GCA DIGEST

(A publication of Government Contract Associates)

First Quarter 2011 Vol 16, No. 1

GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

(Editor's Note. We were very happy to find a few years ago Grant Thorton's Annual Government Contractor Industry Survey that benchmarks primarily professional services firms. The 16th Annual GT survey for 2010 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

79% of the approximately 120 surveyed firms are privately owned, 11% are publicly traded and 7% are not-for-profit concerns. 52% of the companies are classified as large and 48% as small where 21% had sales less than $10M, 13% between $10M-20M, 27% between $20M-50M, 12% between $50M-100M and 27% over $100M. 25% of respondents have been in business between 1-10 years, 27% for 11-20 years, 12% for 21-30 years and 24% 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. 60% of their revenue came from the Defense Department, 34% from other federal agencies, 4% came from state and local government and 2% was commercial. The results confirm the truism that though the commercial sector has experienced major business disruptions government contracting remains a growth industry where 55% of respondents had increased revenue over the prior year, 23% had no significant change while 22% had reductions. Over the next 18 months 26% of surveyed company said they expect to see increases coming from prime contracts while a far larger number of 56% say they are expecting increases in federal government subcontract work while 12% expect increases from state and local government and 19% from the commercial sector.

♦ Indirect Headcount Breakdown

11.9% of total headcount is represented by management and support functions compared to 14.6% last year. The drop is attributable to greater direct billing of support staff hours and outsourcing such functions as HR, legal, internal audit, M&A effort and government compliance. The breakdown of certain functions are finance and accounting (2.4%), contract and procurement administration (1.2%), sales and marketing (1.8%) and other indirect (6.5%). For facilities costs as a percentage of revenue 83% reported less than 5%, 13% 6-10% and 4% greater than 10%.

♦ Government Contracts

Breakdown of Revenue by Contract Type. 40% of revenue from federal contracts come from cost type contracts, 20% are fixed price and 40% are time and material indicating a drop in cost type and a corresponding increase in T&M.

Bid Protests. Respondents stated they filed 22 bid protests of which 11 were sustained in whole or in part. This 50% success rate appears higher than normal statistics reported by the government because many protests are resolved by corrective actions agreed to by the government.

Fees. Average negotiated fees for cost type contracts averaged 6-7%, T&M contracts had an average of 8-9% (compared to 7-8% last year) while firm fixed contracts had 10-11% (compared to 9-10% 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 36%. Reasons stated for loosing competitions was a combination of price and technical – 53%, price only – 26% and technical only – 17%.

Bid and Proposal costs as a Percent of Revenue. 18% reported less than 1%, 52% 1-2% while 25% reported greater amounts.

Claims and Identifying Out-of-Scope Work. Identifying out of scope work, whether it comes from an easy to

recognize direct change or sometimes difficult to recognize constructive changes, provides an important opportunity to receive additional entitled revenue. 31% of the respondents said their procedures for recognizing out of scope work are very effective (last year was 39%), 37% said somewhat effective and 32% said not effective (17% last year). 67% 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, 17% refuse while 68% sometimes performs and sometimes refuses without a price adjustment.

Terminations for Convenience. The regulations governing reimbursement of costs from a termination for convenience are surprisingly very generous where the overriding emphasis is on fairness and ensuring the contractor does not suffer adverse financial consequences. We find in our consulting practice that not many contractors seek the reimbursement they are entitled to and even when they do, they leave out many categories of costs that are usually paid. The survey found that 24% of all respondents had a contract terminated for convenience in recent times where 59% requested an equitable adjustment while 41% did not. Identifying types of costs that are frequently recoverable from a T of C, only 25% asked costs related to idle time, 0% asked for idle facilities, 29% asked for severance pay, only 33% asked for costs related either to preparing the settlement, supporting the resulting government audit or negotiating the settlement while 50% asked for costs related to subcontractor settlements.

Intellectual Property. Company ownership of intellectual property is often an essential feature of limiting competition and generating above average profit. 38% of respondents own intellectual property. In responding to the source of funds for such property, 56% said it was a mix of private and government funding, 38% said private which includes IR&D and acquisitions of other companies (IR&D funds are considered private expense even when partially allocated to government contracts) and 6% said it came from government funds. Unless the government funded all rights contractors may limit or restrict the government rights where 62% said they allowed limited or restricted rights to the government, 25% provided government purpose rights only while 13% allowed unlimited or unrestricted rights. Finally, 44% of companies owning intellectual property charged the government license fees for its use.

♦ Financial and Cost Statistics

Profit. Contrary to common public perceptions, government contracting does not generate abnormally high profits. 40% of survey companies had profit rates before interest and tax between 1-5%, 35% between 6-10%, 9% between 11-15% and 6% above 15%. 10% 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 35.5% 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) - 65% compared to 69% last year (b) on site direct labor and fringes – 38% compared to 48% last year (c) off-site direct labor – 42% as opposed to 47% 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 – 19% compared to 18% last year. When companies used multiple overhead rates logic used for them were location (61%), labor function (24%), customer (7%) and products versus services (8%). 32% or respondents say their indirect cost rates are increasing, 24% decreasing and 44% report no change.

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 15.5% (same as last year).

Material handling and subcontract administration costs. 19% 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 2.2% and 2.2% for the subcontract administration rate, lower than last year due primarily to lower headcount associated with contracts and purchasing.

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 47% of the respondents), information technology (35%), human resources (23%) and printing/ publications (11%).

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 2.3 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.

Special Allocations. Special allocations are allowed when normal allocation practices would yield an inequitable allocation of costs on a particular contract. For example, if a contract has an unusually large amount of equipment, subcontracts or materials allocating a full G&A rate might distort G&A allocations. 18% of respondents, dramatically increased from earlier years, reported using a special allocation.

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.*) 63% of respondents said their employees work uncompensated overtime while 37% said no. 81% of the companies use total time reporting while the other 19% report only 40 hours per week. 76% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 24% use a "standard/variance method" that charges an hourly standard rate on projects and then credits an indirect cost pool for the difference between labor costs charged to projects.

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. 86% (compared to 81% last year) of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract while 14% bill on a cost reimbursable basis (i.e. as an ODC).

Provisional and Actual Indirect Cost Rates. On cost reimbursable contracts, contractors bill the government at provisional indirect rates that are subject to adjustment to actual rates at year end when actual rates are determined. The difference between the two are called a rate variance. 38% of respondents say their actual indirect costs were higher than provisional rates, 18% were lower than provisional rates and 46% said there were no significant differences. When significant rates variances existed 24% said all variances were collected, 19% said none were and 57% said some were collected. For those responding that none or some was collected, funding limitations were cited as the main reason. As for billing practices, only 22% responded they bill the government immediately after submitting their actual rates (they are allowed to do so within six months after year end) while a whopping 78% say they are not exercising due diligence in collecting all of their indirect costs saying they are waiting for final rates to be settled where long delays are common.

♦ 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. 63% of respondents described their relationship as good, 32% as excellent while 14% described it as fair or poor. (*We find this positive attitude surprising since most of our work with clients are often due to poor relationships with DCAA.*) When asked if their relationship with DCAA has changed, 89% said it had stayed the same, 2% reported the relationship had worsened while 9% said it had improved. In effort to measure the quality of relationships with ACOs and DCAA, the survey found 26% of respondents resolve issues efficiently where the remaining 74% say the government was inefficient, 56% believe DCAA is the primary cause for delays of resolving issues while 18% believe it is the ACO. The most frequent types of costs questioned by DCAA are executive compensation (27%), consultant costs (9%), incentive compensation (15%), labor charging (14%), indirect cost allocations (8%), legal expenses (14%) and employee morale (2%). Most frequently cited violations of cost accounting standards were CAS 401, consistency (14%), CAS 403,

home office expenses (7%) and CAS 405, Unallowable costs (7%). Of those companies experiencing audit issues, 33% were very satisfied with the resolution of the issues (down from 49% last year), 42% were somewhat satisfied (compared to 52% last year) and 25% were not satisfied (up from 15% last year).

♦ 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: 2% reported the company pays for less than half, 6% pays 51-60%, 24% pay 61-70%. 37% pay 71-80%, 11% pay 81-90% and 20% pay 91-100%. With respect to health costs as a percentage of labor costs, 16% of respondents incurred health costs less than 4% of labor costs, 8% between 4.1-5%, 15% between 5.1-6%, 11% between 6.1 and 7%, 9% between 7.1-8%, 11% between 8.1-9%, 4% between 9.1-10% and 24% over 10% of labor costs.

410(k) benefits. 7% of respondents do not provide any company contribution, 67% contribute 1-5% of labor costs, 20% contribute 6-10% while the remaining 6% put in more than 10%.

Wages Increases. Surveyed companies state that the average increase was 2.6-3.0%, lower than last year's 3.0-3.5% figures.

Compensation for security clearances. 37% of respondents do not pay premiums for employees with security clearance, 49% pay premiums up to 15% while 14% 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	200	250	300
$11-20M	240	275	350
$21-50M	245	310	425
$51-100M	320	420	525
>$100M	375	475	710

Second Highest Position

Revenue	25%	Med.	75%
$1-10 M	180	230	275
$11-20M	210	255	290
$21-50M	220	375	310
$51-100M	250	310	350
>$100M	320	380	435

Third Highest Position

Revenue	25%	Med.	75%
$1-10 M	150	180	240
$11-20M	150	195	245
$21-50M	210	250	295
$51-100M	230	290	340
>$100M	250	345	395

Fourth Highest Position

Revenue	25%	Med.	75%
$1-10 M	125	160	210
$11-20M	140	180	230
$21-50M	160	200	250
$51-100M	180	250	310
>$100M	230	325	355

♦ 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). 81% of respondents have established formal policies and procedures as required by the FAR compliance clause while 9% 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 52% say they are reasonable and cost effective.

♦ Government Insourcing

Though many government officials are just beginning to express opposition to insourcing, in recent years the government has begun transferring jobs from contractors and bringing them in-house to be performed by government employees. This

insourcing effort is contrary to the historical precedent of the government obtaining its supplies and services from commercial businesses unless the services were considered inherently governmental functions. Asked whether the government has hired their employees in pursuit of insourcing, 47% of the companies report they have indeed lost employees to insourcing while 53% report they have not.

An Oldie But Goodie…

INACCURATE ESTIMATES

(*Editor's Note. More than ever, we are seeing contractors take an overly conservative approach to estimating costs for preparing their price proposals. When we have asked about it, we hear that there is a fear of being accused of inaccuracies, defective pricing and even fraud. They state the government wants contractors to use "objective" data like prior costs rather than more uncertain projections of future costs even though the more objective data does not fit the new products or services being offered. We were glad to come across an article by David Bodenheimer of the law firm Crowell & Moring LLP in the December 2005 issue of Briefing Papers that addresses "false" or "inaccurate" estimates which we think is particularly timely now.*)

The US Government has numerous weapons at its disposal to bend sellers to its will. Some include statutory fraud laws, defective pricing remedies, qui tam relators and many regulations that can be used to challenge inaccuracies included in price proposals long after the fact. However, such acts as the Truth in Negotiations Act or the False Claims Act should not be used to brand inaccurate or false estimates as fraudulent or defective. Estimates have a long and well recognized role in government pricing policy but because estimates are "an opinion or a judgment" they will be wrong on many occasions but they should not be targets for defective pricing or fraud cases.

Role of Judgmental Estimates in Pricing

Having two parties haggle over the quality of an estimate is not only proper but it is the very essence of healthy pricing negotiations. There are two premises that form the basis of estimating: (1) judgmental estimates are fine and (2) it is the role of the contractor – not the government – to decide how much to estimate in a proposal.

♦ Government Recognition of Judgmental Estimates

Due to the inherent uncertainty and risk of predicting future costs, judgment necessarily is a critical element of a pricing proposal. For decades federal pricing policy has recognized and validated the use of judgment as a basic method of cost estimating. For example the Armed Services Pricing Manual (ASPM) and the Defense Contract Audit Agency's Contract Audit Manual (DCAM) identifies "roundtable" estimating as one of the three major methods for estimating. Currently, the Contract Pricing Reference Guide (CPRG), which replaced ASPM, acknowledges the use of judgment as an appropriate estimating method where roundtable estimates are described as experts brought together to develop cost estimates, by exchanging views and "making judgments" based on their experience. Similarly, the DCAM states the "roundtable method" represents one of the three "most frequently used" methods where it describes it as representatives of engineering, manufacturing, purchasing and accounting (among others) developing cost estimates by exchanging views and "making judgments." Once judgments are made, the Guide and DCAM specify the appropriate response is to take a closer look at the estimate and if necessary DCAM suggests using technical assistance to evaluate cost estimates.

♦ Contractor's Right to Decide How to Estimate

The contractor, not the government, has the responsibility of proposing the price and establishing how it will prepare its proposed price. The contractor wants to avoid the risk of having to live with a contract price dictated by the government and wants to propose a price that is consistent with its business strategies, assessment of contract risk and other opportunities. Hence estimating cannot be reduced to bean counting but must be based on the usual business judgmental factors such as competitive threats, perception of risk, assessment of opportunities, etc. The CPRG recognizes this when it states "different judgments on which price is most reasonable…will be based on different perspectives and different assessments of the risks involved."

Common Fallacies in Allegations of False Estimates

Federal agencies, qui tam and even auditor allegations often slap the term "false and inaccurate" labels on estimates when the government thinks it has the "best" estimate or it believes historical data should dictate the basis for the price.

The government knows best. Quite often auditors have a revelation that the preaward parties totally missed the

mark, using the wrong data and estimates to reach the wrong price. Aside from the often wrongheaded results of such assertions, there is a long history of decisions that provide little support for the government having superior abilities to set prices. It would be bad policy and bad law to attempt to usurp the contractor's role in selecting its own estimating methods.

Historical data is always best. It is quite common for auditors to presume that historical data trumps other estimating methods. While use of historical data is a long recognized means of developing an estimate it is certainly not necessarily the best. Both the FAR and its predecessor the DAR stressed that the most important consideration in establishing a contract price should be the total proposed price rather than individual cost elements of a proposal. Even when a cost analysis is conducted, the FAR recommends a price analysis also. As long as the contractor divulges any relevant cost information to the government, the contractor should be free of accusations of defective pricing or fraud simply for using some judgmental estimate instead of historical cost.

Judgments and Estimates Under TINA

In 1962 the government decided it needed to further level the playing field so it passed the Truth in Negotiations Act that required contractors to submit cost or pricing data to be certified to be accurate, complete and current and to provide a remedy of price reduction for any cost data that was "defective" (inaccurate, incomplete or noncurrent). TINA aims to provide the government access to the same information as the contractor in order to negotiate the best possible price. However, TINA is not intended to apply to "inaccurate" estimates or judgments.

♦ TINA is Inapplicable to Judgments and Estimates

Since its inception, TINA has applied only to cost or pricing data, not estimates or judgments. Numerous decisions have held that "pure estimates are not cost or pricing data" and hence need not be disclosed under TINA. Even when the contractor must disclose data that consists of a mix of facts and judgments, TINA provides for no liability for "defective" judgments. As the FAR states, the Certificate of Cost or Pricing Data the TINA covered contractor must submit, "does not constitute a representation as to the accuracy of the contractor's judgment on the estimate of future costs or projections." Similarly, the CPRG makes clear the contractor does not certify "educated guesses" or "estimates." In short, TINA does not punish "defective" estimates or judgments.

♦ Use of Data

Frequently, government agencies have asserted TINA liability on the theory that the contractor failed to use certain data. Such claims have been repeatedly rejected by the courts on the grounds that TINA requires disclosure, not use, of the data. Bowing to this long history, the DCAM rejects any use requirement under TINA stating "TINA addresses only the submission of cost or pricing data. It does not require a contractor to use such data…" It is common for assertions of defective estimates to boil down to an assertion the contractor did not use the best data the government believed should have been used and the simple response is that the contractor has no legal requirement to use the best, second best or even good data.

Estimates as a Basis of Fraud Claims

In fraud claims, allegations of false estimates cannot be defended.

Common law. It has long been held that generally "mere opinions or predictions of future events, are not actionable as misrepresentations." Common law has provided exceptions to this rule when "special knowledge" exists that provides unequal information to the parties. This special knowledge applies to expert opinions of specialized experts such as jewelers, lawyers, physicians, scientists, antique dealers whose opinions are based on "objective, verifiable facts" and the plaintiff is "illiterate and ignorant" of such special knowledge. These conditions do not apply to government contracts because (1) the sellers are not such experts (2) federal agencies will not plead illiteracy and ignorance (3) judgments and estimates do not qualify as "objective, verifiable facts" (4) and TINA levels the disparity of knowledge between the parties. Hence, common law exception should not apply to government contracts.

Federal standards for fraud. A threshold requirement to be liable under the False Claims Act is the requirement that the false claim be "objectively" false. Courts have ruled that a false claim must be "objectively false" meaning "expressions of opinions, scientific judgments or statements as to conclusions about which reasonable minds can differ cannot be false" under the FCA. The test must be based on the existence of a verifiable fact which must be "adjudged

as true or false in a way that permits empirical verification." In contract, a judgmental estimate is not verifiable, by definition. The CPRG recognizes the subjectivity of judgmental "round table" judgments and notes that different perspectives on risk can result in differences in what constitutes a reasonable price.

Conclusion

Federal policy has long recognized the propriety of using judgmental estimates for predicting future costs and developing price estimates. TINA has also long recognized that contractors neither certify such estimates nor have any liability if those estimates turn out to be wrong. Finally, the standards for what constitutes fraud under both common law and the FCA does not apply to "false" estimates. Remember that cost data must be disclosed under contracts subject to TINA but there is no requirement to use such cost data for estimating or preparing proposals.

Case Study…

CHALLENGING IMPOSITION OF PENALTIES ON AN UNALLOWABLE COST

(*Editor's Note. The following is a continuation of our practice to present real life case studies from our consulting practice. DCAA issued an audit report disallowing all costs related to Contractor's annual three day employee conference. (We will disguise the name of the contractor and refer to the employee conference as "the Event."). Following DCAA's recommendations, the Defense Contract Management Agency then wanted to impose penalties in accordance with FAR 42.709 on these unallowable costs and asked Contractor to respond. The edited discussion below represents that response. We believe this case study is particularly pertinent now since acquisition agencies are increasingly seeking penalties on top of DCAA questioned costs following several critical reports stating penalties were not being sought. We believe many of these attempts to impose penalties are inappropriate. We also hope it sheds light on what types of costs may generate penalties up to three times questioned costs and therefore should be closely screened while other costs should not attract penalties.)*

Background

Contractor holds an annual business meeting at different locations each year where all of its employees come together for three days. The purpose of the meeting is to bring employees together to address status of recent and current company operations, technical issues and short and long term plans. In addition and no less important, the purpose of the meeting is for employees, both new and veteran, to meet, get better acquainted and learn to work as teams. The business purposes of the event are accomplished through two mornings of intense presentations and discussion groups and organized team activities for the rest of the day as well as evening meals.

Contractor has traditionally identified and accumulated its costs related to its annual business meeting and followed the same approach of identifying unallowable costs related to these events. The company takes a conservative approach where both clearly unallowable costs are deleted such as spousal expenses, alcoholic beverages and less clear unallowable costs are also deleted such as team sporting events even though they could reasonably be considered allowable employee morale costs.

Prior to the year the costs were questioned, Contractor had at least five audits of its earlier incurred cost proposals where the business meetings, representing a material amount of costs, were reviewed. Without exception, no audit found any questioned costs. Since the type of event and approach to screening unallowable costs did not differ from prior years, Contractor had no reason to believe the same type of costs were unallowable.

Audit Position

The auditor took the position that the entire event was unallowable entertainment and hence all costs related to the event were unallowable. When asked what would have been considered an allowable business meeting, the auditor told Contractor the President should have flown to each company location and made a presentation there. Contractor stated such an approach has little to do with the business team building objectives of the Event. In addition, agenda information was disregarded that showed that 17 people would have had to travel to each location as there were 17 other presenters at the meeting.

With respect to the Event, four FAR sections are cited in the DCAA report that support the position that all costs related to the event were unallowable: (1) FAR 31.201-3 - the costs were not "reasonable" (2) FAR 31.201-4 – the costs were "not allocable" (3) FAR 31.205-14 – the costs were unallowable "entertainment costs" and (4) FAR 31.205-13 - the costs were unallowable "employee morale costs.

Contractor Position

Throughout the audit, during the exit conference and even during the draft and final audit preparations Contractor explicitly told the auditor they disagreed with DCAA's position where this is confirmed in the audit report. Nonetheless, Contractor's experience was quite frustrating where it made the decision to simply accept the resulting audited rates that excluded the questioned costs rather than go through the process of challenging DCAA. Though it accepted the audited rates in order to go on with life, it was always made clear that Contractor disagreed with the audit finding that the Event was unallowable and it repeated this assertion frequently. Contractor never dreamed that the questioned costs would be considered expressly unallowable and hence subject to penalties. In our opinion, the auditor's assumption that only trips made by a CEO to different locations constituted acceptable business meetings showed the government was clearly wrong. Just as many organizations, including most government agencies, recognize the need for some off-site meetings where all or most employees attend, Contractor similarly needed such an event.

Basis of Disagreement

Though the Contractor recognized that this was not the place to exhaustively argue the merits of whether the costs were allowable or not, it did decide to use this response as an opportunity to demonstrate that the costs claimed could reasonably be considered allowable in order to establish the disallowed costs were not expressly unallowable and hence subject to penalties. Contractor stated their position: (1) the disallowed costs, in spite of allusions to FAR cost principle sections, can reasonably be considered to be allowable and hence the costs should not be considered as "expressly unallowable" (2) the meaning of "expressly unallowable" only applies to claimed costs by a contractor that are "beyond doubt", "unmistakably" "obvious", beyond "reasonable disagreement" or is not "colorable" and (3) Contractor had a reasonable basis to assume its costs were allowable based on prior audits and since it had a reasonable assurance the costs were allowable penalties should not apply.

♦ FAR Cost Principles

Contractor believes the auditor has misinterpreted the FAR citations he puts forth and has regrettably not cited a cost principle that makes the event allowable.

FAR 31.201-3, reasonableness. Reasonableness generally addresses whether the amount paid for something is not excessive – the reasonable man criteria. Though it argues below the event itself was a perfectly acceptable normal business expense, the criteria of reasonableness should apply to whether the costs for the event were reasonable. As is its custom, Contractor went through a long process (documented) of ensuring the hotel selected offered the best value for the meeting requirements. In addition, all claimed meal costs were charged at per diem rates provided by the government. There should be no question about the reasonableness of these charges.

FAR 31.201-4, allocability. The allocation issue addresses whether costs are allocable to government contracts or any specific contract. The issue in this FAR section is not one of allowability, but of allocability. The costs in question here were considered indirect costs, not direct to any particular final cost objective, and hence were charged to the relevant overhead and G&A pools. This is the proper way to charge an indirect cost so there should be no reasonable assertions of non-allocabilty.

FAR 31.205-14, entertainment. Though there were certain costs incurred at the Event that were clearly unallowable entertainment costs (e.g. spousal related expenses) and others that could potentially be construed as entertainment expenses (e.g. river rafting related expenses) as well as alcoholic beverages these costs were voluntarily deleted. Contractor maintains the remaining costs were not unallowable entertainment costs but were allowable business meeting expenses.

FAR 31.205-13, employee morale. Though the auditor quotes the relevant section he does not consider the relevance of the quote. Section (a) of this cost principle states "aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale and employee performance" are allowable. The event was clearly intended to improve "employer-employee relations, employee morale and employee performance."

Though the auditor quotes numerous sections of the FAR cost principles the most relevant one is not even mentioned:

FAR 31.205-43, trade, business, technical and professional activity costs. The section starts out "The following types of costs are allowable" where section (c) states "when the principal purpose of a meeting,

convention, conference, symposium or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity." Contractor believes the event was clearly a "business, technical and professional activity" and clearly qualifies as a business "meeting" whose purpose is to "stimulate" better production of its services and provide more to customers at the least amount of cost e.g. productivity.

♦ Meaning of Expressly Unallowable

FAR 42.703 provides that a cost that is "expressly unallowable" is subject to penalties. There is a common misunderstanding on what constitutes expressly unallowable. That misunderstanding is that if an unallowable cost can be cited by one of the FAR cost principles, then that makes the cost expressly unallowable. So if an auditor opines that a given cost is unallowable by alluding to a cost principle (or multiple cost principles as is the case here) then the mere assertion that a given cost principle applies to the cost in question makes that unallowable cost expressly unallowable. This common misunderstanding does not stand up to the meaning of the term as reflected in CAS promulgations, case law and expert opinion. In addition to an assertion that a cost principle makes a given cost unallowable, another condition for an unallowable cost to be expressly unallowable is it must be "beyond doubt", "unmistakably", "obvious" not "colorable" and the existence of no "reasonable disagreement."

Let us consider examples of costs that may be properly "expressly" unallowable and those that are not. Many costs expressly cited in the FAR are unquestionably unallowable – e.g. alcoholic beverages, interest, bad debt, lobbying, donations – because the cost principle actually identifies by name the costs where, if claimed, would qualify as expressly unallowable. Other costs are potentially subject to some debate but if no doubt is cast they also would be expressly unallowable. For example, brochures as unallowable advertising and public relations, defense costs related to fraud litigation, federal income taxes as unallowable taxes, stock options as unallowable compensation, spectator sports events as unallowable entertainment, gifts as unallowable employee morale, acquisition related expenses as unallowable organization costs, excess travel over FTR rates as unallowable travel expenses would qualify as expressly unallowable costs if there is no doubt they were expended and could not reasonably be confused with allowable costs.. However, many types of costs that may turn out to be unallowable are in the gray area. For example, a given plain covered publication may reasonably be considered either unallowable advertising or allowable dissemination of technical information, use of a government sanctioned compensation survey may indicate excess compensation while an industry accepted salary survey may indicate reasonable compensation, unused capacity may be considered unallowable idle capacity while need for it in the near future might make it not idle, differences in estimates of useful life would likely generate differences about whether depreciation costs are excessive or not. Such gray events are not "clearly" unallowable. In such cases even if it is determined that a given cost is unallowable and a cost principle can be cited as support for its unallowability the lack of it being "clearly" or "unmistakably" unallowable would preclude calling it "expressly unallowable." Contractor contends that the nature of the event is, at a minimum, in the gray area. Reasonable justification can be put forth for the costs being either unallowable entertainment costs or allowable business meeting or employee morale boosting costs. Especially the fact that similar costs were deemed allowable in prior audits would make the allowability of the costs in the relevant year far from "certain." As such, even if some or all of the claimed event related costs were considered unallowable, they would nonetheless not rise to the certainty level required of calling an unallowable cost expressly unallowable.

Regulatory, Legal and Expert Opinion on Certainty Requirements of Expressly Unallowable Costs

♦ CAS Promulgation.

CAS 405 defines an "expressly unallowable costs" as "a particular item or type of cost which, under the express provisions of an applicable law, regulation or contract is specifically named and stated to be unallowable." This definition is the same as used in the FAR Part 31 cost principles. In explaining the term, Preamble A to the original promulgation of CAS 405 refers to "costs whose nonallowability is *obvious*" and costs that are "*obviously* unallowable." (Italics added) The promulgation comments for CAS 405 also state the CAS Board used the word "expressly" in the "broad dictionary sense" i.e. "that which is in direct or *unmistakable* terms." (Italics added).

♦ Cases

Courts and boards have declined to expand the definition of an "expressly unallowable cost" to cover costs other than those that are directly or

unmistakably unallowable. For example, in one case the ASBCA has noted that "Congress adopted the 'expressly unallowable' standard to make it clear that a penalty should not be assessed where there were reasonable differences of opinion about the allowability of costs" (*Fiber Material Inc., ASBCA No. 53616, 07 BCA* (citing *General Dynamics Corp. ASBCA No. 49372, 02-2 BCA* and *Rumsfeld v General Dynamics Corp., 365 Fed. 1380 (Fed. Cir 2004*). Thus, in order to assess penalties, "the Government must show that is was unreasonable under all the circumstances for a person in the contractor's position to conclude that the costs were unallowable."

In the same *Fiber Material case*, the board of contract appeals overturned an assessment of penalties imposed for including disallowed costs in indirect cost rates because "some costs were allowable and the disallowed costs were either sufficiently colorable to preclude penalties or were under $10,000." A dictionary lookup of the word "colorable" is "seemingly valid or genuine" which is consistent with the terms we have seen that an unallowable cost must be "obvious", "unmistakable", "beyond doubt" and not subject to "reasonable disagreement."

In the *General Dynamics* case quoted above, a board of contract appeals overturned the assessment of a penalties imposed for costs included in an overhead cost proposal because the government failed to show it was unreasonable for the contractor to conclude the costs were allowable. After quoting Congress that penalties should not be imposed where there were reasonable differences of opinion with respect to allowability of costs, the court noted "Because the costs were the subject of serious and reasonable disagreement between the parties" penalties should not be imposed.

♦ Existence of a Reasonable Dispute

Thomas Lemmer and Steven Masiello, current partners in the law firm of McKenna Long, LLP, have written on the subject of penalties. In their Briefing Papers of May 1999, "Penalties for Unallowable Costs" after citing several cases (including the ones discussed above) supporting the assertion that an expressly unallowable cost must meet the certainty standard of being "unmistakable" they assert "When the Government alleges that a type of cost is expressly unallowable, the first relevant question is whether the type of costs involved is, in fact, unallowable in *every* circumstance under law, regulation or contract clause. Absent clarity that the type of costs is always unallowable, it is not expressly unallowable" (Italics is theirs). They continue by saying "the next relevant question is whether the facts surrounding the specific incurred cost in question establishes it as a type of costs that is expressly unallowable. Again the existence of a reasonable dispute in that regard precludes a conclusion that the incurred costs are expressly unallowable costs."

They go on to state the intent of the penalty provision is to primarily safeguard the government from contractors abusing the contract negotiation and cost reimbursement process by inflating cost submissions with costs that all parties understand to be unallowable. The abuse of the process is not present when the contractor has a reasonable basis to dispute a government finding that a cost is unallowable.

They conclude that "other sources of evidence that a reasonable dispute on allowability may exist include case law, relevant accounting guidance and the history of the cost principle involved. When any of these authorities create doubt regarding whether a cost is expressly unallowable, then the cost involved cannot be an expressly unallowable cost, even if the cost is ultimately disallowed by mutual agreement or by court or board decisions."

♦ Prior Years Acceptance of Similar Costs

As discussed above, there is, at a minimum, reasonable differences as to whether the costs are allowable meaning the government may not impose penalties on Contractor. These differences are further demonstrated by the fact the government reviewed and paid nearly identical costs on a yearly basis and as a result Contractor had a reasonable basis to claim these similar costs in the year in question. Because the government cannot show Contractor acted unreasonably by treating the costs at issue as allowable, the costs do not meet the definition of "expressly unallowable costs" and the government may not penalize Contractor for including these costs.

RECOVERY OF COSTS ON TERMINATION FOR CONVENIENCE OF COMMERCIAL ITEM CONTRACTS

(*Editor's Note. We have been helping clients maximize their allowable cost recovery for terminated fixed price and cost type contracts for about 20 years now. One of our most valuable*

source over the years for identifying what costs can be claimed has been articles we have read by Paul Seidman of Seidman and Associates, PC. The following is based on a new article by Mr. Seidman published in the September 2010 issue of the Nash & Cibinic Report.**)**

As we have written in the past (Q199 and Q299), the government provides generous opportunities for contractors to recover certain costs under a termination of convenience. The FAR clause at 52.212-4, Terms and Conditions-Commercial Items and FAR 12-403 provides significant changes to what a contractor can recover when its commercial item contract is terminated for convenience, usually allowing less costs but in some circumstances, possibly more. FAR 52.212-4 provides that the contractor will not be required to comply with the cost accounting standards or the FAR contract cost principles in determining how much it is entitled to. There will be two measures of cost recovery under these contracts: (1) "a percentage of the contract price reflecting the percentage of work performed prior to the notice of termination" or for time and material and labor hour contracts "an amount for direct labor hours determined by multiplying the number of direct labor hours expended before the effective date of termination by the hourly rate(s) in the contract, less any hourly rate payments already made to the Contractor" and (2) "reasonable charges the contractor can demonstrate to the satisfaction of the government using its standard record keeping system, have resulted from the termination." We will focus on these two measures.

The method envisioned for commercial items is different than the *cost based* formula under traditional fixed price government contracts. For these traditional contracts the contractor is entitled to allowed costs incurred in performance of work, which is defined in a special cost principle at FAR 31.205-42, plus a reasonable profit on all costs except settlement expenses. The special cost principle allows such costs as unavoidable continuing costs after termination, unamortized initial costs not fully absorbed because of the termination, loss of useful value of special tooling and equipment, rental costs of unexpired lease, alterations of leased property, idle facilities, subcontractor claims and settlement costs. If a loss on the contract can be proven, then profit may not be added and the amount of costs to be reimbursed may be reduced. Finally, the guiding principle of "fair compensation" should be followed where even otherwise unallowable costs may be reimbursed.

Unlike the cost based formula, the Commercial Item approach is a modified price-based formula since the first element is price based while the second is cost based.

How is the Percentage of Completion Calculated.

Three possibilities exist in how to compute the first element: (1) percentage of physical completion at termination multiplied by contract price (2) payment of contract price for completed units of work at time of termination or (3) percentage of effort expended up to the time of termination multiplied by contract price. Two important cases we will be discussing, *Red River Holdings (ASBCA 56313*) and *Corners & Edges (CBCA 762*) held the percentage of completion means percentage of physical completion as opposed to percentage of effort expended. Though neither case concerned a T&M or L/H contract, percentage of physical completion multiplied by contract price was considered to be consistent with the intention of FAR 52.212-4.

What Are Considered Reasonable Costs Resulting From the Termination

Whereas the cost principle applicable to traditional contracts clearly allows for recovery of unamortized performance costs as well as certain costs continuing after termination, the two cases point to two different interpretations of what costs are recoverable. The commercial item clause speaks of reasonable charges resulting from the termination as opposed to reasonable costs. Even though unamortized performance costs (e.g. pre-contract expenses, dedicated equipment) are not the result of a termination because they are sunk costs prior to the termination, recovery of such costs have been deemed allowable under traditional contracts where the special cost principles explicitly allows for it to "keep the contractor whole." *Corners & Edges* recognized the allowability of these costs in a commercial item contract termination where the Board ruled they were reasonable charges resulting from the termination and other cases cited such reimbursement is consistent with the FAR 49.201(1) fair compensation principle to make the contractor whole in exchange for the government being able to terminate the contract.

However in *Red River* the ASBCA ruled that costs that were not fully unamortized as the result of a termination are unallowable. The Board stated that unlike the cost principle for traditional government contracts that allow for costs continuing after termination, the commercial clause states because they are sunk costs they would have

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been incurred irrespective of the contract. The only post-termination costs that appear allowable under *Red River* are settlement expenses. The author disagrees with this conclusion where he recognizes that unamortized costs and unavoidable costs continuing after termination would have been incurred anyway and are not incurred as the result of a termination. Nonetheless, the cost principle has long held that there is the need for special treatment of costs that would not have arisen had the contract not been terminated and to charge such costs is reasonable to make the contractor whole. To rule otherwise might result, for example, in a small business contractor incurring millions of dollars in preparation costs yet being entitled to nothing if the contract is terminated for convenience prior to any measurable physical performance.

The author then goes on to make the argument there are grounds to be able to recover more costs than even under traditional contracts. Whereas the FAR 31.205-42 cost principle provides for recovery of *particular* costs resulting from a termination, the commercial item provisions allow recovery of *all reasonable charges*. So where rulings by cases and DCAA prelude recovery of anticipatory profit and post-termination unabsorbed overhead (amount of overhead normally applied to direct costs that is not recovered because of no direct costs being incurred) such costs are recoverable for commercial items. The author argues this is evident from the Uniform Commercial Code 2-708 applicable to private sector contracts which defines "damages" as including "the profit (including reasonable overhead) that the seller would have made from full performance by the buyer." In addition since the commercial item contract is not subject to the FAR cost principles costs that would be unallowable (e.g. legal expenses related to attempting to overturn a legally insupportable termination for default) are recoverable under a termination of a commercial item contract.

Since the *Red River* case was decided by the ASBCA and later appealed to the Court of Federal Claims Mr. Seidman recommends avoiding these two entities if a contractor is attempting to appeal a CO decision for unamortized costs or unavoidable continuing costs and instead, if the terminated contract is with a civilian agency, bring a suit to the CBCA who ruled favorably in *Corners & Edge*. Also Mr. Seidman recommends an approach we have used on occasion where rather than push for a T of C settlement go for a government-caused delay claim. Since terminations follow a stop work order which translates into failure to be able to perform, that means a contractor may be entitled to an equitable adjustment for unamortized performance costs under the "Changes" or "Disputes" clauses whereas it could not recover such costs if a Board was following the *Red River* decision under a termination settlement claim.

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