customers were (compared to 51% last year), which is neither advisable nor required – generally, the fewer the better.

### ◆ Financial and Cost Statistics

*Profit.* Contrary to common public perceptions, government contracting does not generate abnormally high profits. 31% of surveyed companies had profit rates between 1-5%, 40% between 6-10%, 12% between 11-15% and 3% above 15%. 14% of respondents reported no profit. These figures would be diminished after deducting interest and taxes.

*Fringe Benefit Rates.* Fringe benefit pools consist of payroll taxes, paid time off, health benefits and retirement benefits (some include bonuses while others do not). Fringe benefit rates as a percentage of total labor averaged 35% when bonuses were included and 33% when excluded.

*Overhead Rates.* These costs are considered to be in support of direct staff working directly on contracts and hence are normally allocated as a percentage of direct labor costs. Some companies include fringe benefits associated with direct labor in the direct labor base while others do not – the result when they do is to lower overhead rates. Average overhead rates are as follows: (a) on-site direct labor (on-site means performed at company sites) - 69% compared to 81% last year (b) on site direct labor and fringes – 48% compared to 51% last year (c) off-site direct labor – 47% as opposed to 49% last year (off-site is lower because facility related costs are normally borne by the customer at their facilities) (d) off-site direct labor and fringes – 18% compared to 17% last year. When companies used multiple overhead rates logic used for them were location (30%), labor function (53%), customer (13%) and products versus services (4%).

*G&A Rates.* The survey states that general and administrative rates are typically those incurred at the headquarters and include executives, accounting and finance, legal, contract administration, human resources and sales and marketing. G&A costs are most often allocated to contracts on total cost input (direct operating costs, overhead, material, subcontracts) or a value added base that generally includes all the above costs except material and/or subcontracts. Average G&A rates under a total cost input was 13% (11% last year) while those using a value added cost input was 15% (same as last year).

*Material handling and subcontract administration costs.* 23% of surveyed companies used a material handling/subcontract administration rate as a burden chargeable on material and subcontract costs. The survey notes that in service industries a handling rate is established in conjunction with use of a value added G&A base to reduce burden applied to pass-through subcontract and material costs. Average material handling rate was 3%, subcontract administration rate was 4% and combined was 3.5%, identical to last year's results.

*Service centers.* Certain functions that support the company are accumulated in separate pools and then charged to users (e.g. clients, indirect cost pools) on a pre-established allocation method. The most frequently used service centers are facilities (used by 46% of the respondents), information technology (34%), human resources (21%) and printing/publications (13%).

*Labor multipliers.* Multipliers, a term commonly found in the commercial world, are fully loaded labor multipliers used to price out work and are derived by dividing total burdened labor cost by base labor cost.

The average labor multiplier was 2.1 for on-site work and 2.0 for off-site work (compared to 2.4 and 1.8 last year). Almost all respondents expressed a belief their labor multipliers were competitive with their industry. It should be pointed out that the labor multipliers are overall averages where many companies commonly use different multipliers for different markets.

*Uncompensated overtime.* (Editor's Note. *Uncompensated overtime refers to hours worked exceeding the normal 40 hour work week by those salaried employees exempt from the Fair Labor Standards Act.*) 62% of respondents said their employees work uncompensated overtime while 38% said no. 74% of the companies use total time reporting while the other 26% report only 40 hours per week. 80% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 20% use a "standard/variance method" that charges an hourly standard rate and then credits an indirect cost pool for the difference between labor costs charged to projects.

*Billings for Rate Variances.* On cost reimbursable contracts, contractors bill the government at provisional indirect rates that are subject to adjustment to actual rates at year end when actual rates are determined. The difference between the two are called a rate variance. 37% reported that actual rates were higher than provisional rates (sharply lower than the 50% last year), 12% said actual rates were lower (sharply higher than last year's 6%) while 51% report no significant difference. For companies where actual rates exceeded provisional rates, 20% collected all of the variance (compared to 34% last year), 38% collected none and 42% collected some (compared to 28% last year). Reasons cited for collecting either some or none reported insufficient Client funding, customer relations, capped ceiling rates were in effect or government inefficiencies. 82% of surveyed companies said they waited for final incurred cost audits, contract closeouts or other formal approvals before billing for the rate variances while 18% billed the rate variances when the annual incurred cost proposals were made. This later figure is surprisingly low since contractors are allowed to bill rate variances as long as actual rates are submitted on time so why wait until final rates are settled where long delays are normal.

#### ◆ Dealing with the Government

The Defense Contract Audit Agency, because of their Defense Department contracts or contracts with other agencies that use the audit agency, audits most of the contractors in the survey. 53% of respondents described their relationship as good, 33% as excellent

while 14% described it as fair or poor. (The survey states the results reflect the situation through late 2008 and says deteriorating relationships with DCAA will likely result in less positive results next year.) When asked if their relationship with DCAA has changed, 81% said it had stayed the same, 3% reported the relationship had worsened while 16% said it had improved. In effort to measure the quality of relationships with ACOs and DCAA, the survey found 35% of respondents resolve issues efficiently where the remaining 65% saying the government was inefficient, 45% believe DCAA is the primary cause for delays of resolving issues while 20% believe it is the ACO. The most frequent types of costs questioned by DCAA are executive compensation (23% citing this as an audit issue compared to 18% last year), consultant costs (14%), labor charging (14%), indirect cost allocations (12%) legal expenses (6%) and employee morale (6%). Interestingly, bonuses and incentive pay are not on the list though that could be included in executive compensation. Most frequently cited violations of cost accounting standards were CAS 403, home office expenses (13% cited this as a compliance issue compared to 18% last year), CAS 405, Unallowable costs (16%, up from 11% last year), and CAS 401, consistency (16%, up from 8% last year). The survey states that it appears as if DCAA is turning its attention back to CAS compliance after paying relatively less in prior years. Of those companies experiencing audit issues, 49% were very satisfied with the resolution of the issues (up from 35% last year), 36% were somewhat satisfied (compared to 52% last year) and 15% were not satisfied.

#### ◆ Workforce Compensation and Fringe Benefits

The shortage of skilled workers has forced most companies to offer a comprehensive package of incentive compensation and fringe benefits as part of a minimum compensation package to attract needed personnel.

*Medical benefits.* In response to questions asking what percent of health benefits are paid by the company the survey results were: 1% reported the company pays for less than half, 11% pays 51-60%, 22% pay 61-70%. 14% pay 81-90% and 12% pay 91-100%. With respect to health costs as a percentage of labor costs, 10% of respondents incurred health costs less than 4% of labor costs, 9% between 4.1-5%, 12% between 5.1-6%, 14% between 6.1 and 7%, 17% between 7.1-8%, 4% between 8.1-9%, 8% between 9.1-10% and 26% over 10% of labor costs.

*410(k) benefits.* On average the company will match an employee's contribution up to 6% of their compensation and 85% of respondents reported they do not anticipate any changes in the near future.

*Wages Increases.* Surveyed companies state that the average increase was 3.0 -3.5 %, lower than last year's 3.5-4.0% figures.

*Paid time off.* 64% of companies polled paid 10 holidays per year, 6% offered 9 and 5% offered 8. None offered more than 12. Though answers were not given the last three years, 2006 results indicated approximately 49% of responding companies combine vacation, holiday and sick leave into a single personal time leave package while 47% maintain separate leave benefits for each type of leave.

*Compensation for security clearances.* 43% of respondents do not pay premiums for employees with security clearance, 46% pay premiums up to 15% while 11% pay premiums between 16-30%.

◆ **Executive Compensation**

*(Editor's Note. Care should be used if our readers consider substituting the following results for a bona fide compensation survey where hundreds of firms are surveyed. However, the results shown below are interesting.)* Surveyed companies provided information on the four highest paid executives in the company and the results are presented by company size measured by revenue for 25<sup>th</sup>, median and 75<sup>th</sup> percentiles. The following is a summary of the results.

Highest Position (in thousands)

Revenue	25%	Med.	75%
\$1-10 M	220	295	325
\$11-20M	232	300	389
\$21-50M	250	395	510
\$51-100M	375	480	650
>\$100M	450	580	950

Second Highest Position

\$1-10 M	169	242	300
\$11-20M	195	250	340
\$21-50M	220	300	380
\$51-100M	295	375	440
>\$100M	375	450	490

Third Highest Position

\$1-10 M	155	200	237
\$11-20M	177	220	242
\$21-50M	180	280	310
\$51-100M	250	325	390
>\$100M	280	380	440

Fourth Highest Position

\$1-10 M	117	150	175
\$11-20M	150	190	220
\$21-50M	160	240	285
\$51-100M	230	275	350
>\$100M	260	345	400

◆ **Charging Subcontractor Hours on T&M contracts**

We have frequently reported on new regulations that provide when subcontract labor can be charged at fixed rates provided in the prime contract and when blended or separate rates may be used. 81% (compared to 76% last year) of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract while 19% (compared to 24% last year) bill on a cost reimbursable basis (i.e. as an ODC).

◆ **Compliance and Ethics Program**

We have reported on recent new regulations requiring contractors create new ethics and compliance programs (e.g. written code of ethics 30 days after award, business ethics awareness program and internal controls 90 days after award applicable to non-small businesses). 88% of respondents conduct compliance training at least once a year while 50% conduct formal audits. 7% report there have been allegations of ethics and compliance violations. As for cost effectiveness of the programs, 48% say the new regulations are excessive and not cost effective while 50% say they are reasonable and cost effective.

**RECENT DCAA CHANGES  
GENERATE LOTS OF  
INDUSTRY OPPOSITION**

DCAA is facing a flurry of criticisms coming from many corners stemming from some GAO reports indicating DCAA audit reports either mischaracterized facts or were misinterpreted by people trying to politicize routine contracting issues. DCAA now finds itself the object of intense scrutiny

for alleged unprofessional misconduct from many corners and is implementing changes in their approach to audits. Both the attitude changes on DCAA's part that stem from these allegations and its new changes are and will continue to significantly affect contractors subject to DCAA audits.

## Background

On July 22, 2008 the General Accounting Office issued a report to Congress after receiving some complaints from certain DCAA employees at three offices in Southern California. GAO reviewed audit files and issued a highly critical report concluding DCAA had failed to comply with Generally Accepted Government Audit Standards (GAGAS). The GAO concluded (a) documentation in the work paper files did not support the audit opinion (b) DCAA supervisors dropped findings and changed audit opinions without adequate evidence for the changes and (c) sufficient work was not performed to support the audit opinions. GAO said that in its opinion DCAA was too lenient on contractors and questioned whether or not DCAA had sufficient independence from the contractors they were auditing. GAO concluded that DCAA's failures were because of a management and agency culture that focused on a production-oriented mission, which led DCAA management to establish policies and procedures that emphasized performing large quantity of audits to support contract decisions where there was inadequate attention to performing quality audits.

As a result of the GAO report, DCAA issued several new policies and procedures including (a) elimination of production metrics and implementation of new metrics intended to focus on achieving quality audits (b) established an anonymous website to address management and hotline issues and (c) revised other policies to address auditor independence and other audit issues. Several of the new policies were issued as formal audit guidelines we have reported on. These included:

1. On Dec 19, 2008 DCAA issued audit guidance on significant deficiencies, material weaknesses and audit opinions on internal control systems. The new guidance stated DCAA would no longer issue reports stating systems are "inadequate in part." The new policy is that if any significant deficiency or material weaknesses was noted, the report would include an opinion that the system is "inadequate." The new guidance also stated that DCAA would no longer include recommendations to improve the system in the audit report. Finally, the new guidance said it was not necessary to show actual questioned costs were

found to report a significant deficiency or material weakness but rather only there is a "possibility" of questioned costs.

2. On March 3, 2009 DCAA issued audit guidance on reporting suspected contractor fraud and other contractor irregularities. Under the new policy, working level auditors are authorized to make fraud referrals directly to cognizant investigators without prior discussions with or approval of the DCAA Branch Manager as was the case before.

3. On March 13, 2009 DCAA issued audit guidance on reporting significant/sensitive unsatisfactory conditions related to other government officials. The guidance provides examples of unsatisfactory conditions such as where a CO ignores audit recommendations and negotiates cost or profit that DCAA considers to be unreasonable or excessive. This situation can be reported directly to the Inspector General rather than a higher level of management at the CO's organization.

4. On July 23, 2009 DCAA issued audit guidance related to audits of contractors' code of business ethics and conduct. The guidance requires auditors to conduct procedures to address requirements of the new compliance regulations during an audit of a contractor's control environment and accounting system controls. The audit program that was developed includes audit steps to verify contractor adherence to each aspect of the compliance and ethics program e.g. assignment of responsibility, internal periodic reviews, internal reporting mechanisms of wrongdoing, disciplinary actions, timely disclosures.

On September 23, 2009 GAO issued a report summarizing their examination of several other DCAA offices beyond the three California offices and concluded that major problems existed throughout the agency. Congressional hearing were held where senators piled on criticisms of DCAA. For example, Sen. McCaskill expressed outrage at DCAA backing off from an adverse opinion about a contractor's accounting systems after the contractor objected saying there were forged supervisor signatures while Sen. Lieberman decried DCAA's "culture" of emphasizing speed over quality of its audit work. Many critical of DCAA expressed the shortage of resources for DCAA indicating the likelihood of increased supply of auditors we are already seeing. The DOD IG conducted its own review of a sample of audits citing inadequate audits of defective pricing, billing system reviews where direct billing privileges should have been withdrawn, adequate corrective actions taken

where floor checks showed deficient practices and poor documentation of forward pricing audits. Shortly after, the DCAA Director was terminated.

## Assessments of Current Conditions

Many commentators have put forth their views about the developments, most quite critical, where we have selected a few comments that illustrate their thinking. Grant Thornton addresses several areas and states the changes being implemented as a result of these actions “threaten to destroy any semblance of order or efficiency that is needed for government procurement.” They assert that in an unreasonable rush to assess blame for exaggerated claims of contractor misconduct, the role of DCAA as part of the procurement process has been forgotten. In responding too eagerly to the complaints of a few disgruntled employees the GAO has focused too much on GAGAS standards and sacrificed the critical mission of auditing a large quantify of audits to support negotiation and administration of government contracts. Now timeliness is no longer a paramount factor. DCAA will now also issue system deficiencies while not including recommended improvements and will produce audit reports where entire systems are deemed inadequate even though only one part of the system has deficiencies. Finally, all commentators states the authority of the contracting officer has been severely diluted who sees the auditor as someone to fear because DCAA auditors are now allowed to make fraud referrals with no supervisory review at all and will refer COs to the IG if it feels COs are not sufficiently considering their findings contained in audit reports.

Contrary to the rather rosy picture portrayed in the GT Survey discussed above stating contractors high satisfaction levels with DCAA, we have been observing quite the contrary in our dealings with contractors and contractor specialists. Though our evidence is anecdotal the attitude we are encountering is unmistakable – the highest level of dissatisfaction that we have seen in over 25 years. A recent article in the Nov 24 issue of Federal Contracts Report interviews several professionals serving contractors is indicative of the comments and observations we encounter in our day to day dealings with contractors, DCAA auditors and management, ACOs and professionals in the field.

Peter MacDonald of Navigant Consulting states “there has been a sharp increase in the number of episodes where DCAA auditors have made unreasonable, if not absurd, findings.” He states that

“dealing with DCAA across the board these days has become increasingly difficult for a large number of contractors across all industries and this has impaired the contracting process.” McDonald asserts COs are permitting DCAA auditors to usurp their authority as decision makers and are allowing auditors to “drive the train when it comes to enforcement.” Whereas auditors, who have no enforcement authority, used to advise COs as a member of the procurement team they are recently becoming more “confrontational”, “uncommunicative and intransigent” where now they are taking positions without even listening to contrary arguments from contractors. In addition, he said auditors are making “unsupported findings” and “reaching beyond their charter” citing an example of them recommending an Iraqi contractor drawdown contractor personnel. He also criticizes auditors’ practices citing “blanket requests for records or access to employees where there is no legal justification” as well as imposing unrealistic deadlines for providing audit requested information. He also mentions that documents that used to be perfectly acceptable are now considered inadequate which he asserts does not serve their own clients – COs – well.

Alan Chvotkin, the executive vice president and counsel for the Professional Services Council agrees that DCAA is taking a more enforcement role. A sea change in deference to DCAA findings have occurred in the last couple of years – rather than COs making independent judgments as to the significance of a DCAA findings now those findings are considered correct unless someone can prove them wrong. Chvotkin alludes to the fact that DCAA has become “hermetically sealed” from the rest of the procurement community where rather than acting as a team member to reach a good procurement result they are increasingly taking the attitude that “here is my work, you evaluate it any way you want to.”

Both McDonald and Chvotkin stress the March 2009 memo addressing DCAA’s process for reporting “unsatisfactory conditions related to actions by government officials” as a critical development. They note that the broad definitions of unsatisfactory conditions – mismanagement, failure to comply with specific regulatory requirements or gross negligence – and encouragement to report such conditions to the Department of Defense inspector general rather than going up the DCAA chain of command is strongly affecting the way procurement business is handled. McDonald states the guidance instills “a climate of fear among COs, who are often apprehensive about making decisions that their

auditor disagrees with for fear of being on the wrong side of an IG investigation.” Chvotkis is a little less worried stating there must be a pretty egregious condition but he points out that COs are now seeking legal guidance to avoid triggering investigations.

A third commentator, David Metzger of the Arnold & Porter law firm states that DCAA is overreacting and becoming more adversarial and aggressive about their findings. He focuses much of his comments on DCAA auditors’ “poor training” resulting in their inappropriate enforcement approach and making judgments they are unqualified to make. He states most “auditors” are not really auditors because that term should be applied only to CPAs who alone have the training to do full blown audits. As a result these poorly trained auditors make many mistakes asking for wrong documents, reporting wrong costs to COs and bringing up false issues. Metzger concludes that DCAA must do a better training job so their initial questioning of costs can be relied upon.

Both MacDonald and Metzger, who are lawyers, say contractors should expect disagreements with auditors to result in more litigation which will drive up contract costs. As DCAA gets more aggressive and those inadequate findings become adopted by the procurement group they will need to be litigated. To prepare for such occurrences, McDonald recommends that relevant documentation be gathered and labeled. The one point of contract policy with government auditors should be adhered to in order to minimize confusion and inappropriate communications with the government. Metzger recommends that contractors should continue to reach out to DCAA auditors and not hesitate to escalate problems within the DCAA audit chain, especially when they encounter auditors they believe are not well trained or do not understand the issues at stake. Contractors should politely but clearly state they disagree and ask for a more experienced auditor to be involved.

## DCAA’s Response

As expected, DCAA through their spokesperson Tara Rigler, has responded to many of the points raised by the three individuals cited here. She makes the following points:

1. Rigler denies that there has been a substantial move into enforcement stating DCAA’s mission is limited to providing contract audits and accounting and financial advisory services.

2. DCAA’s policy on reporting unsatisfactory conditions related to government officials’ actions “rises above simple disagreements” between the audit position and the COs position. DCAA continues to handle these matters through the government’s official management chain for resolution but adds “on some circumstances certain unsatisfactory conditions warrant an independent assessment due to the significance or sensitive nature of the matter” where now DCAA’s revised policy is to report these conditions to the DOD IG.

3. Rigler states that much of the GAO’s criticism of DCAA’s audits for the most part involve lack of sufficient testing and allowing contractors to make corrections before DCAA issued its reports resulting in deficiencies not being identified. Now, “DCAA requires better and timelier access to records” and has revised its processes and procedures to assure greater conformity to GAGAS. *(Editor’s Note. This comment explains a troubling trend we observe where contractors are no longer allowed to make even minor changes to written policies once DCAA has received them for review.)*

4. Rigler denies that DCAA auditors are poorly trained, make improper document requests or otherwise commit errors.

*(Editor’s Note. Surprisingly little comment was made on what we and many other practitioners consider to be some of the most troubling trends – both poor supervision allowing unreasonable audit opinions to surface in final audit reports and reluctance of DCAA managers to reverse a decision of one of their subordinate auditors.)*

## CASE STUDY – INDIRECT RATE ALTERNATIVES AND SHIFTING COSTS FROM G&A TO OVERHEAD

*(Editor’s Note. The following article is part of our ongoing practice to provide real life case studies from our consulting engagements that we believe will have relevance to our readers. As usual, we disguise the client name – referring to “Contractor” – and other private information. We were asked to evaluate Contractor’s indirect rate structure with respect to whether it provides the best possible indirect rates for pricing its government work, consider alternatives, conduct a quantitative analysis of viable alternatives and once the best candidate was selected, consider how expenses previously charged to one pool could be charged to another. The following is a summary of our analysis.)*

## Background Information

Contractor is primarily a professional services company with a portion of prototype work that has a mix of federal government (80%) and commercial clients. The government work is with several government departments with one large cost type contract having significant subcontract work as well as time and material and fixed price work having little to no subcontract work. Currently, Contractor has three indirect rates: (1) overhead allocated on a direct labor cost base (2) G&A allocated on a value added base consisting of all costs excluding direct material and subcontracts costs (M&S) and a (3) subcontract/material handling rate allocated on a direct subcontract and material cost base. The M&S rate is a little more than 1 percent where Contractor believes it could charge the government a higher rate if its cost structure provided for it but the government would not be happy about a G&A add-on exceeding 10 percent.

## Alternatives

We generated five alternative indirect rate structures that we believed were worthy of consideration. Though there were variations within each here is a simplified version of the alternatives:

### A. Current method.

B. *Increase handling rate.* This alternative kept the current structure but reassigned dollars to different pools. (*At this stage, we did not attempt to determine whether the reallocation of costs could be justified but only reassigned costs to see whether there might be a better result for pricing purposes.*) We deducted an amount from the G&A cost pool and added these costs to the M&S pool so the result would be to double the M&S rate. Alternatively, costs could be taken from the overhead rather than G&A pools or a portion from each.

C. *Eliminate handling rate.* Both the G&A pool and base are increased to absorb the costs that were included in the M&S pool and base. A modification might include increasing the overhead pool for the costs included in the M&S pool and increasing the G&A base for the subcontract and material direct costs.

D. *Reduce the G&A rate to a more palatable 10%.* Under all three alternatives above, the result was a G&A rate far in excess of the 10 percent level the government would accept as an add-on to subcontract costs. In order to achieve the desired 10 percent rate, approximately \$700,000 of costs included in the G&A

pool would have to be reallocated to overhead which would lower the G&A rate by both (1) decreasing costs in the pool and (2) increasing the costs in the G&A base.

E. *Charge fringe benefits direct as a percentage of direct labor and change the overhead base to direct labor plus fringe.* This change provides the appearance of lowering the overhead rate (both direct costs and fringe costs rather than only direct costs are in the overhead base) and making changes identified in D above would yield the 10% G&A rate.

## Sensitivity Analysis

We conducted a three step analysis to determine which of the five approaches would provide for maximum recovery.

1. The first step consisted of reassigning costs from one pool and base to the other, without considering whether the reallocations could be justified. For example, we moved costs from the G&A pool to the M&S pool under Alternative B approach and we moved \$700K of G&A costs to overhead under the Alternative D approach.
2. Once we made the reassignments of costs we took the second step of calculating the resulting indirect cost rates.
3. After verifying the past mix of direct costs would not vary significantly in the future, we used the most recent incurred cost proposal data to lay out the mix of costs experienced under most large contracts in each category of contract type (e.g. cost type, T&M, fixed price). Next we applied the resulting indirect cost rates generated from Step 2 above to the appropriate direct costs for each contract and then compared the total cost recoveries under each of the five approaches.

The results were clear – Alternative D provided the best cost recovery under the large cost type contracts that included significant subcontract costs while the current method provided the best results for T&M and fixed price work where there were minimal subcontract costs. Since the cost type work with significant subcontract costs were expected to predominate near future work (next 2-3 years) Alternative D was the preferred structure.

It is one thing to see the benefits of Approach D – eliminating the M&S rate and reallocating \$700K of G&A costs to overhead – and quite another to make

the changes required with, hopefully, gaining acceptance of the changes by the government. Could the reallocation of \$700K of G&A costs to overhead be made? The next step was to examine the G&A costs and see whether a reallocation of costs would be considered to be reasonable on cost allocation grounds. Our working definitions of overhead and G&A are quite common – overhead costs are indirect costs not identifiable with any one particular project but incurred in support of projects while G&A costs are those indirect costs more closely associated with supporting the company as a whole. The list of significant G&A costs and our analysis of whether some or all of the costs could be reassigned to overhead follows.

**Contract administration.** Currently, contract administration costs are included in the subcontract handling pool. Since those costs need to be reassigned, the question is do they belong in overhead or G&A. Though both treatments are fairly common, one can argue they belong in overhead since contract administration normally supports contracts (hence the name) as opposed to the company as a whole.

**Office Lease.** Again, both overhead and G&A treatments are common. More precision can be obtained by establishing a facilities cost pool where not only office leasing costs but also other facility related costs like utilities, repairs and maintenance, landscaping, any building related depreciation would also be included in the facilities pool. Then those costs could be allocated to overhead versus G&A on a square footage usage basis. An ideal method would be to somehow calculate the space taken up by G&A versus overhead functions. However, when allocating service or cost center costs, less than ideal solutions are usually sought. For example, an acceptable basis might be headcount or labor cost basis where, for example, the percentage of direct labor and overhead related employee expenses versus G&A labor expenses might form the basis of allocating the facilities related costs that would be a surrogate measurement for a square footage allocation.

**Business Management.** If by “business management” you mean marketing and sales, those costs are most likely oriented to G&A. However, if by the term you mean administrative or contract related supervision, then that may be primarily overhead.

**G&A Salaries.** Its quite common to include the costs of entire functions into one pool. However, it is probably more accurate to split out the functions and assign the corresponding costs to appropriate pools.

For example, the head of HR may properly be included in G&A because their activities relate more to overall corporate activities while the HR staff time is more commonly focused on supporting direct labor personnel and hence properly allocable to overhead.

**Legal fees.** Similar to G&A salaries, either the head of the legal department or certain functions of outside attorneys may be related to overall corporate matters and hence G&A (if significant, these efforts may be unallowable if related to mergers and acquisitions, corporate financing, etc.). However, many legal duties are more closely related to support of projects (employee suits, environmental issues, vendor disputes).

**ESOP.** These costs, like payroll taxes and fringe benefits should follow the labor costs if they are assigned to specific individuals.

**Depreciation costs.** Depreciation costs should, of course, follow the assets so treatment of such costs should be based on usage of the assets. Building depreciation should be included in the facilities cost pool. Computer depreciation costs could be allocated by headcount, especially if everyone has similar computers while shared assets like printers, reproduction and servers might follow computer depreciation cost allocations. Alternatively, since most asset use is derived from headcount or labor related costs, such costs may be included in the facilities cost pool if a similar basis for allocating facilities costs is logical or a separate IT cost pool may be created where allocation could be on a similar allocation basis. Exact or ideal precision is not required or, in most cases, even desired since the effort and cost of such precision is usually high – only reasonableness of assumptions is needed.

**Professional Insurance.** Though it is not uncommon to treat all “insurance” costs the same, the purpose of the insurance is a better gauge. So, whereas general liability insurance may more properly be considered G&A, professional insurance that applies primarily to project employees is more logically allocable to overhead.

**Recruiting and relocation.** These costs certainly follow the people they are associated with. Recruitment and relocation of employees primarily engaged in project or overhead functions should be allocated to overhead while if related to hiring a corporate executive more properly to G&A.

**Office staff.** Staff may be assigned to one or multiple

functions. If primarily in support of either G&A or overhead personnel, their costs with associated fringe benefits should follow. If mixed, then either assignment to one pool or the other would be acceptable or for more precision, ask them to use timesheets if it is common for non-direct people and assign costs to the efforts reflected on the timesheets.

Internal accounting costs. Though often simply charged to G&A, a breakdown also can make sense. For example, like HR costs discussed above, the CFO and corporate controller might be considered G&A because their efforts are primarily related to the company as a whole (e.g. corporate policies, corporate financial statements) while subordinate accounting staff are more commonly associated with support of projects and hence overhead (e.g. payroll, AP, AR). Outside accounting and audit fees, on the other hand, are more commonly considered to be G&A costs.

Business Development. This function is usually G&A because costs of sales and marketing are generally associated with expanding the overall company base. It is not unreasonable, however, to distinguish between new contract work – either commercial or government which would be charged to G&A and expanding existing work which might be considered overhead. However, it should be realized that charging any “marketing” or “sales” costs to overhead is unusual and hence may generate a red flag.

Though our discussion with our client about how to divulge the changes that adoption of Alternative D would entail is beyond the scope of this article, all contractors need to consider the proper timing of such a significant change as the adoption of alternative D. When disclosure is made to the ACO and or DCAA, it is likely that a writeup detailing the changes, why they were made, justifying them and showing a gross cost impact on the changes can be expected. Also, depending on the timing of the change, there may need to be an adjustment of provisional billing rates and or an adjusting invoice where a DCAA audit can be predicted.

## **TEKNOLEDGE CASE – BENEFIT TO A GOVERNMENT CONTRACT**

*(Editor’s Note. In the last couple of years we have been focusing on cases addressing “benefit to the government. This elusive, evolving concept has great practical significance on what costs*

*are deemed to be allocable and hence allowable government contract costs. The following is summary of a most recent case addressing this issue where it illustrates some of the factors that need to exist for an indirect cost to be allocable to a contract.)*

### **Basic Facts**

Teknowledge is an internet transaction company providing solutions for the government. (*Full disclosure – we have provided consulting services to the company unrelated to the current case.*) In 1999, Teknowledge began developing the TekPortal software program, a customer information aggregation service for the financial services industry. The company intended for the TekPortal program to be dual use software for both commercial and governmental customers.

At the time, Teknowledge had two reporting segments – commercial and government. The commercial segment oversaw development of TelPortal and Teknowledge allocated a portion - \$285,000 - of the amortized development costs of \$885,000 to the government segment’s G&A pool based on headcount of the two segments. From 2001 to 2005, Teknowledge proposed use of TekPortal software in response to three Government RFPs but the government never purchased the program. The Contractor admitted that none of the government contracts utilized the TekPortal technology “per se.”

The Government asserted the costs associated with developing TekPortal program were not allocable to the Government and even if allocable, they are not allowable because they are not reasonable and do not comply with generally accepted accounting principles (GAAP). The contractor argued the costs are allocable because (1) they benefit the government and can be distributed to the government in reasonable proportion to the benefit received and (2) are necessary to the overall operation of its business. Further, it states the costs are allowable because they are reasonable and comply with GAAP. In July 2005 the Defense Contract Management Agency issued a notice of intent to disallow the amortized software costs from TekPortal and issued a final decision Jan. 2006 where upon in April 2006 Teknowledge filed a compliant to the Court challenging the disallowed amortized software costs of \$285,000.

### **Contractor’s Costs Are Not Allocable**

The Court stated a cost is allocable to a government contract if it is “assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship” (FAR

31.201-4). Alluding to recent cases, the court stated allocability is an accounting concept involving relationships between incurred costs and contract to which they are charged and the test for allocability is whether there is a sufficient “nexus” between the cost and the contract. Accordingly, the cost must meet one of three factors to be considered allocable: (1) incurred specifically for a contract (2) benefits both the contract and other work and can be distributed in reasonable proportion to the benefit received or (3) is necessary for the overall operation of the business, though a direct relationship to a particular cost objective cannot be shown (FAR 31.210-4).

#### ◆ **First Prong - Is the Cost a Direct Cost**

To determine allocability, the Court says it must first assess whether the costs are direct or indirect. The Government asserted the costs are direct costs and since it had never purchased the software there was no specific contract to charge the direct costs to. Teknowledge stated it could not meet the direct test because there was no contract for the software and argued the costs were indirect. The Court agreed that the costs were not direct and ruled the indirect costs must be subject to the second and third prongs of allocability.

#### ◆ **The Second Prong – Benefits the Contract and Other Work**

Teknowledge claims the software development costs are allocable as an indirect costs because they benefit the contract and other work and can be distributed in a reasonable proportion. Citing two cases, *General Dynamics Corp.* (ASBCA No 18503) and *KMS Fusion v US* (24, Cl. Ct 582), the contractor asserts the courts have taken a broad view of the meaning of “benefit” to the government that includes any cost that increases business or reduces indirect costs benefits the government. Teknowledge argued that the TekPortal costs allow it to both maintain its ability to perform government contracts and spread the financial risk of the development costs across both commercial and government segments. The government countered by saying the test for allocability is not “some vague, prospective benefit to the government” and cited *FMC Corp. v US* that held “remote and insubstantial benefits to the government” do not meet the benefit test. The government contended the government never purchased TekPortal and admits the costs were not related to any contract but was rather a speculation in anticipation of acquiring both commercial and government contracts.

The Court concludes the government did not receive benefit from the TekPortal technology. Citing two cases – Boeing and Lockheed – it stated the test for allocability is where there is a sufficient “nexus” between a given cost and a government contract and the word “benefit” for an allocability test requires some showing the cost relates to a government contract, not that it promotes the government’s public policy interests. The Court stated that in the cases Teknowledge put forth there was a nexus existing between the cost incurred and some underlying government contract. In *KMS Fusion*, marketing consultant costs benefited the contract because additional business brought in reduces the indirect costs allocable to the contract. In *FMC Corp* the bid and proposal costs associated with an Arctic tanker program was allocable to the government because the B&P costs maintained the viability of the commercial enterprise of the company. In *Lockheed*, personal property taxes assessed on facilities were allocable because the government benefitted from Lockheed’s fulfillment of its responsibilities as a corporate citizen to the local community.

As opposed to these cases, the Court found no nexus. The only benefits cited by Teknowledge are the general viability of the company and reduced indirect costs to its government segments where the Court said Teknowledge misconstrued the definition of “benefit” under the FAR and failed to show any connection between the TekPortal program and a current government contract, concluding the asserted benefit to the government was too remote and insubstantial to be allocable.

#### ◆ **Third Prong – Necessary to the overall operation of the business**

Citing FAR 31.201-4(c) and *Caldera v Northrop Worldwide Aircraft Servs. Inc.* (192 F.3d 962, 972) Teknowledge asserted the development costs are allowable because they are “necessary to the overall operation of the business.” The contractor maintains the TekPortal costs were necessary to create a product that could be sold in the marketplace, which were similar to the *KMS Fusion* case where consultant costs were deemed allocable because they brought in new business. The government rejected this argument stating Teknowledge provided no factual evidence showing how the TekPortal program kept the company viable.

The Court ruled against Teknowledge. First, it omitted a key part of the allocability test even under

the third prong where a nexus to a government contract must be shown. Unlike KMS Fusion where a benefit was shown how the consultant costs benefited the DOE contract by lower indirect costs allocated to the government, no such nexus was shown here. Second, Teknowledge offered no evidence showing how the TekPortal keeps the company afloat or will bring in new business in the future. The Court concluded since the costs are not allocable to a government contract they are not allowable.

## RECENT DECISIONS ON TRAVEL

### “Special Circumstances” Can Be Invoked if it Saves the Government Money

Rather than fly from his home in New Mexico to Los Angeles for his househunting trip in anticipation of his relocation, Damon found out that flying out of New Mexico was significantly more expensive than flying out of Colorado so he and his family drove the 500 miles and flew out of Colorado. When he submitted his claim that included miscellaneous and incidental expenses incurred in Colorado the government denied them saying he was entitled to temporary lodging and M&IE expenses at the old or new duty station and nowhere else. The Appeals Board supported Damon noting the travel regulations for his agency stated he was not entitled to be reimbursed for expenses outside of proximity of the old and new duty station “unless justified by special circumstances.” The Board rules the fact he saved the government a significant amount of money was precisely the kind of special situation that “special circumstances” applied to (*CBCA 1314-RELO*).

### Limits on Moving Personal Vehicles

Lou Ann drove her car to her new duty station and shipped the second one by train. Her agency denied the cost asserting (1) she was entitled to reimbursement for only one personal owner vehicle (POV) and (2) the weight of the car should be included in the maximum weight of her household goods (HHG). The Board denied payment saying

she was entitled to only one vehicle unless she had a dependent in which case she was entitled to one or two (she had no dependents). However the Board rejected the argument about inclusion of the car in the HHG quoting the JTR saying HHG does not include autos, trucks, vans or similar motor vehicles (*CBCA 1505-RELO*).

### Selling Expenses Apply Only Occupied Home

Torralba received notification for a position at a different duty station where at the time he lived in a home he owned. After receiving the notice he completed a contract of purchasing a house he was having built at his old duty station. His agency rejected his claim for reimbursement of expenses related to selling the new house. The Board sided with his agency quoting the FTR 302-11.5 - to be reimbursed for expenses incurred in your residence transactions, you must occupy the residence at the time you are notified of your transfer (*CBCA 1524-RELO*).

### “New Hires” Entitled to Limited Relocation Reimbursement

*(Editor's Note. Though the Federal Travel Regulations have limited applicability to private contractor employees, we have frequently seen auditors question costs like those found unallowable below on the grounds the FTRs do not allow it. The following case illustrates the need for contractors to explicitly identify costs that will be reimbursable in their company policies where if they are not, the FTR will often become the “default” regulation in the eyes of auditors.)*

Evester resigned from a government position in Aug 2006 and was hired by another Department in Oct 2006. His claim for relocation included temporary quarters, storage expenses, mileage expenses for his spouse, miscellaneous expenses and real estate transaction costs for his move to Washington DC. His agency denied the real estate transaction costs asserting he was a “new hire” which in accordance with 5 USC Section 5720 excluded such costs for new hires. The Board agreed he met the definition of a new hire – first appointed as well as appointed after a break in government service – and though he was entitled to most of his relocation costs those did not include real estate transactions expenses (*CBCA 1582-RELO*).