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GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

(Editor's Note. As we have been doing the last several years now, we are happy to present a summary of Grant Thorton's Annual Government Contractor Industry Survey that benchmarks primarily professional services firms. The 18th Annual GT survey for 2012 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

53% of the surveyed companies are classified as large and 47% as small where 18% had sales less than $10M, 10% between $10M-20M, 17% between $20M-50M, 13% between $50M-100M and 42% over $100M. 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. 84% said their primary customer is the federal government. 47% of their revenue came from the Defense Department, 37% from other federal agencies, 7% came from state and local government and 9% was commercial. The survey shows government business trends are lower where 36% of respondents had increased revenue over the prior year (50% in 2011),

Indirect Headcount Breakdown

12.5% of total headcount is represented by management and support functions. There is an overall downward trend over the last several years which is attributed to more outsourcing of support services such as HR, legal, internal audit, contract compliance as well as some larger contracts allow for direct billing of normal indirect support costs. The breakdown of certain functions are finance and accounting (2.9%), contract and procurement administration (1.7%), sales and marketing (2.1%) and other indirect (5.8%). Though not reported this year, facilities costs as a percentage of revenue last year was reported by 80% of respondents as less than 5%, 14% reported 6-10% and 6% said it was greater than 10%.

Government Contracts

Breakdown of Revenue by Contract Type. 40% of revenue from federal contracts came from cost type contracts compared to 45% last year, 20% are fixed price (equal to last year) and 40% are time and material (compared to 35% last year) indicating a decrease in cost type and a corresponding increase in T&M.

Fees. Though fees were not tracked this year, the results for last year which is pretty consistent from year to year were average negotiated fees for cost type contracts was 6-7%, T&M contracts had an average of 8-9% while firm fixed contracts had 9-10%. 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% and 50% when they were the incumbent. Win rates when either a special business unit or joint ventures were created was 50%, higher than 43% last year.

Bid and Proposal costs as a Percent of Revenue. 14% reported less than 1%, 41% 1-2% while 44% reported greater amounts.

Contractor Business Systems. The survey notes recent changes to contractors either fully or modified CAS covered are now subject to audits of six business systems (cost accounting, EVMS, estimating, purchasing, material management and accounting and property management) where future surveys will focus on results of these audits. For now, the survey found that 33% of respondents had already undergone at least one of these audits and that 29% said they had made im-

provements to their business systems in order to comply with these new rules.

Financial and Cost Statistics

Profit. Contrary to common public perceptions, government contracting does not generate abnormally high profits where the survey defines it as profit before interest and taxes as a percent of revenue. Profit rates appear to be plunging compared with prior years where 56% of survey companies had profit rates between 1-5%, 31% between 6-10%, 5% between 11-15% and 4% above 15%. 4% of respondents reported no profit. These figures would be even lower after deducting interest and taxes. Compared to last year, there has been a substantial decrease in profit where this year 60% of surveyed companies either did not make a profit, experienced a loss or posted a 1-5% profit rate compared to 37% last year.

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 36.4% when bonuses were included and 34% when excluded which is an increase from last year.

Wages Increases. Wage increases ranged from 0 to 7% where the median response was 3%.

Medical Expenses. In response to questions asking what percent of health benefits are paid by the company the survey results were: 5% reported the company pays for less than half, 12% pays 51-60%, 20% pay 61-70%. 36% pay 71-80%, 9% pay 81-90% and 18% pay 91-100%. With respect to health costs as a percentage of labor costs, 6% of respondents incurred health costs less than 4% of labor costs (14% last year), 5% between 4.1-5%, 11% between 5.1-6%, 13% between 6.1-7%, 9 between 7.1-8%, 5% between 8.1-9%, 12% between 9.1-10% and 39% over 10% of labor costs.

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) - 84% compared to 80% last year (b) on site direct labor and fringes – 43% compared to 48% last year (c) off-site direct labor – 38% as opposed to 48% 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 – 21% compared to 23% last year. When companies used multiple overhead rates logic used for them were location (52%), labor function (13%), customer (28%) and products versus services (7%).

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 as well as IR&D and bid and proposal costs. 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 base was 12% (13.5% last year) while those using a value added cost input was 15% (15.4% last year).

Material handling and subcontract administration costs. 24% of surveyed companies used a material handling and or subcontract administration rate as a burden chargeable on direct material and subcontract costs (higher than last year's 22% and 19% the previous year). 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 3.0 and subcontract handling rate of 3.4% (2.7 and 2.5% last year).

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 2.2 for on-site work and 1.9 for off-site work. 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.*) 60% of respondents said their employees work uncompensated overtime (UOT) while 40% said no. 80% of the companies working UOT use total time reporting while the other 20% report only 40 hours per week. 78% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 22% 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.

Dealing with DCAA

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. Regarding the respondents opinions of DCAA audits, 47% say auditors' opinions are substantiated with appropriate references and 53% are arbitrary and not substantiated while 40% of auditors are open-minded and receptive to contractor rebuttals and 60% say auditors are inflexible and are rarely receptive. When asked if their relationship with DCAA has changed, 71% said it had stayed the same, 19% reported the relationship had worsened (compared to 2% last year) while 10% said it had improved. The most frequent types of costs questioned by DCAA are executive compensation (23%), consultant costs (7%), incentive compensation (17%), labor charging (11%), indirect cost allocations (12%), legal expenses (9%) and employee morale (5%). Costs questioned as a percent of revenue were less than 1% of revenue (61%), 1% of revenue (11%), 2% of revenue (6%), 3% of revenue (3%), 4% of revenue (0%) and 5% or more of revenue (19% compared with 4% last year). Of those companies experiencing audit issues, 18% were very satisfied with the resolution of the issues, 61% were somewhat satisfied and 21% were not satisfied.

Executive Compensation

Though not intended to represent a valid compensation survey, surveyed companies provided interesting information on the four highest paid executives in the company and the results are presented by company size measured by revenue for 25th, median and 75th percentiles. The following is a summary of the results.

Highest Position (in thousands)

Revenue	25%	Med.	75%
$0-10 M	250	320	447
$11-50M	260	349	500
$51-150M	275	407	585
>$150M	300	410	708

Second Highest Position

$0-10 M	170	262	432
$11-50M	225	294	444
$51-150M	250	339	479
$>$150M	280	372	646

Third Highest Position

$0-10 M	160	242	300
$11-50M	180	269	379
$51-150M	225	279	450
>$150M	260	357	565

Fourth Highest Position

$0-10 M	144	189	267
$11-50M	157	228	310
$51-150M	208	241	344
>$150M	218	322	395

Companies whose executive compensation was challenged by DCAA and provided rebuttals and/or additional information state 30% of their positions were sustained, 30% stated a reasonable compromise was achieved and 40% stated either DCAA's position was sustained by the ACO or an unreasonable compromise was put forth.

DCAA'S NEW GUIDANCE ON SELECTING ICE PROPOSALS TO AUDIT

The Defense Contract Audit Agency has issued new guidance that significantly affects whether your Incurred Cost Estimate (ICE) proposal will be audited. The guidance includes sections on (1) a policy, sampling techniques and procedures to be used for selecting ICE proposals to audit (2) a "Class Deviation" statement from DOD stating either an audit report or a memo

will meet the audit requirements of FAR 42.705 (3) a checklist for determining risk of ICE proposals (4) a proforma report that will be used when an ICE proposal is not selected for audit (5) Incurred Cost Sampling Implementation Plan and (6) Frequently Asked Questions. The following is a summary of sections of the guidance we believe will be most relevant to our readers.

Procedures Used to Select Audits

1. In order to establish a universe, identify all ICE proposals on hand. The universe of proposals will be established at the field audit office (FAO) level and will exclude corporate, shared services and intermediate home office ICE proposals, nonprofit and educational institutions and contractors who have 100% of non-DOD contracts. Audits that have already begun will also not be included in the universe.

2. If not already done, perform an adequacy determination on all proposals. As in the past, this adequacy determination will be based on FAR 52.216-7 where DCAA's Incurred Costs Proposal Adequacy checklist will be used where if significant deficiencies are found, the proposal will be returned with written instructions for corrective action.

3. All adequate proposals exceeding ADV (auditable dollar value) of $250 million will be automatically audited.

4. Adequate proposals less than ADV $250 million received will be assessed for risk. The auditor will determine whether the proposals should be assessed as high or low risk using a risk assessment worksheet (discussed below).

5. All adequate ICE proposals deemed high risk will be audited.

6. All adequate low risk proposals will be randomly selected for audit based on the following sampling plan:

- 1% of proposals up to an ADV of $1 million or less.
- 5% of proposals with an ADV of $1 million to $50 million.
- 10% of proposals with an ADV of $50-100 million.
- 20% of proposals with an ADV of $100-250 million. A mandatory audit of this group will occur once every three years.

Note this sample plan differs significantly from the prior plan requiring a one third chance of audit each year for all low risk proposals. Also of note, in order to reduce the backlog of ICE audits, all adequate ICE audits with an ADV of $1 million or less that were submitted before October 1, 2011 will not be selected for audit.

7. A Memorandum to the Contracting Officer will be drafted for all low risk proposals not selected for audit. This step replaces the traditional desk review which has been eliminated. DCAA has established a proforma memo that states, in part, no significant audit leads or concerns were identified, a "mathematical verification" was conducted and the proposal is signed by upper management certifying the proposal contains no unallowable costs. All proposed final indirect cost rates are identified in the memo, stating it is the ACO's responsibility of determining final indirect rates. Finally, the memo states DCAA recommends the contractor adjust its interim billings on all affected contracts to reflect the settled direct and indirect costs and update its schedule of cumulative direct and indirect costs claimed and billed. In addition to the Memo, DCAA has internal administrative procedures to use for proposals not selected for audit that need not concern us.

8. If a contractor has more than one ICE proposal in the low risk group DCAA will follow the following procedures:

a. If no proposals in the pool are selected, close out all proposals using the memo procedure discussed above.

b. If one or more proposals are selected for audit, none of the others will be dispositioned until the audit is completed. If significant questioned costs are found, then audit all other proposals, using multi-year audit techniques. If no significant questioned costs are found, close out all other proposals using the memo procedure discussed above.

Guidelines For Determining Risk Assessment

Each FAO is instructed to establish whether each ICE proposal under an ADV of $250 million is high or low

risk where a low risk determination is found using the following criteria:

1. An ICE audit has been performed in the past.

2. No significant audit leads or other significant risk has been identified (e.g. known business system deficiencies such as an inadequate accounting system that would have a material impact on the ICE, significant risk identified by the ACO).

3. No significant questioned dollars (called "exception dollars") in the last year audited. Significant questioned dollar amounts are:

- $15,000 on ADV proposals of less than $1 million.
- $25,000 on ADV proposals between $1-15 million.
- $55,000 on ADV proposals between $15-50 million.

REDUCED GOVERNMENT SPENDING REQUIRES FAMILIARITY WITH LIKELY GOVERNMENT CONTRACTING ACTIONS

(*Editor's Note. Daily news reports on sequestration or at least a high probability of austerity means the government will likely attempt to generate savings on existing contracts and subcontracts. The most likely contract vehicles they will use include terminations for either default or convenience or deductive changes. It may also use a combination of partial terminations with deductive changes. Though we have examined T of Cs and deductive changes in depth in prior articles we thought it would be a sound idea to provide a basic understanding of these vehicles now since there is a good chance you will be faced with one of them under the current environment. We have used a recent article in the November issue of the CP&A Report written by Mary Wills and J. Andrew Stowe as well as our extensive experience helping clients manage these occurrences.)*

The US government has the unique ability to terminate or reduce the scope of a government contract. In exchange for these unique rights, it has the obligation to allow a number of remedies to make the contractor whole. You should have a basic familiarity with (1) which termination or contract change is appropriate under the circumstances (2) which processes are followed under them and (3) what remedies are available under each action to maximize cost recovery.

Terminations for Default

FAR Part 49 generally address all forms of terminations. A termination for default (T for D) may be either full or partial where it requires the government to show in a written notice of default to the contractor (1) it has failed to deliver products or services on time or failed to perform work specified in the contract within time specified (2) the contractor is making progress in performing the work at a rate that endangers performance or (3) other provisions of the contract are failing to be performed. If the contract is to be terminated before delivery, then a cure notice is required. If not enough time remains on the contract (less than 10 days) then a cure notice will not be used but a show cause notice will be substituted which requires the contractor to provide a realistic reason as to why it is not in default by showing it can meet the deadline, is able to make sufficient progress so as not to endanger performance to provide quality products or services or is following other contract terms and conditions.

In its rush to meet its budget cutting goals or to limit a contractor's cost recovery opportunities, the government may issue a T for D. Because a T for D leaves a black mark, makes the contractor liable for the costs of completing the contract and limits the cost recoveries a contractor is entitled to it always benefits the contractor to attempt to convert the T for D into a termination for convenience (T for C). It is appropriate to use a T for D only if there are material contract delinquency circumstances that cannot be cured e.g. significant delivery delays, project progress or contractors' unwillingness to follow contract provisions. The contractor should be prepared to document its version of key issues (e.g. schedule slippage, subcontractor defaults) to either withdraw the T for D or have it converted into a T for C. Though contractors are often quite successful in obtaining this T for C conversion, an appeal through the Disputes clause may be necessary but still worth it to avoid a black mark or allow for greater cost recovery.

Termination for Convenience

As history has taught us, an environment of budget cuts or sequestration will guarantee a proliferation of terminations for convenience. A T for C can either be a full or partial termination. A long list of cases have established the government's right to terminate a government contract when it is in their interest to do so. The first step is the government issues a notice of termination to the contractor specifying the extent of it and the effective date. Immediately upon receiving the notice the contractor must (1) stop work as specified in the notice (2) place no further subcontract orders except as necessary to complete the continued portion of the contract under a partial termination (3) terminate all subcontracts that relate to the work being terminated (4) at the direction of the CO or TCO (termination contracting officer) assign all rights, title and interest of the contractor under subcontracts terminated which gives the government the right to settle or pay any termination settlement proposals (5) with approval from the CO settle all outstanding liabilities and settlement proposals of subcontractors (6) as directed by the CO transfer and deliver to the government fabricated or unfabricated parts, work in process, completed work, supplies and materials acquired for the terminated work, completed or partially completed plans, drawings, information and property and other property that would have been required to be furnished by the government (7) complete performance of the work not terminated (8) take all action needed, or that the CO may direct, to protect the property related to the contract and (9) use its best efforts to sell any property identified in No. 6 above if the contractor is not required to extend credit to any purchaser or if it wants to acquire the property at prices approved by the CO. The CO usually issues the termination notice and then a TCO is identified to settle the termination.

In exchange for its right to terminate the contract the government has the obligation to make the contractor whole through the termination settlement process. A settlement can be made by a negotiated agreement, a determination by the TCO, costing-out vouchers or a combination of these. Settlement proposals under a T for C can be a no-cost settlement or a cost proposal based on the inventory or the total cost method. A no-cost basis is obviously preferable to the government though it may be valid if no contractor costs have been incurred but the government commonly seeks such a settlement under most circumstances. It is advisable for contractors to reject this first offer where if a no-cost settlement is not executed, then the other two methods – inventory or total cost – may be used. Of these two, the government usually prefers the inventory method.

The difference between the inventory basis and total costs basis is that the inventory basis itemizes only those costs incurred for the terminated portion of the contract while the total cost basis itemizes the entire cost of the contract. Generally under the total cost method the contractor can recover its allowable incurred costs up to the total contract price minus the amount paid on the contract. If an equitable price adjustment is approved then that can be added to the total contract price to determine the maximum allowable.

We have written in detail (use our key word search function at our website) how to maximize cost recovery on a T for C and we highly recommend a careful review of these articles before preparing a settlement proposal. Basically the FAR cost principles together with a separate termination cost principle at FAR 31.205-49 address what costs are allowable. In summary, the allowable costs include (1) allowable pre-contract costs (2) initial "ramp up" costs which are abnormally high at the beginning of a contract (3) completed products or services which have been accepted but not delivered (4) facilities cost of capital (5) termination inventory (6) loss of useful value of special tooling, machinery and equipment (7) rental under unexpired leases (8) restorations of leased property even if they would not be allowable under a non-terminated contract (9) post termination costs (10) subcontractor claims (11) settlement costs that include in-house or outside consulting, accounting, legal or clerical costs, reasonable storage and transportation costs (12) indirect costs applicable to relevant costs in the proposal and (12) profit on all costs except for the settlement expenses. It should be noted that profit is not allowed if the contract was in a loss position where if so, a "loss ratio" is computed and is used to reduce not only profit but also the amount of costs you are entitled to. (However, see our articles on how to reduce the perception of a loss position.) In addition, anticipatory profit on the work not performed on the terminated portion of the contract is not allowed.

Under a partial termination a contractor may request an equitable adjustment (REA) in the price of the continuing work of a fixed price contract. For example, if the contractor has incurred costs for expendable tools, dies, fixture for the terminated portion of the contract then if there are no other uses for these items it would be entitled to an equitable adjustment in the price of the contract for these items.

The contractor has one year from the effective date of the termination to submit a final settlement proposal to the TCO. If the Truth and Negotiations Act threshold is exceeded (currently $850,000) the contractor must certify the submittal is accurate, current and complete. Once submitted, the TCO is required to have an audit performed on any prime or subcontract settlement proposal exceeding $100,000. Once the audits are performed and the parties agree upon a settlement proposal, a negotiation memo is prepared by the TCO where it is recommended the contractor prepare their own memo. Rather than wait for government audits, the prime may select to conduct its own audits of subcontractor costs where such audit costs are allowable settlement costs.

Deductive Changes

Work scope or delivery may be eliminated from a contract using a deductive change process. Under such a method, the government changes the specification for a portion of the work. The contractor is supposed to be left "unharmed" because of the deleted work and associated profit being removed from the contract. The process for a deductive change is the same for any contract change. There are specific clauses in the contract that are applicable to fixed price, cost reimbursable and time-and-material or labor hour contracts. The different clauses in each contract defines what can be charged by the government so it behooves contractors to become aware of these clauses in the contracts.

We have addressed the significant cost and pricing issues related to deductive changes in our prior articles of the GCA DIGEST so we will not recount those here. In summary, contractors have the normal remedies available under the Changes clauses including REAs which if applicable must be submitted within 30 days of the written notice of the change. Be aware that under a deductive change, the contractor may be entitled to less settlement costs than what would be available under a T for C.

Partial T for C versus Deductive Changes

Whether a contractor characterizes an event as a termination or a change often significantly affects the dollar recovery it may be entitled to where there is often considerable flexibility in how to characterize the event. Several cases have addressed the uncertainty of "termination" versus "change" where for example, major versus minor variations, elimination of identifiable work or the government's continuing need for work will affect how an event is characterized. For example, a termination may exist when the government no longer has a need for the article or a major variation in the plan exists while a deductive change may exist if there is a minor variation in the plan, elimination of non-identifiable work or the government has a continuing need for the products or services. Though too detailed to recount here, differences in characterizing the event can affect both profit and allowable settlement expenses. Obtaining expert help in all the areas discussed here is highly recommended where such costs are normally reimbursable as allowable settlement expenses.

Case Study…

CHANGING TO A TOTAL COST INPUT BASE FOR INTERMEDIATE HOME OFFICE AND SEGMENT G&A

(*Editor's Note. The following represents an edited response from us to a client that was considering changing the method of allocating its G&A costs within two business segments. We believe it is instructive to our readers because it addresses many issues that need to be considered when evaluating both your current structure as well as making changes.*)

Background

Contractor is primarily a manufacturing company. Its business has changed where one of its business units (we will call it BU1) is going after large contracts that are highly price sensitive where it must find ways to

reduce cost allocations and hence reduce its offered price. Its other business unit (BU2) has more of a mix of contracts where some are somewhat price sensitive while others are not – its unique position in industry provides it considerable pricing flexibility. Each segment has an identical indirect rate structure – overhead allocated on direct labor and general and administrative (G&A) costs allocated on a value added base of direct labor and overhead.

The company is considering switching its G&A base to total cost input (TCI) which would apply to both segments. It expects this would lower its G&A rate which in turn would lessen the burden costs on direct labor making prices lower and more competitive. There are also questions related to the timing of this change and how to communicate the change to the government or prime contractor but it will not be addressed here.

Thoughts on the Indirect Rate Structure

First, I agree totally with your approach to the issue – you are considering, first and foremost, your pricing objectives (e.g. lower prices on all contracts) and then considering the best indirect rate structure that will achieve that. Many contractors attempt to design their indirect rate structure on abstract accounting concepts rather than on what structure will best achieve their pricing objectives so I agree with your approach.

Several thoughts have occurred to me when considering your idea to establish a TCI base at each segment:

1. Two different rate structures are possible at each segment. So we should be considering whether different rates in each segment would be appropriate. For example, a TCI base at one and value added base at the other may achieve desired results or a material handling rate at one or both segments may be worth considering.

2. What is the level of price sensitivity for BU1 and BU2 contracts? In an email to me you stated that BU1's contracts were highly price sensitive and needed to definitely be lowered while for BU2's products there was room to allocate even more costs. Is the desire for lower cost allocations equal for each segments' contracts?

3. Using a TCI base may or may not be a good idea. It is true that the use of the TCI base will have the effect of lowering the allocation of indirect costs on direct labor but that change will now create an allocation of costs to direct material, subcontracts and ODCs. Will your customers now accept burdened costs on these direct costs when there were not such costs in the past? If not, then you wind up not recovering all of your costs in your price. For example, for BU2, the G&A rates applied to direct labor goes from 35% to 25% but will your customer accept 25% add-ons to direct material, direct subcontracts and ODCs when no such add-ons were made in the past? If not, then you are stuck not recovering all your costs.

4. If some customers will accept it and others not, then you may want to consider a material/subcontract handling rate at one or even both segments where some G&A and/or overhead costs are removed from their respective pools and placed in a material/subcontract handling pool where the base is direct material and subcontract costs. The G&A base stays as value added. Use of a material handling rate generally results in a burden rate of 3-5% on material and/or subcontract costs.

5. Based on our discussions, there seems to be many types of costs included in the G&A pool that can legitimately be moved to the overhead pool (e.g. IT related costs). This flexibility can significantly affect the indirect costs rates within each segment.

Knowing Your Cost Principles…
BONUS COSTS

(Editor's Note. We have found that bonus expenses are one of the most common cost elements being scrutinized by auditors these days and some of the most common areas of questioned costs. Bonus expenses offer auditors two bites of the apple – if they don't find such expenses to question as unallowable bonus costs they can still question some or all costs when added to other compensation costs that exceed survey amounts their Mid-Atlantic compensation team determine or GSA compensation caps because bonuses are one of the four cost elements of compensation. Given the interest expressed by our clients and subscribers we thought bonuses would be a good area to explore here. Our sources for this article include (1) one of our favorite texts – Accounting for Government Contracts, Federal Acquisition Regulation (2) an article by Karen Manos in the Dec. 2007 issue of Briefing Papers (3) the Defense Contract Audit Manual

(DCAM) and (4) our own experience helping clients either challenge questioned bonus costs or helping them develop bonus policies that would be acceptable by auditors.)

There are several common types of bonuses and incentive compensation that are usually allowable: incentive compensation for management employees, cash bonuses, suggestion awards, safety awards and incentive compensation based on production, cost reduction or efficient performance. In addition, deferred incentive compensation and bonuses are also allowable if they meet certain conditions discussed below. In order to be allowable, bonuses must be (1) granted under an agreement entered into in good faith between employer and the employee before services are rendered or (1) granted pursuant to an established plan or policy followed consistently to the point of implying an agreement. (*Editor's Note. For some inexplicable reason, we are seeing auditors recently interpret the "agreement" provision as equivalent to a "written agreement" where there is no such provision in the FAR but nonetheless they are questioning otherwise acceptable bonus costs on that basis. DCAA management is simply accepting this revised interpretation of the requirement and one of our clients is litigating the issue.*)

The government has a long history of sometimes challenging bonus plans that were not strictly based on production, cost reduction or efficient performance. In recognition that this was too narrow a criteria, FAR 31.205-6(f) was changed to distinguish management employees from the rank and file employees. In *Bell Helicopter Company (ASBCA No. 9625)* the board ruled that incentive compensation for management employees need not be limited to actions based on production, cost reduction or efficient performance because management may not affect such operations performance but rather by successful operations as a whole where such success is commonly measured by the profit of the company. In recognition of this distinction, FAR 31.205-6(f) was changed in 2003 to delete the reference to production, cost reduction or efficient performance where accompanying comments to the new rule stated though those three elements may be "good standards for allowability" they should not be the only criteria for allowing incentive compensation.

Some cases have addressed the allowability of specific employee plans. In one case, a plan based on longevity and other factors was questioned where the government did not believe longevity was an appropriate factor. In *Lulejian and Associates (ASBCA No. 20094*) the board upheld the government's challenge on profit sharing and life insurance costs on the grounds the costs for these two elements where more than twice the amounts paid as salaries. In *Cesesco Industries (ASBCA No. 20569*) the government challenged an incentive plan it considered to be a distribution of profit but the appeals board disagreed holding the contractor was not obligated to pass the profits onto employees and therefore the merits of the incentive plan should be judged on its own.

Bonuses for closely held corporations are quite closely reviewed to ensure that those payments are not disguised dividends which are unallowed. In *Digital Solutions Systems (NASA BCA 975*) the Board agreed that bonuses based on profits exceeding the contractor's total profit for the year were unallowable. In *Martin Marietta Corporation (ASBCA 12143)* bonuses paid to induce employees to continue employment through the end of the contract were accepted by the Board because the contractor could establish that low turnover was critical and the training costs for new employees were high.

Deferred Bonuses

Deferred compensation is considered payment for services rendered in previous accounting periods. It does not include year-end accruals that are paid within a reasonable time after the end of an accounting period. Deferred bonus is considered to be unallowable if it is awarded in an accounting period subsequent to the period related to the services rendered – in other words, bonuses cannot be awarded retroactively. Of course, deferred bonuses are allowable when entitlement is based on current or future services. Even if not CAS covered, the measurement, allocation and accounting rules are covered by CAS 415, Accounting for the Cost of Deferred Compensation. Basically, CAS 415 requires (1) the assignment of costs to the period when obligations are incurred and (2) the use of the present value of future payments as a means of determining the liability in the period incurred.

If the otherwise allowable bonus does not meet the conditions to be deferred – e.g. recognized in a prior period than it is paid, then the cost will be considered to be incurred during the period it is paid. Decisions

on deferring bonuses provide a very flexible tool for determining the timing of when the bonus is considered to be incurred. For example, if higher levels of government contracts are expected this year rather than in subsequent periods, it may behoove you to establish a deferred bonus program this year to be paid out in subsequent periods; or conversely, if higher levels of contracts are expected in subsequent periods, then you need to ensure future payments of bonuses are not deferred plans e.g. a bona fide liability this year is not established. Or, if bonus payments cannot be afforded in the current year, then it may benefit you to establish the deferred bonus program this year to allow for entitlement this year of future payments. Be sure to establish the conditions set forth in CAS 415 e.g. a bona fide obligation, etc.

Elements of Essential Written Policies

The most effective way of establishing the allowability of bonus costs and to challenge attempts to question the costs is to have a written policy in place before payments or deferrals are established. Though a written policy can be prepared to meet a variety of needs, we find policies that are usually accepted by auditors need to have at least the following features:

1. Identification of all bonuses for owners, officers, management and rank and file employees.

2. Except for spot or morale boosting bonuses, establish the basis for the bonus pool. For example, 5-10% of net profits, 1% of sales, etc. We find a range rather than specific numbers to be the best.

3. Establish what categories of employees will participate in each bonus pool and criteria of distribution to demonstrate a bona fide policy exists but broad enough to provide flexibility.

4. Establish that each bonus pool is dependent on the discretion of management to again provide flexibility.

5. Identify who is to approve of the bonuses.

DCAA Guidelines

DCAA is questioning more and more bonus and incentive compensation, asserting such costs are not "supported." DCAA is now, for example, requesting employee performance evaluations that are supposed to support the bonus paid which runs counter to most bonus plans that state there are some measurable parameters but usually stress that it is the company's prerogative to determine the amount of the bonus pool and how much is given to each employee. This area will likely be a shocker for most contractors who have not been exposed to many ICE audits due to the backlog and who have not been required to document such costs.

In doing our research for this article we were quite surprised to see how little guidance there is in either the DCAA Contract Audit Manual (DCAM) or in DCAA's audit programs considering how extensive this area is audited. The absence of audit guidance in this heavily scrutinized area is we suspect at least a partial explanation for the wide variety of positions we see auditors take, some of which are quite "creative."

In the Chapter 5.803-1 section of the DCAM addressing audits of executive compensation, bonuses are considered to be one of the elements of such compensation and the audit guidance states there should be a "determination that the policies and procedures provide a description of how executive compensation levels are established, who approves these levels, and eligibility criteria and bases" for how they are established. The section also addresses long term incentive plans where award periods are for two or more years with the goal of retaining key executives. So a reading of this very brief DCAA guidance indicates there should be written policies and procedures with a description of how the bonus levels are established, who must approve these levels and the criteria for eligibility.

The DCAM also addresses bonuses that result from a business combination. Section 6-614.7 states that bonuses or other forms of payments that are in excess of the employee's normal salary level or unallowable in accordance with DFARS 231-205-6(f)(1). However, this limitation does not apply to severance or early retirement incentive payments where such costs, if reasonable, are allowable in accordance with FAR 205-6(g).

APPLYING COMMERCIAL PRICING TECHNIQUES FOR GOVERNMENT CONTRACTS

(*Editor's Note. The following is the first of many future articles we plan on addressing practical pricing issues. We would like to apply our extensive experience helping clients price their proposals to provide some insights into pricing strategies and techniques. In this article we address possible approaches found in the commercial world that contractors and the government can agree to use that differ from a cost build up approach. Whether it is to increase revenue or offer lower prices than a full cost approach would require, pricing found in the commercial world often offers better alternatives. The source of the following article comes from Darrell Oyer's text Cost Based Pricing as well as our own experience.*)

The FAR recognizes commercial, catalog and market based pricing. Many of our clients are simply used to pricing their products and services using cost based estimates for fixed price and time-and-material contracts and actual costing for cost reimbursable contracting. However, pricing based on commercial pricing rather than cost can either generate more revenue or less to meet lower price objectives. The following addresses certain commercial pricing concepts and contrasts them from normal cost based pricing.

Cost based pricing is detailed in many FAR provisions but commercial, catalog and market based pricing is also prevalent. For example, Part 38, Federal Supply Service (FSS) establishes market based pricing on schedules where agencies purchase items without the burden of issuing solicitations and price reasonableness is assumed to exist by comparing prices of other vendors. FAR Part 12 is dedicated to commercial item pricing. Commercial pricing can apply even to new products where various techniques are useful for pricing the items and evaluating the price for reasonableness.

Commercial and Market Pricing For T&M and Labor Hour Contracts

Commercial time-and-materials contractors do not require cost or pricing data but rather a market rate for the labor being priced where pricing based on cost data is a foreign concept. These techniques are highly relevant in the government world where under similar conditions, the prices are evaluated by comparing them to other vendors and upon evidence of sales at these prices for commercial situations.

Before 2007, subcontract costs had to be invoiced at cost plus any additives such as G&A or subcontract administration. However, in early 2007, the FAR was revised to allow for commercial and non-commercial T&M contracts. For commercial items and non-commercial items that were competitively awarded, the rule permitted payment based on the prime contract labor-hour rate for all labor hours that meet the qualifications in the contract whether those hours were supplied by the prime contractor or subcontractor. Though DOD limited noncommercial contracts, all other government departments do allow T&M commercial and noncommercial contracts that are awarded with adequate price competition to invoice subcontractors at prime contract labor rates.

Commercial Pricing Additives

In the commercial market it is quite common and desirable to be able to add items and price them accordingly. For example, expedited delivery or freight charges are common examples. Such pricing is difficult when FAR required costing practices exist. Under FAR-covered negotiated contracts, a contractor must establish direct and indirect costs in its accounting structure for purposes of pricing cost-based government contracts. A contractor may have clients who pay market prices for goods or services where they are invoiced to the client but are not classified as direct costs in the contractor's accounting system. For example, under cost based government contracts, if a contractor wants to charge more for the expedited delivery or freight charges, these costs must be specifically identified as direct costs in its accounting system. This is not true for market-based prices. If the prices are not cost-based, no segregation of such cost additives in the cost accounting system are needed to substantiate a price. If a contractor records these costs (e.g. delivery, freight) as indirect they may nonetheless negotiate a market based higher price for the expedited delivery or freight charges though the costs accumulated on the government contract does not reflect these costs. In this case, the government benefits by receiving additional value and the contractor is able to realize added revenues without violating the FAR or cost accounting standards. Some caution

may be called for because there may be the assumption that negotiating added revenue is based on such costs being separately identified so there should be an explicit understanding that a negotiated price was made.

Price Analysis

Price analysis is the process of evaluating a proposed price without evaluating separate cost elements and proposed profit. When commercial items are priced, no cost data is required and the buyer must rely on price analysis to ensure price reasonableness exists. Price analysis is the cornerstone of ensuring prices are reasonable, both in the commercial and government world. There are many accepted techniques that government buyers find acceptable for ensuring price is fair and reasonable such as comparing proposed prices, comparing proposed with historical prices (significant time lapses and different terms of conditions should be considered), parametric estimating or rough yardsticks (e.g. dollars per pound), comparison with published price lists, market research or value analysis of the worth of a product or service.

Value Based Pricing For New Items

Imagine pricing a new product or service the government wants on cost incurred in the current year. In such cases it is certainly desirable to avoid pricing a new product on a cost basis. As an extreme example, consider a government purchase of Microsoft Office where the price must be based solely on the cost of the one dollar disc containing the software. Though the government's first choice may be to seek cost data for the item since no market price exists but an alternative basis may be desirable. Even if the development costs were partially recovered in prior years as IR&D costs that were accumulated over several years the current year's costs are probably negligible. Under such circumstances it is almost futile to establish a fair and reasonable price for the contractor based on costs incurred. In such circumstances, the fair and reasonable price must be based on an evaluation of output (i.e. what value the item provides to the buyer) not the input (e.g. costs). Here, the seller and buyer should compare the price of the item to similar-functioning items in the market. Alternatively, most new items like software and hardware are valuable because they reduce the buyers costs, save lives, improve processes so a valid technique would be to calculate the savings the buyer will derive from purchasing the item.

Incremental Pricing

Sometimes it is desirable for contractors to keep prices low. Under these circumstances prices based on incremental costs may be desirable. Such incremental costing is contrary to the government concept of full-absorption costing where all direct and indirect costs are taken into account but charging for incremental or marginal costs is quite common in the commercial world.

Incremental costing includes all direct costs but only a small amount or even no indirect costs caused, say, by the production line or office staying open for a little extra time. As a general rule, about 80 percent of overhead is variable (varies with direct labor dollars) and 20 percent is fixed while about 90 percent of G&A costs are fixed. So a new item may cause some additional overhead to be incurred but not much G&A so full rates as applied using FAR based full-absorption costing would not reflect actual costs incurred. Though a detailed variable versus fixed cost analysis could be performed a shortcut method might be to apply overhead but no G&A to the new or additional items.

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