
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 Thornton's Annual Government Contractor Industry Survey that benchmarks primarily professional services firms. The 15th 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 contractor 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 survey 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 is 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 25th, median and 75th 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 from 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 hearings 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, GT 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 gather 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.)

WHAT CONSTITUTES AN ACCEPTABLE WRITTEN ESTIMATING POLICY

Following our recent article on DCAA’s Internal Control Questionnaire (GCA REPORT, Jan-Feb 2010) where written adequate policies and procedures are increasingly being scrutinized and have become a surrogate measurement for sound internal controls, we have been literally inundated with requests to address what are considered to be essential elements of such written policies. Accordingly, we have decided to provide a series of articles here that identify what we consider to be essential elements in some of the most important written policies that are often requested and reviewed. Our major source of

information comes from our consulting engagements in actually preparing such policies where we have long reviewed what DCAA considers essential internal controls and what experts put forth.

Our first policy addresses estimating policies and procedures. In the wake of extensive criticism of DCAA's failure (see article above) to examine contractors' estimating policies and not being aggressive enough at eliminating direct billing privileges we find requests for estimating policies to be one of the essential data requests when conducting forward pricing proposals, DCAA's highest priority audit.

1. General Information

This section should have "Purpose", "Policy", "Applicability", "Distribution" and "Government Requirements" subsections.

The *Purpose* is a 2-3 sentence statement that this policy is to provide internal controls over preparing price proposals that are compliant with government regulations. The *Policy* will include several bullet items saying it is our policy to (1) comply with the regulations (2) provide a written description of the estimating systems and make it available to relevant employees (3) who is ultimately responsible for the policy and its updates and (4) deficiencies identified either internally or by auditors will be corrected. The *Applicability* section states what contracts the policy applies to (e.g. TINA covered contracts which are in excess of \$650K). The *Distribution* section states that it should be available to either all or at least relevant employees.

The *US Government Requirements* sections are by far the longest. It should allude to relevant FAR and DFARS sections such as:

- FAR 15.407-5, Estimating Systems.
- FAR 31.201-1(a) basically defines what a cost is.
- DFARS 252.215-8002 and 215.407-5007. This is the key regulation which specifies what the elements of an acceptable system are. It should be read by all people involved with estimating and the policy should incorporate all the points.

Definitions. Though not necessarily considered to be a critical element of internal control we find it highly useful to identify terms not familiar to many people, especially if wide distribution of the policy is anticipated.

2. Requirements

Delineation of personnel responsibilities in the proposal preparation and review process is the number one emphasis by DCAA on what constitutes an adequate written policy.

2.1. Estimating Process Organization.

This section is perhaps the most important section from an audit point of view since designation of roles and responsibilities and separation of functions are considered key internal controls. This section should identify the key positions that are responsible for estimating with a one sentence summary. For example the Business Center Manager is responsible for ensuring that proposals are prepared in accordance with the policies, procedures, and practices set forth in this Policy or the Proposal Manager is responsible for the overall coordination of the proposal process as defined herein. In recognition that the functional roles for estimating may not correspond with the titles and duties of the people who may fill those roles or individuals may fill multiple roles there should be explicit reference to this along with some examples specific to your organization. Individuals performing the functions described below during the proposal process must comply with and be responsible for the duties defined below.

2.2. Personnel Responsibility Descriptions

The subsection should spell out all the major roles for the estimating process. Each position should include several bullets. For example, the Profit Center Manager should have (1) final approval of cost/price estimates from technical, operational and financial perspective (2) confirm that cost estimates are prepared and documented in accordance with the company's Estimating Policy (3) select the Proposal Manager (if Profit Center Manager does not perform role), etc. The Proposal Manager (1) prepares proposals in accordance with this Policy (2) coordinates and manages the proposal process (3) identifies Key Personnel to be proposed, etc.

2.3. Personnel Responsibilities Matrix

Though this was in the past an optional element found usually only in written policies for large companies, we find auditors are commonly including a matrix as an essential component. The matrix consists basically of a list of functions where one or more functional titles are identified. For example, determining

applicability of the policy to individual proposals may lie with the Division Manager, selection of team managers may be the Business Center Manager, obtaining direct labor rates may be the CFO, etc.

Though the three subsections above are indispensable, the following are important options that are commonly found in good policies.

2.4. Evaluation of Business Opportunities and Decision to Bid

This section normally alludes to the company's Go/No-Go bid policy. As we have discussed in previous articles, such a policy is a good idea to more formalize decisions about bidding to allow better bang-for-the-B&P-dollar.

2.5. Proposal Format

To many auditors, this is a critical item so as to ensure that relevant sections of the FAR are adhered to when presenting a proposal. It should state that each proposal will include a narrative explaining the methodology and basis for each proposed cost element and that the proposal is prepared in accordance with the RFP, FAR Table 15.2, if required or an alternate proposal format, if requested by the Contracting Officer or the RFP.

2.6. Proposal Review

This subsection has undergone probably some of the biggest changes we have encountered. What was once a section containing perhaps a few sentences addressing the need to have a policy in place to ensure vigorous review of proposals and compliance with the policy has mushroomed into its own separate sections with pages of detailed general policy as well as detailed requirements under the proposal review sections. Now, there are two key areas – Technical Quality Control and Financial Quality Controls where specific named functions are identified with detailed steps presented. For example, under the Technical Quality Control section, a Quality Control person is designated by the Proposal Manager who has certain requisite knowledge, may delegate sections of the proposal to others and will perform logic checks between work scope and estimated costs. The Financial Quality Control function will also have a QC person appointed by the Proposal Manager who will review adherence to the RFP, verify pricing and costing methodologies and assumptions, verify consistency between cost and technical proposals, ensure proposed costs are allowable and consistent with CAS

and Disclosure statement requirements if applicable, indirect costs are consistent with provisional billing rate agreements, subcontractor documentation is in order, certifications are properly completed, etc.

2.7. Proposal Proprietary Information

All proposals will be marked as proprietary with appropriate language restricting disclosure of proposal information (e.g. *Restrictions on Disclosure and Use of Data (April 1984)*):

3. Basis of Estimate (BOE)

Second to lack of detail on delineation of responsibilities, a section of Basis of Estimate seems to be a key element for rejecting estimating policies as inadequate. The BOE is sometimes known as planning, budgeting or estimating documentation. This section should allude to the need to capture historical cost data and explain estimates and judgments applied to that data in forming resource and cost estimates used as the basis of proposal prices. Normally there are three elements of a BOE that needs to be identified - Task Description, Basis of Estimate and Calculation Summary. There should also be steps identified to explain how a BOE is developed. An example of such steps might be: (1) document the Work Breakdown Structure (WBS) number of the activity being estimated, if one has been assigned, and describe the activity being estimated (2) record the name and date of the preparer as well as the reviewer of the BOE (3) describe how the estimate was developed for the scope of work - not simply a description of the hours or dollars to be bid, but rather an explanation of the analytical methods used to determine any aspect of resource requirements e.g. labor qualifications, functions, number of Full Time Equivalent (FTEs) hours, subcontract effort, ODCs, etc. Basis for the estimate should be discussed e.g. did the estimate of the hours come from past experience on a similar project, was it an 'engineering estimate' based on judgment or was it based on historical data? Other Direct Costs (ODCs) as well as travel should also be included in this section with similar detailed explanation of resource needs and related costs.

4. Estimating Costs and Profit

Though a written policy should not be confused with a detailed manual, the estimating policy is still probably the most detailed policy we will encounter. This section should be both comprehensive in the sense of

addressing the major cost elements you encounter in preparing a proposal and outline the general methodologies and approaches that might be used in estimating costs to ensure the appropriate use of source data, application of estimating techniques and application of indirect rates. Examples of topic to be addressed and suggestion for scope of discussion are:

4.1. Narrative about use of historical cost data e.g. estimating costs of similar labor or ODCs.

4.2. Direct Costs. There should be a short definition and at least the following components of Direct costs.

a. **Direct Labor.** A determination of labor qualifications and estimated required hours need to be identified and then state that direct labor costs are derived from applying the appropriate labor rates to hours and that the assumptions are supported by the BOE and how labor rates are determined.

If labor dollars are a significant portion of costs, it may be advisable to drill down and have separate subsections consisting of:

a.1. **Direct Labor Hours** – source of information like RFP versus engineering estimates, types of estimates (e.g. bottoms up, historical), assumptions about paid time off

a.2. **Direct Labor Rates** - use HR information, average or weighted average rates or actual rates of named people, Service Contract Act or Davis Bacon if relevant, employee commitment letters, contract specified rates like GSA or Blanket Purchase, escalation assumptions (its wise to specify numerous sources for escalation so you will not be locked into only one).

2.b. **Subcontracts and Direct Material.** You will want to state the RFP Statement of Work is used to estimate subcontract and material requirements and provide that technical or engineering estimates are used if there is no relevant experience or similar usage adjusted for expectations if there is relevant history. You will want to specify a range of methods to use without committing to any one such as prior PO with quantity adjustments, prior cost estimate, current vendor quote, written justification if sole source, catalog prices. If applicable, bill of material costs estimates and presentations should be addressed. You will also want to briefly cover Make versus Buy decision making.

2.c. **Other Direct Costs.** You want to specify types of ODCs and address bases of estimates (e.g. RFP specified, bottom up/technical estimate, historical) that are documented in the BOE. If travel is significant you want to address relevant regulations (FAR 31.205-46, FTR). You may also have separate subsections for travel such as Air Travel (e.g. coach or equivalent, documentation, no first class), Rental Vehicles (e.g. needs justification, competitive quotes), Personal Vehicle Use (e.g. basis of estimates), Parking Tolls and Taxis, Per Diem Lodging, Meals and Incidentals (e.g. not to exceed FTR rates, lodging estimates – one day less than number of days, definition of incidentals). Other direct costs might include Equipment Repair and Maintenance where types of estimates should be identified (e.g. historical experience, vendor quotes, industry standards) or Relocation where you want to reference FAR 31.205-35 and contract unique limitations.

4.3. Indirect Rates. There should be a brief definition, identification of where to obtain indirect rates (e.g. CFO), statement about consistent treatment of costs (proposal versus booked costs, direct versus indirect), basic indirect information (e.g. number of indirect rates, types of estimates – final, provisional, indirect allocation basis). A critical deficiency these days is failure to explicitly state and use budgeted or estimated data for the relevant years a proposal covers.

4.4. Fee or Profit. Definitions of fee and profit (as opposed to cost or negotiated add-ons), some verbiage about nature of profit, allusion to structured approached in FAR 15.404, mention of different fee ranges for different types of contracts.

5. Truth in Negotiations Act (TINA).

There definitely needs to be a writeup about the Truth in Negotiations Act. There should, at the least, be sections of the act itself, relevant FAR clauses, and TINA related proposal requirements such as updating the proposal and executing the certification as well as documenting the pre- and post negotiation phases.

6. Documentation Standards

This section will address the responsibilities and elements of a proper proposal file (e.g. RFP, correspondences, proposals and revisions, technical estimates, BOEs, cost element buildups in sufficient detail, vendor quotes, catalog prices, etc.

7. Training and Internal Review/Audit

Next to an adequate written policy, attention to training of personnel and internal audit are critical criteria for demonstrating adequate internal controls. Personnel involved in the cost estimating process need to be provided training, either internally or externally. Training areas should include government regulations (e.g. FAR, CAS, etc.). Company policies, company practices and methodologies, estimating system policy and basis of estimate development. Also, the policy should address the function of internal reviews e.g. compliance with established practices and periodic management reviews conducted either by in-house staff or outside consultants.

ACCOUNTING TREATMENT OF TEMPORARY EMPLOYEES – CASE STUDY

We have just encountered DCAA reactions to a client's treatment of temporary employees and briefly responded to them. We thought the communications would be of interest to our readers since it presents possible alternatives for treating this type of labor, possible positions that DCAA may take and responses to their position. We must admit this article is brief and less authoritative than many other case study white papers we have presented because the communications have just begun and no final positions by DCAA have been taken.

Background

In addition to use of regular employees on its cost type professional services contract Client (we will disguise the name) uses what it calls temp employees on many of its task orders. The government asked Client to use certain recommended individuals for limited time so they proposed using 1099 consultants to be billed at their higher hourly rate (because they were usually in demand and received no fringe benefits) and burdened with Client's provisional overhead rate. The government resisted, saying such a practice would be too expensive so Client created a temp labor employee where they would apply a lower overhead rate to their hourly pay and charge a slightly higher rate on regular employees to meet the budgeted provisional billing rate for the year. Client informed the government of this approach and there was no objection.

In anticipation of possible problems in the future, Client adopted a new practice in 2010. It would treat the term employees as if they were 1099 consultants and charge the government only the average full time employee rate for the labor categories they worked and charge the excess to overhead. This approach was reflected in the 2010 provisional billing rates.

DCAA Response

During its audit of prior years' invoices, the auditor noted quickly the different rates applied to full time and temp employees. She stated that would be completely "unacceptable" since there was an approved provisional billing rate and all direct labor costs should be billed at that one rate unless there was a change in the rate. Billing two rates – a lower one for temp employees and a higher one for regular employees would be "improper."

During a separate audit of 2010 provisional billing rates, the auditor stated that charging a partial amount of the term labor payments to direct labor and another amount to overhead was also improper stating that in his "21 years of experience as an auditor did I ever hear of such a thing." He also stated such a practice might result in an "inequitable" allocation of the resulting overhead costs and was in violation of FAR (without quoting a section).

Our Response

At this point in the communications no formal audit positions or formal responses were taken. Rather all communications were made by email.

◆ Billing Two Rates

We first admitted there was an apparent "disconnect" between use of two indirect rates for temp and full time labor. We explained the use of temp employees was initiated to meet government requests for specific individuals and to bill them "without breaking the budget" and they were informed of the practice. We stressed that though there was a disconnect with the billing practice, the critical point was that there was no harm to the government. We asserted that the government was not charged for any more costs than it incurred and in fact the amount of overhead costs charged was less than what would have been charged had we used the provisional rate (a subsequent analysis confirmed this assertion).



◆ **Charging Some Temp Labor to Overhead**

Thought we intuitively believed the practice of allocating some of the payments made to temp employees to direct and overhead costs was acceptable, we knew we would have to allude to some authoritative sources that would show the auditor that in spite of his 21 years of never seeing the practice that it was acceptable. We examined what we thought might be relevant sections of the FAR and found no allusions to the practice. Though we found no direct allusions in the FAR or even CAS, we did find a section in the DCAA Contract Audit Manual – Purchased Labor – that more or less addressed our practice. I say more or less because “purchased labor” generally refers to non-employees who are either 1099 consultants or subcontractors but I was prepared to argue that the temp employees were in substance equivalent to 1099 consultants. (Too detailed to address here.) We asserted that the practice recognized in the DCAM provides for the exact method we were adopting – charge hours worked by the temp employee at only the average full time employee rate for that labor category and charge the excess to overhead. We explained that the practice benefited the government where rather than a dollar for dollar charge as direct labor, a portion of the amount paid to the temp hire would be charged to overhead and allocated to all contracts (federal fixed price and commercial).

Preliminary Conclusion

It appears that the auditor conducting the invoice audit has recovered from her shock of seeing two

burdened rates used for billing purposes and to her credit, has agreed to determine whether there was any harm to the government by comparing the amounts of overhead actually billed to the amounts that would have been billed had Client used the provisional billing rates where any excess will be questioned. Though it is possible she may select invoices where higher overhead amounts were billed due to a disproportionate use of full time higher burdened labor, we are reasonably confident she will see there is no harm to the government in the approach taken by Client. Though I believe the other auditor will see that our approach may be reasonable, we shall see what comes up during the audit. I suspect we may need to demonstrate that the term employees are, in substance, 1099 employees and Client may need to be willing to discontinue use of temp employees and make them consultants so the prescriptions of purchased labor may apply. We shall see.

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