GCA Digest

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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 17th Annual GT survey for 2011 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 surveyed firms are privately owned, 9% are publicly traded and 8% are not-for-profit concerns. 54% of the companies are classified as large and 46% as small where 28% had sales less than $10M, 11% between $10M-20M, 27% between $20M-50M, 20% between $50M-100M and 21% over $100M. 24% of respondents have been in business between 1-10 years, 36% for 11-20 years, 19% 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. 93% said their primary customer is the federal government. 63% of their revenue came from the Defense Department, 30% from other federal agencies, 3% came from state and local government and 4% was commercial. The results confirm the truism that though the commercial sector has experienced major business downturns still government contracting remains a growth industry where 50% of respondents had increased revenue over the prior year, 21% had no significant change while 29% had reductions. Over the next 18 months 55% of surveyed company said they expect to see increases coming from prime contracts while a far larger number of 50% 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

12.3% of total headcount is represented by management and support functions compared to 11.9% last year. This amount fluctuates from year to year which is largely attributed to hiring billable staff for new work and reducing them for completed work. The overall trend downward is likely attributed to more outsourcing of support services such as HR, legal, internal audit, contract compliance as well as some larger contracts allow for direct billing of normal indirect support costs. The breakdown of certain functions are finance and accounting (2.5%), contract and procurement administration (1.1%), sales and marketing (1.7%) and other indirect (7.0%). For facilities costs as a percentage of revenue 80% reported less than 5%, 14% for 6-10% and 6% greater than 10%.

♦ Government Contracts

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

Fees. Average negotiated fees for cost type contracts averaged 6-7%, T&M contracts had an average of 8-9% while firm fixed contracts had 9-10% where all are about equal to 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 loosing competitions was a combination of price and technical – 48%, price only – 30% and technical only – 15%.

Bid and Proposal costs as a Percent of Revenue. 16% reported less than 1%, 47% 1-2% while 36% reported greater amounts.

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 they could receive. The

survey found that 26% of all respondents had a contract terminated for convenience in recent times where 40% requested an equitable adjustment while 60% did not. Identifying types of costs that are frequently recoverable from a T of C, only 12% asked for costs related to idle time, 0% asked for idle facilities, 50% asked for severance pay, 50% asked for costs related to preparing the settlement, 40% for supporting the resulting government audit and 25% for negotiating the settlement while 40% asked for costs related to subcontractor settlements. As for partial terminations, where an increase in contract price is usually justified due to allocating fixed or semi-fixed costs over a smaller base, only 17% of those experiencing a partial termination actually negotiated a price adjustment on continuing work.

♦ 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 between 1-5%, 37% between 6-10%, 18% between 11-15% and 8% above 15%. 6% of respondents reported no profit. These figures would be diminished after deducting interest and taxes. Compared to last year, there has been an increase in profit.

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 34% when bonuses were included and 32% when excluded which is a slight decrease from last year.

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) - 80% compared to 65% last year (b) on site direct labor and fringes – 48% compared to 38% last year (c) off-site direct labor – 48% as opposed to 42% 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 – 23% compared to 19% last year. When companies used multiple overhead rates logic used for them were location (64%), labor function (15%), customer (15%) and products versus services (6%). 32% of 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 13.5% (13% last year) while those using a value added cost input was 15.4% (about the same as last year).

Material handling and subcontract administration costs. 22% of surveyed companies used a material handling/ subcontract administration rate as a burden chargeable on material and subcontract costs (higher than last year's 19%). 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 2.7% and 2.5% 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 39% of the respondents), information technology (24%), human resources (23%) and printing/ publications (6%).

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 2.4 for on-site work and 2.0 for off-site work. Almost all respondents expressed a belief their labor multipliers were competitive with their industry. It should be pointed out that the labor multipliers are overall averages where many companies commonly use different multipliers for different markets.

Uncompensated overtime. (*Editor's Note. Uncompensated overtime refers to hours worked exceeding the normal 40 hour work week by those salaried employees exempt from the Fair*

Labor Standards Act.) 65% of respondents said their employees work uncompensated overtime while 35% said no. 83% of the companies use total time reporting while the other 17% report only 40 hours per week. 72% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 28% 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.

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 as opposed to the older way of simply billing subcontractor costs plus applicable prime indirect rates. 82% (compared to 86% last year) of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract or subcontract while 18% 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 is called a rate variance. 43% of respondents say their actual indirect costs were higher than provisional rates, 20% were lower than provisional rates and 47% said there were no significant differences. When significant rates variances existed 33% said all variances were collected, 17% said none were and 50% 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 21% 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 79% 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.

Mergers and Acquisitions. 12% of respondents said they were involved in M&A activity where 75% of the activity involved the purchase or sale of the company while 25% said it involved purchase or sale of certain or all contracts. For those involved in M&A the purchase price of the company as a percentage of revenue was less than 50% of revenue (55%), 51-75% of revenue (15%), 76-100% of revenue (15%, compared to 67% last year), over 100% of revenue (15% compared to 33% last year).

♦ 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. 57% of respondents described their relationship as good, 24% as excellent while 19% described it as fair or poor. When asked if their relationship with DCAA has changed, 71% said it had stayed the same, 19% reported the relationship had worsened (compared to 2% last year) while 10% said it had improved. In effort to measure the quality of relationships with ACOs and DCAA, the survey found 22% of respondents resolve issues efficiently where the remaining 78% say the government was inefficient, 28% believe DCAA is the primary cause for delays of resolving issues while 50% believe it is the ACO. The most frequent types of costs questioned by DCAA are executive compensation (29%), consultant costs (7%), incentive compensation (11%), labor charging (12%), indirect cost allocations (10%), legal expenses (8%) and employee morale (7%). Most frequently cited violations of cost accounting standards were CAS 401, consistency (16%), CAS 403, home office expenses (4%) and CAS 405, Unallowable costs (4%). Costs questioned as a percent of revenue were less than 1% of revenue (60%), 1% of revenue (10%), 2% of revenue (9%), 3% of revenue (10%), 4% of revenue (4%) and 5% or more of revenue (4%). Of those companies experiencing audit issues, 16% were very satisfied with the resolution of the issues (down from 33% last year and 49% the year before), 60% were somewhat satisfied (compared to 42% last year) and 24% were not satisfied (about the same as 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: 5% reported the company pays for less than half, 12% pays 51-60%, 20% pay 61-70%. 36% pay 71-80%, 9% pay 81-90% and 18% pay 91-100%. With respect to health costs as a percentage of labor costs, 14% of respondents incurred health costs less than 4% of labor costs, 10%

between 4.1-5%, 8% between 5.1-6%, 9% between 6.1-7%, 13 between 7.1-8%, 7% between 8.1-9%, 8% between 9.1-10% and 31% over 10% of labor costs.

410(k) benefits. 9% of respondents do not provide any company contribution, 70% contribute 1-5% of labor costs, 18% contribute 6-10% while the remaining 3% put in more than 10%.

Wages Increases. Surveyed companies state that the average increase was 2.6-3.0%, the same as last year.

Compensation for security clearances. 30% of respondents do not pay premiums for employees with security clearance, 53% pay premiums up to 15% while 17% 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 sometimes 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	180	260	325
$11-20M	220	280	375
$21-50M	250	320	450
$51-100M	315	380	580
>$100M	400	600	750

Second Highest Position

$1-10 M	150	220	290
$11-20M	195	260	320
$21-50M	230	300	350
$51-100M	280	350	475
>$100M	350	420	580

Third Highest Position

$1-10 M	140	190	275
$11-20M	170	220	290
$21-50M	200	275	320
$51-100M	250	325	390
>$100M	325	400	550

Fourth Highest Position

$1-10 M	135	175	260
$11-20M	160	200	270
$21-50M	180	260	290
$51-100M	230	300	350
>$100M	300	375	425

♦ Government Insourcing

Asked whether the government has hired their employees in pursuit of in-sourcing, 60% of the companies report they have indeed lost employees to in-sourcing (compared to 47% last year) while 40% report they have not.

TWO IMPORTANT CASES

In the last two issues of the GCA REPORT we reported on two cases that are too significant to simply briefly summarize so, as promised, here are more detailed accounts of the cases.

BOARD RULES DCAA'S REVIEW OF EXECUTIVE COMPENSATION IS "FATALLY FLAWED"

Most companies except for large contractors have or will go through a compensation review of at least their senior executives. A special compensation team out of the Mid-Atlantic region conducts these reviews for all local DCAA offices and the following case addresses how these typical reviews may be "fatally flawed." The case actually shows two sets of challenges to DCAA's findings that can be instructive for contractors going through a review – challenges to DCAA during the audit itself where some were accepted and then challenges that the appeals board ruled on.

Background

J.F. Taylor (we will refer to the contractor as JF) did work for the Navy, Army and other branches where its primary business included engineering services and producing aircraft trainers and trainer-related products. Its engineering services were broken down into simulation, Test & Evaluation (T&E) and systems engineering groups. The company had experienced significant growth since 1983 where in the relevant period for us, 2002-2005, it had grown revenue, profit

and personnel 20-25% on average each year. The organization of the company was characterized as "flat" where there was a CEO at the top, John Sr. who was the founder of the company, and four vice presidents where Wayne, John Jr. and Mark were the sons of the founder and Dave was not. With the exception of Wayne, who handled the business administration tasks, each VP was responsible for distinct parts of the business (e.g. simulation services, T&E and engineering service).

DCAA Audit

During its audits of JF's incurred cost estimate (ICE) proposals for the periods 2002-2005 DCAA's Mid-Atlantic compensation team conducted an executive compensation review for each year and concluded that a total of $589,000 of excess compensation allocable to all relevant cost reimbursable contracts had been overcharged through its provisional billing rates for the four years. The methodology used by DCAA was typical of its approach where it decides what positions it will evaluate, selects at least three surveys that are comparable to the company's size and other relevant factors, escalates the survey data to the mid-point of the contractor's fiscal year, finds the median value of each survey, obtains a "market consensus" of the surveys by taking the average of the median values, applies a 10 percent "range of reasonableness" (ROR) factor to the consensus data, makes any adjustments needed (e.g. offset for any under market fringe benefits), compares the results with claimed compensation of the contractor and questions the difference. FY 2002, which we will use to illustrate the issues involved, is:

EXECUTIVE	CLAIMED CASH COMP	ECS	WTPF	EXEC	DIETRICH	SURVEY AVERAGE + 10% ROR	DIFFERENCE
President	$ 375,000	$ 280,100	$ 339,139	$ 364,181	$ 261,000	$ 342,216	$ 32,784
VP	260,000	240,900	229,941	196,858	210,684	241,555	18,445
VP	260,000	186,900	195,108	ND	179,251	205,795	54,205
VP	260,000	150,300	184,051	161,027	178,364	185,279	74,721
VP	260,000	144,300	ND	126,793	143,719	152,098	107,902
TOTAL	**$ 1,415,000**	**$ 1,002,500**	**$ 948,239**	**$ 848,859**	**$ 973,018**		**$ 288,057**

The methodology used for the other years was identical but some surveys were dropped and substituted by others.

During disposition, the supervisor was asked several questions such as (1) Is any more weight given to one survey over another (Answer - No) (2) Why is a 10% ROR used (Answer - Compensation specialists say if you are between 90 and 110 of market consensus, compensation is reasonable) (3) Is any statistical analysis of the survey results conducted? (Answer - No because the survey houses have already conducted the analysis and we just use the results.)

♦ Summary of Positions Benchmarked and Surveys Used

DCAA compared JF compensation with "similar executive positions found from firms of the same size and industry" designating for the "Vice Presidents" the titles of "COO", "Executive VP", "CFO" and "Top Marketing and Sales Executives." Rather than benchmark the sales revenue for the company as a whole to the four VP positions, DCAA decided the sales for the three operating VP positions should be for only those portions of the business they managed so they attributed different revenues figures for the three VP operating positions based on the percentage of each area of business they controlled - 55, 30 and 15% of the total $35 million in sales. The characteristics of the surveys were different where, for example, ECS surveyed 110 organizations and surveyed "services" while the other surveys had significantly less sampled companies and used a variety of industries such as "technical and professional services" and "engineering services."

DCAA's initial results were presented to JF who responded with six arguments. Arguments it presented and were accepted by DCAA included changing the industry benchmarked for the ESC survey from the overbroad "services" to "engineering and research services," agreeing to drop the WTPF survey because

its "professional services" were too broad and accepting one of three other surveys proposed by JF. Other arguments were rejected such as using a higher percentile due to superior financial performance, eliminating the 55-30-15% revenue attributes for each position and offsetting compensation because of lower fringe benefits paid.

Taking into account JF's arguments and DCAA's revised position, DCAA's new analysis resulted in a reduction of the original $288K of excess compensation questioned in FY 2002 to $218K. DCAA and JF followed similar exchanges for the other years where there were adjustments to DCAA's original position. DCAA's final position was that $859,051 was excess compensation for the four years, the ACO reviewed and agreed with DCAA's position and asserted government demands for the excess billings. JF appealed.

Appeals Board Decision

The government's expert witness specializing in compensation who had testified over 40 times as an expert witness essentially agreed with the validity of DCAA's approach stating it was well within "industry standards." However, due to some question about his academic credentials the Board gave little credence to his statements while JF's expert witness, a specialist in statistics, statistical sampling and regression analysis with admittedly little experience in compensation had a great deal of credibility in the Board's eyes.

The following is based on arguments put forth by JF's expert, Jimmy Jackson. Before we summarize his specific points, Mr. Jackson's overall opinion of DCAA's methodology is that "while it has the look of an objective mathematical model for determining unallowable compensation there is no substance to this scientific veneer. Instead there are fundamental flaws in DCAA's methodology and in addition there are numerous flaws in its execution of the review. These methodology and execution flaws render the DCAA estimation of unallowable executive compensation to be overstated and speculative." Mr. Jackson cites nine separate errors DCAA committed where the Board sustained eight of them.

1. Ignored Data Dispersion/Used Arbitrary 10% ROR Allowance

This is the most significant flaw in DCAA's methodology which accounts for most of the compensation deemed unreasonable. The arguments presented are quite technical where the conclusion is the use of an arbitrary 10% ROR fails to measure the actual amount of dispersion among the data where if it was used, the 10% would be a lot more.

Mr. Jackson offers two examples to illustrate his point. If one was to use the Watson Wyatt survey (ESC) to measure the CEO level, it produces a figure of $280,100 for a $34 million company where the sample size is 110 firms. If one looks at the 25th and 75th percentiles of that survey it would show compensation of $211,800 and $370,400, respectively where the difference of $160,000 is a measure of the "data dispersion." So what that means is that 75% of CEOs in $34 million companies earn less than $370,400 and 25% earn more. Since the median of the survey is $280,100 and you have a $160,000 data dispersion the median figure is not a very precise estimate because you have such a huge range between the 25th and 75th percentiles.

Mr. Jackson offers another way of thinking about this using the familiar bell curve, this time using the EXEC survey for the CEO for illustration purposes. The top of the bell constitutes the $364,180 figure DCAA uses as the median point where if it was to use its 10% ROR would provide a $400,000 figure over which any compensation would be deemed excessive. Over half of all such companies pay compensation over this amount which from a statistical and common sense perspective does not make sense that all of them would be paying an unreasonable amount. The more statistically valid approach is to consider the "precision" of its estimate which in statistics courses is determined by establishing a "confidence" level where you allow the resulting data dispersion to help you determine what pay level is valid. The most typical confidence level in financial analysis is 95 percent which computes to be $747,044. This figure on the bell curve would be the amount over which any pay would be considered unreasonable. Jackson put forth arguments why the 95% confidence level is the most appropriate measure to use (financial analysts, IRS and even DCAA use it).

Jackson concludes that use of a fixed 10% ROR rather than one based on the actual data variability is "arbitrary, unsupported, and unsupportable."

2. Ignored Differences in Survey Sizes

Jackson states it is improper as a matter of statistical analysis to ignore the differences in sample size amount between the surveys. He found the sample size of the surveys ranged from only five companies to 110. He said DCAA's assumption that a 50th percentile from a survey having 110 companies is just as reliable as one

with five companies represents a "statistical flaw." He stated DCAA should weight the surveys so a survey with 25 companies, for example, should receive five times the weight of one with five companies. DCAA's treatment of all equally is "unreasonable."

3. Selection of Revenue Base for JF

Jackson states that DCAA should have evaluated the compensation of all its VPs based on the revenue of the company as a whole not the amount of revenue attributed to each VP. Interestingly, this is the only argument put forth by Jackson that was rejected by the Board. (*Editor's Note. We say this is interesting because we have put forth arguments against DCAA taking similar approaches with clients and found that DCAA sometimes has accepted our position*.)

4. Failed to Consider Financial Performance Without Challenge

Jackson objected to DCAA automatically assuming every company should be in the 50th percentile when it establishes its initial position. Though this objection did not affect the trial (he did not assert a different percentile should apply) he wanted to stake out the position a 50th percentile should not be the default position. (*Editor's Note. We wonder why this point was not pursued given JF's over 20% growth rate*.).

5. Failed to Consider Other Discriminators Such as Security Clearances, Customer Satisfaction and Other Factors

Jackson states the proper steps of a compensation review should include, step one the "art" of selecting the right surveys, step two the "science" of going from the surveys to preliminary results and step three consideration of other subjective factors such as a employees' security clearance, customer satisfaction, product quality and geographic location such as competing in the DC area. He asserted DCAA did not consider these third subjective factors.

6. Inconsistent Company Industry

In spite of the fact the company's business and industry did not change during the four years audited, DCAA kept shifting "back and forth as to what industry" JF was in throughout the audit (e.g. engineering services, services, professional services). Jackson added the correct industry should have been engineering services.

7. Inconsistent Executive Positions

Jackson stated that in some years John Sr. was benchmarked to a CEO/Chairman position while other years he was benchmarked to CEO/Non-Chairman.

8. Inconsistent Usage of Different Surveys

Jackson pointed out it was arbitrary how certain surveys (e.g. Mercer) were used, then dropped in the next year and pick up the following year.

9. Inconsistent Use of 50th Percentile Vs Mean

Jackson pointed out that the 50th percentile means half the companies paid less and half paid more while the mean is another word for "average" (dividing the sum by number of observations). Jackson pointed out while most surveys followed the 50th percentile Dietrich used the mean.

Jackson's Computation and Board Decision

After pointing to the flaws used in DCAA's methodology Jackson went on to compute adjustments to DCAA's own data that would, in his opinion, be appropriate. Though too detailed to recount in depth here, he basically conducted his own review of each position for all years following his own prescriptions e.g. adjusting surveys (eliminating some where statistical data was missing, changing industries benchmarked, used prior year data when percentile data did not exist due to small sample size), using weighted averages based on sample size, computing statistical data such as data dispersions, standard errors using 95% confidence factors and distribution of data on bell shaped curves. He summarized the results and concluded $42,437 of executive compensation was unreasonable compared to DCAA's $849,051.

The Board sided with JF. It ruled the government made no effort to respond to JF's statistical arguments that DCAA's methodology was "fatally statistically flawed" and therefore unreasonable and the government's effort to support its methodology was presented by an expert witness that was of "questionable judgment." It found Jackson's testimony to be "credible and unrebuffed" and ruled JF had met its responsibility of showing its executive compensation was reasonable except for the $42,437 found by Jackson.

We shall see how this recent seminal case affects DCAA executive compensation reviews and ACO support of their reviews *(J.F. Taylor, ASBCA Nos. 56105 and 56322).*

BOARD DECISION ON ALLOWABILITY OF DEFERRED IR&D, EXECUTIVE BONUS AND MEAL EXPENSES FOR RECRUITING

(*Editor's Note. We briefly reported on this case in the Dec/Nov 2011 issue of the GCA REPORT. Since the case addresses important cost issues, conditions for them to be allowable like documentation and contract agreements and new limitations of using the highly effective estoppel argument - i.e. "it was allowed in the past" - we could not resist expanding on our brief coverage.*)

During the audit of SplashNote's FY 2005 incurred cost proposal DCAA questioned and the ACO sustained three charges in its overhead and G&A pools: (1) deferred independent research and development (IR&D) costs for $59,417 (2) a bonus paid to its CEO, Scott Tse, who was a majority owner for $34,168 and (3) meals incurred locally in 2005 to discuss recruiting with professional colleagues for $478. Added together the government asked Splashnote to pay the $84,950 that was allocable to its cost reimbursable contract, Portlet.

Basic Facts

Deferred IR&D. The costs in 2002-2005 were amortization of capitalized IP technology costs incurred in 2001-2002. The Portlet contract did not contain any provision allowing the deferred IR&D costs but SplashNote asserted the costs were allowable (1) in accordance with provisions of FAR 31.205-18 that allowed for deferred IR&D costs under certain circumstances (2) were acceptable under Financial Accounting Standards 86 and (3) the government was estopped to deny allowability of these costs because other audits and reviews had not raised the issue in the past.

Bonus. Because of its strong net income and cash flow for 2005, SplashNote declared for the first time a "profit-sharing performance bonus" where Mr. Tse received $34,168 and its senior and junior engineers received $7,718 and $6,375, respectively. Tse stated his 71% of the bonus was justified because the two employees made lesser contributions where they were part time. Its written policies had not mentioned the bonus until 2011, after litigation began. Tse argued his total compensation of $121,000 in salary plus the bonus was very reasonable (which DCAA did not disagree with). There was an apparent dispute about the bonuses where DCAA asserted Tse said the bonuses were a way of "netting out income" where SplashNote clarified the bonus was considered "at the end of the year where there is a profit" and asserted that $49,950 remained in net income after bonuses were paid, supporting the position the bonus was not a distribution of profit.

Local Meals to Discuss Recruiting. SplashNote charged $478 for 23 meals at local restaurants where it produced receipts and told DCAA it was to discuss recruiting with professional colleagues and asserted the costs were allowable under several FAR cost principles addressed below.

Board Decision

♦ Deferred IR&D Costs

The Board rejected all three of SplashNote's arguments.

FAR 31.205-18. The Board did not disagree that a certain section of the cost principle provided for deferred IR&D but the contract to which those costs are to be allocated must provide for deferred IR&D cost allocation. Specifically section (2) of FAR 31.205-18(c), Deferred IR&D costs, states

> "When deferred costs are recognized, the contract (except for firm-fixed-price and fixed price with economic adjustment) will include a specific provision setting forth the amount of deferred IR&D costs that are allocable to the contract. The negotiation memorandum will state the circumstances pertaining to the case and the reason for accepting the deferred costs."

Here, the costs are unallowable because there is nothing in the contract specifically authorizing any deferred IR&D nor has SplashNote provided a copy of the negotiation memorandum to suggest anything otherwise. Without any such evidence of government agreement before contract award, these costs are not properly charged to the contract under FAR 31.205-8(d).

SplashNote did assert that such a requirement is optional as a permissive advance agreement. The Board rejected this position saying authority for advance agreements under FAR 31.109 is different from the express requirement for a contract provision under FAR 31.205-9(d)(2). Whereas an advance agreement is optional, the contract requirement is not,

so without such a contract agreement the deferred IR&D costs are unallowable.

FAS 86. The Board asserted though SplashNote's treatment of the IR&D costs were consistent with FAS 86, compliance with the FAS does not automatically establish cost allowability under the contract and under FAR. The FAR requirements for cost allowability include compliance with terms of the contract and with limitations imposed by the FAR cost principles in accordance with FAR 31.201-2(a). So, the specific FAR cost principle on deferred IR&D governs the allowability on this issue.

Estoppel. (*Editor's Note. Whereas equitable estoppel used to be a common argument to put forth where prior acceptance of costs "estopped" the government from disallowing that cost in a subsequent audit unless a law was being violated, recent cases have made the estoppel argument significantly more difficult to put forth. This decision reflects these recent changes*). SplashNote argued the government was estopped to deny the allowability of these IR&D costs because other audits and reviews had not disallowed the costs. The Board said SplashNote has the burden of proving the elements for an estoppel defense are present. Quoting *Mabus v General Dynamics C4 Systems (33 F.3d 1356*) the Board said there must be a showing of three elements (1) misleading conduct leading another to reasonably infer the rights will not be asserted against it (2) reliance on this conduct and (3) material prejudice as a result of this reliance. Quoting a more recent case, *United Pacific Insurance Co V Roche (401 F.3d 1362*) the Board added that when estoppel is asserted against the government, "a showing of affirmative misconduct is required in addition to these elements." The Board ruled, as discussed below, SplashNote did not meet this burden.

SpashNote put forth certain government actions to support its estoppel claim: (1) a 2004 accounting system survey (2) the review of 2004 ICE costs where the report was issued in 2007. The Board rejected all of these arguments. First, as for the 2004 accounting system survey, the Board said a government's approval of the accounting system cannot be viewed as approval of specific costs. In addition, no "affirmative misconduct" can be asserted. Second, the review of 2004 costs where the report was issued in 2007, SplashNote has not proved the reliance or prejudice elements of estoppel since such elements cannot pre-date the action complained about. That report was issued 6-7 years after the costs were incurred, three years after the contract was awarded and two years after the contested costs were allocated to the contract so nothing the government did or did not do in the 2007 report of 2004 costs would have affected SplashNote's decisions about how to treat these costs from 2000 through 2005.

Bonus

For Mr. Tse's bonus to be allowable it must meet the criteria of FAR 31.205-6(f) that provides it must be paid pursuant to either an "agreement entered into…before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment" and also the basis of the bonus must be supported. Further, the bonus must meet the criteria of FAR 31.205-6(a)(6) which governs specific individuals. Here where the cost principle addresses owners of closely held corporations, part (ii)(B) of that section states the bonus paid may "Not be a distribution of profits (which is not an allowable contract cost)." The Board stated it need not decide wither there was a valid bonus agreement or bonus plan because regardless of their existence Mr. Tse's bonus was a distribution of profits and thus unallowable.

Alluding to *Lulejian and Associates (ASBCA No. 20094)* the Board looked at several factors to assess when a bonus is actually a distribution of profits – were dividends declared (i.e. is the bonus a disguised dividend), how large a share of the bonus pool goes to executive(s) and how substantial is the rest of the compensation. In *Lulejian* where the bonus was ruled a distribution of profits, no dividend was declared, the top four executives earned 51% of the bonus pool and their compensation was otherwise substantial. Under SplashNote, no dividend was declared, 71% of the bonus pool was paid to Mr. Tze alone and though compensation was reasonable which is an indication the bonus might not be a distribution of profit the other two factors suggest it was.

In addition, the Board ruled that letters to employees announcing their bonuses were being paid pursuant to the company's "Profit-Sharing Bonus Plan" support the conclusion that Mr. Tse's bonus was a distribution of profit. The Board also responded to SplashNote's contentions that (1) bonuses for other employees were not questioned whereas Mr. Tse's was (2) SplashNote's bonus payouts are contingent on profits existing and (3) an established bonus plan existed. For the first point, the Board said the "distribution of profits" prohibition applies to designated individuals (e.g. owners) not all employees.

As to the second point, the Board said the point that bonuses are paid only in years where there is a profit "goes more to whether or not it has a bonus plan that is consistently followed" not whether paying a bonus to Mr. Tse in a profitable year constitutes a distribution of profit. As for the third point, whether or not SplashNote demonstrated a bonus agreement or bonus plan exists (which the Board did not decide on), the "lack of specificity, constraints or parameters contributes to the conclusion" that Mr. Tse's bonus was a distribution of profit.

Meals to Discuss Recruiting

SplashNote argued that the cost of the meals to discuss recruiting with professional colleagues is allowable under any one of three cost principles: FAR 31.205-34, Recruitment costs; FAR 31.205-46, Travel costs and; FAR 31.205-43, Trade, business technical services and professional activity costs. The Board rejected all three.

As for the recruitment cost principles, the contractor and government focused on two of the six enumerated allowed costs – travel costs of employees engaged in recruiting personnel and travel costs of applicants for interviews. However, these two categories are linked to the travel cost principle which applies only to per diem payments for travel more than 12 hours where they prohibit per diem payment within a permanent duty station or within an employee's commuting area. Since the travel regulations do not allow reimbursement for local meals these meal costs are not allowable under either the recruitment or travel cost principles.

As for allowability under FAR 31.205-43, SplashNote asserted the recruiting was discussed at these meal meetings, that recruiting discussions qualify as stimulation of production or productivity (requirements of allowing costs during these meetings) and that "any expenses incurred outside the office in the service of the company are legitimately reimbursable expenses." The Board said the problem with SplashNote's explanation is the lack of information to support compliance with the cost principle. The only record of information were statements by SplashNote after the issue was raised and contested in the audit. The Board stated the absence of information about these meals stand in contrast to other court decisions where evidence about attendees and purpose of the meetings were required to allow the costs. The Board said their concern was less with receipts, which show the costs were incurred which is not disputed here, but more with the criteria of the cost principle being met. Without adequate information on the expense report they cannot say the meal costs qualify as subsistence costs of "organizing, setting up or sponsoring" a meeting the cost principle alludes to. The conclusion is that general assertions that recruiting was discussed at the meal meeting, which is all they have to rely on "do not provide an adequate foundation to show compliance with the criteria of the cost principle."

Our Comments

1. The most salient lesson for us in this case is the need to provide better documentation of costs incurred. Since there is considerable time lapses between the time the expense was incurred and auditors review the costs, often with principals gone, adequate documentation needs to be instituted. The case highlights several areas needing documentation attention: (1) for bonuses, written policies on how bonuses are computed, who receives them and making sure any communications exclude mention of anything that can be interpreted as a distribution of profit (2) ensure deferred IR&D is mentioned in the contract, proposal and/or the government or contractor's negotiation memorandum (3) for recruitment and similar costs, make sure an expense report is completed clearly showing attendees and specific topics discussed and (4) in general, the case makes clear that a reasonable argument that a given cost is allowable in accordance with a specific cost principle is apparently not enough where proper documentation of those costs needs to be provided.

2. The case reminds us there are several ways for the government to disallow executive compensation. They can assert that total compensation, even if each element is allowable, is excessive and hence unallowable. They can also pick on the individual elements – salary, bonus, deferred compensation, defined benefit pension costs – and disallow those even if total compensation is reasonable.

3. The ability to put forth the estoppel argument is significantly less these days. In addition to the normal three conditions that must be met – conduct that leads one to conclude rights will not be asserted against it, reliance on that conduct and material harm as a result of this reliance – the additional condition of showing "affirmative misconduct" has created a high hurdle to overcome to be able to assert equitable estoppel arguments.

PAST PERFORMANCE BASICS

(*Editor's Note. Past performance evaluations have become perhaps one of the most important discriminators in winning awards. Of most importance is how can contractors challenge a government past performance evaluation. Several rule changes and a few cases have occurred since we last visited this issue. We are using an article in the September 2011 issue of the Briefing Papers written by Kara Sacilotto of Wiley Rein LLP.*)

In light of increased use of past performance evaluation (PPE) and past performance information (PPI) contractors have more incentive to ensure PPEs are accurate and complete, dispute resolutions are in place and even litigation opportunities exist. Agencies have accelerated efforts to collect, document and use PPI. One of the prominent recent developments has been the establishment of a Congress-mandated new database for gathering and reporting PPI – the Federal Awardee Performance and Integrity Information System (FAPIIS). The new system combines information from a whole host of various agency databases. As envisioned by Congress FAPIIS includes performance reviews, suspensions, debarments, nonresponsive determinations, terminations for default, civil, criminal and administrative proceedings related to government contracts and grants performed by government contractors and grantees.

In addition to having the government agencies establish the FAPIIS database they were also tasked to develop procedures to have contractors notified in a timely fashion when information about them is posted to FAPIIS and to provide "opportunities… to submit comments pertaining to information about them." Accordingly, FAR 52.209-9 was added to provide a contractor will receive notice when information about it is posted in FAPIIS and allows contractors the opportunity to post comments regarding information that has been posted. Comments are retained as long as the associated information is retained for a total of 6 years and remains a part of the FAPIIS record unless the contractor changes them. Finally, whereas FAPIIS was restricted to government personnel, Congress required and the FAR Council provided in Jan 2010 an interim rule that implemented public access to the database.

Following up on a GAO recommendation to standardize PPE across agencies and phase out agencies' feeder systems the FAR councils in June 2011 issue a proposed rule to amend FAR 42.15 to standardize performance factors and ratings to those used in by the Defense Department that would rate "(1) Technical or Quality (2) Cost Control (as applicable) (3) Schedule/timeliness (4) Management or Business Relations and (5) Small Business Subcontracting (as applicable)" In addition all agencies would use the five-scale rating system and definitions used by DOD: exceptional, very good, satisfactory, marginal and unsatisfactory. Proposed modifications to the FAR will expand coverage to task and delivery orders that exceed the minimum simplified acquisition threshold which will be entered annually and performance ratings under incentive and award fee contracts will also be entered.

FAR Part 42.15 has been amended several times which identifies the PPI process. In addition to being able to comment on PPEs in the FAPIII the FAR now provides other opportunities for contractors to comment on PPEs in their development stages which ideally will be reflected in the final opinion. After an earlier amendment inadvertently eliminated FAR text providing contractors a right to comment upon and escalate comments regarding a PPE, the FAR councils issued a correction Aug. 9, 2011 that moved back the text that was omitted and moved around other text where now the existing procedures are housed in FAR 42.1503(b). Under the current version, agencies are instructed to provide contractors a copy of a PPE as soon as it is completed. Contractors are then provided a minimum of 30 days to submit comments that rebut the statements in the evaluation or provide additional information for the agency's consideration. FAR 42.1503(b) also provides for a review at a level above the CO of any disagreements and states "the ultimate conclusion of the performance evaluation is the decision of the contracting agency." The contractor provided PPI is retained as part of the evaluation and may be treated as source selection information.

The authors state contractors should consult with other FAR supplements issued by other agencies. For example the Army FAR Supplement and the Defense Information Services Agency FAR has additional agency-specific guidelines on contractor comments on PPE.

If the contractor fails to achieve satisfaction they may decide to obtain a third party opinion where, though limited, recent cases and decisions open up more opportunities than ever to challenge it. Though the authors discuss numerous cases and decisions, it will suffice for our purposes here to summarize the salient points derived from the cases.

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1. Earlier decisions before Todd IV declined to exercise jurisdiction over claims challenging evaluation performance. After Todd IV (*Todd Construction LP, v US*) it was established that the US Court of Appeals for the Federal Circuit and the ASBCA could hear challenges if they were presented in accordance with Contract Dispute Act requirements. That is, challenges to PPE could be heard if they were presented as a "claim" in accordance with the CDA where the court allowed nonmonetary disputes to be heard since most claims for PPE did not include a "sum certain" amount. However, several such claims were rejected because they did not adhere to CDA requirements such as express intent to pursue a claim, a written demand seeking contract relief as a matter of right and request to the CO of a final decision.

2. The courts and appeals boards have established that they may review a PPE only to ensure it was reasonable and consistent with stated evaluation criteria in the solicitation or relevant regulations. They are reluctant to interfere with the discretion of agencies to make their own decisions on PPE where there is full consideration that a determination of the relative merits of a PPE is primarily a matter of the agency's discretion. However, several cases allowed for overturning PPE when the contractor could show either the PPE was "arbitrary or capricious" or an "abuse of discretion."

3. As for relief to be granted, the courts and boards have ruled they do not have the authority to grant "injunctive relief" – compel an agency to give a particular performance rating or change an existing one.

The authors provide several recommended guidelines:

1. Contractors should avail themselves the opportunity to comment upon and escalate their PPE concerns within an agency. Persuasive and well-documented comments have a real chance of changing an initial evaluation.

2. Contractors should also consider making comments in the FAPIIS. If they don't prevail using the FAR 42.1503 process they will at least have the opportunity to tell their side of the story for future source selection decisions.

3. If the contractor wants to pursue a claim as defined in FAR 2.101 it needs to follow all CDA requirements for a claim e.g. "written demand or written assertion," seeking as a matter of right "an adjustment or interpretation of contract terms," a request for a final CO decision.

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