GCA DIGEST

(A publication of Government Contract Associates)

First Quarter 2015 Vol 18, No. 1

DCAA GUIDANCE ON WHAT UNALLOWABLE COSTS ARE EXPRESSLY UNALLOWABLE

(*Editor's Note. DCAA has recently issued two Memorandums for Regional Directors (MRDs) addressing which costs determined to be unallowable are "expressly unallowable" and hence subject to imposition of penalties. The December 18th MRD lists what DCAA believes are the FAR and DFARS "cost principles that identify expressly unallowable costs." DCAA issued a second January 7 MRD that is a follow-up guidance that seeks to provide further clarification on its views of why certain unallowable costs are subject to penalties (a summary of this MRD is in the last issue of the GCA REPORT). Industry representative comments on the first MRD were highly critical stating DCAA is "overreaching" and its definition of expressly unallowable costs are "contrary" to case law. We believe such negative reactions are the reason the second MRD was issued where it is too soon to see what reactions that MRD is generating. We decided to summarize below the first MRD because (1) it provides an excellent review of selected FAR cost allowability rules which even we found enlightening and (2) those unallowable costs that are considered to be expressly unallowable costs and hence subject to penalties should be identified since a decision to include or exclude these costs from government submittals like incurred cost proposals, forward pricing proposals or forward pricing rate proposals should strongly consider whether inclusion of such costs will mean that penalties will be sought.)*

The Dec. MRD includes a 32 page set of quotations from the FAR and DFARS cost principles where 110 unallowable costs are considered to be "expressly unallowable." As if that were not enough, the guidance states the listing is not "comprehensive" and that "there could be situations where the costs questioned could be expressly unallowable based on the facts and circumstances of that particular situation" where then the audit team may perform additional analysis to determines whether the costs in question are expressly unallowable.

Though we will spare the reader an extensive listing of each unallowable cost DCAA believes is expressly unallowable, we will summarize the more common costs incurred where we identify the relevant FAR or DFARS section.

1. Major repair and overhaul of rented equipment (31.105).

2. Indirect costs that meet the definition of "excessive pass through charges" referenced in FAR 52.215-23.

3. All unallowable advertising and public relations costs (31.205-1). The guidance recognizes that some advertising costs are allowable (e.g. required by contract, needed to acquire scarce resources, promote sales of products overseas that are normally sold to the US government, help wanted ads). Unallowable public relations and advertising costs that are expressly unallowable are those found in section (d) and (e) such as whose primary purpose is to promote the sale of products or services or to call favorable attention to the company to sell those products or services. Other examples of unallowable costs subject to penalties include (a) trade shows unless they promote export sales (b) sponsoring meetings, conventions, symposia, seminars and other special events when the primary purpose is other than disseminating technical information or stimulation of production (c) ceremonies such as corporate celebrations or new product announcements (d) promotional material such as brochures, handouts, magazines, tapes and other media (e) costs of souvenirs, models, imprinted clothing or other mementos provided to customers or the public (f) memberships in civic or community organizations or (g) donations of excess food to nonprofit organizations.

4 By far, the greatest types of unallowable costs are those related to compensation for personal services found in 31.205-6. Examples of compensation costs believed to be expressly unallowable are:

- Compensation for certain individuals needing special considerations such as owners of closely held companies, partners, sole proprietors, members of immediate family or those committed to acquire a financial interest in the company. Examples of unallowable costs for these individuals are a distribution

of profit disguised as compensation or amounts in excess of what the IRS considers to be deductible.

- Payments made to employees who move to a replacement contractor (g)(3) where there is continuity of employment with credit for prior length of service
- Abnormal or mass severance (g) that is payment on a conjectural basis. Only specific payments will be considered on a case-by-case basis. Also severance paid to foreign nationals in excess of what is typically paid to employees in the same industry in the US
- Backpay (h) as a retroactive adjustment of prior years' salaries. Exceptions to unallowable costs are when the payments are a result of (1) underpaid work (2) the difference in past and current wages for union employees working without a contract and (3) payments to nonunion employees based upon results of a union agreement.
- Compensation calculated based on changes in the price of corporate securities (i)(1)
- Compensation represented by dividend payments or calculated based on such payments (i)(2)
- Payments to an employee in lieu of them receiving or exercising an option (i)(3)
- Except for nonqualified, pay-as-you go pension plans, pension costs assigned to the current year but not funded by the time set for filing of the federal income tax return, including extensions (j)(1)(i).
- Cost of changes to pension plans that are discriminatory to the government or not intended to be applied to all employees under similar circumstances in the future (j)(1)(ii)
- Deferred compensation if awards are made in periods subsequent to the period when the work being remunerated was performed (k)
- Costs for a business acquisition if they are (1) payments for special compensation in excess of the normal severance pay practices if their employment terminated following a change in management control or (2) special compensation that is contingent on the employee remaining with the contractor for a specified period of time (l)
- Portion of company-funded automobile that relates to personal use by employees regardless of whether the cost is reported as taxable income to the employee (m)
- Employee rebates or discounts of products or services of contractor (n)
- Post retirement benefits must be funded by the time set for filing federal income taxes, including extensions and any increased costs caused by delay in funding beyond 30 days (o)
- Excess compensation for senior executives (p)(1) or all employees (p)(2) for either contracts awarded before June 24, 2014 or any employee for contracts awarded after June 24, 2014 (p)(3)

5. Contributions or donations including cash, property and services regardless of recipient (31.205-8)

6. Actual interest cost in lieu of imputed cost of money (31.205-10)

7. Certain depreciation costs (31.2015-11) including those that (a) would significantly reduce the book value of a tangible capital asset below its residual value (b) depreciation, rental or use charges on property acquired from the government by a division or affiliate (c) lease costs under a sale and leaseback arrangement that exceeds the amount that would be allowed if the contractor retained title (d) capital leases between related parties exceeding those that would exist had the parties not been related and (e) no depreciation or rental allowed on property fully depreciated by the contractor. (*Editor's Note. Though not mentioned in the guidance, negotiated use charges on fully depreciated assets are allowable so be sure there is an advance agreement.*)

8. Gifts that are not in recognition of employee achievements or not included in 31.205-6(f). (31.205-13). Also costs or recreation except for those costs of employee participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work or physical fitness.

9. Costs of amusement, diversions, social activities and directly associated costs such as tickets to shows or sports events, meals, lodging, rental transportation or gratuities (31.205-14). Also costs of membership in social, dining or country clubs or other organization having similar purposes regardless of whether the costs is reported as taxable income to the employee.

10. Costs of fines and penalties resulting from violations or failure to comply with federal, state, local or foreign

laws or regulations except when they are incurred as a result of compliance with specific terms and conditions of a contract or written instructions from the CO (31.205-15).

11. Costs of idle facilities unless they are needed to meet fluctuations in workload or necessary when acquired and are now idle due to changes in requirements, economies, reorganizations, terminations or other causes not reasonably foreseen. These costs are allowable for only a reasonable period, ordinarily not to exceed one year, depending on initiatives taken to dispose of the facilities (31.205-17).

12. IR&D costs incurred in a previous accounting period except for deferred IR&D costs provided the following four conditions are met: (a) the total IR&D costs applicable to the product can be identified (b) the proration of such costs to sales of the product is reasonable (c) the contractor had no government business during the time the costs were incurred or did not allocate IR&D cost to government contracts except to prorate the cost of developing a specific product to the sales of that product and (d) no costs of current IR&D costs are allocated (31.205-18).

13. Insurance costs are also a significant area identified in the guidance (31.205-19). Here are some unallowable insurance costs that are considered to be expressly unallowable:

- If purchased insurance is available, the self-insurance costs plus administrative expenses cannot exceed the costs of comparable purchased insurance
- Self insurance charges for risks of catastrophic losses
- Actual losses unless expressly provided in a contract except for losses under nominal deductible insurance or minor losses of small hand tools occurring under ordinary course of business that are not insured
- Costs allowed for business interruption insurance shall exclude coverage for profit
- Costs of insurance on the lives of officers, partners, proprietors or employees unless the insurance represents additional compensation
- Insurance costs to protect contractors against costs of correcting its own defects in material and workmanship unless it is a normal business expense to cover fortuitous or casualty losses resulting from defects in materials or workmanship
- Late payment charges related to paying deferred compensation or pension plan costs

14. Interest on borrowings however represented. In addition, bond discounts, costs of financing or refinancing capital (net worth plus long term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing stock. The exception is interest assessed by State and local taxing authorities when connected to actions taken by instructions given by the contracting officer (FAR 31.205-20).

15. Costs related to activities to prevent employees from exercising their rights to bargain collectively (31.205-21).

16. Lobbying costs (31.205-.22). Many examples of unallowable lobbying costs are provided (e.g. any attempts to influence federal, state or local legislation, outcomes of elections, and contributions to any political organizations). There are also examples of actions that are not unallowable such as providing technical and factual information related to a contract to a political body or their representative.

17. Excess of costs over income from any other contract (31.205-23).

18. Organization or restructuring of the corporate structure (31.205-27). These costs include those related to mergers and acquisitions, resisting reorganization attempts, raising costs where all related costs such as fees, attorneys, consultants, etc, whether they are employees or not. (*See our article below on restructuring costs.*)

19. Reconversion costs – e.g. restoring or rehabilitating to the same condition as before the contract - are unallowable (31.205-31). Fair wear and tear are excepted as well as costs related to removing government property and the restoring or rehabilitating facilities related to this removal.

20. Costs of professional and consulting services (31.205-33). These costs are identified in section (c). (*Editor's note. We have covered this area is several prior articles – conduct a word search at our website for access to them.)*

21. Relocation costs (31.205-35). The guidance provides details on costs that are unallowable and those that are allowable. (*Editor's Note. Again, we invite the interested reader to several prior articles we have written on this issue which can be accessed at our website.*)

22. Rental costs (31.205-37). The guidance states rental costs for property owned by affiliates or related parties are unallowable to the extent they exceed normal costs of ownership such as depreciation, taxes, insurance, and facilities cost of capital (in lieu of interest) and maintenance.

23. Royalties on patents or amortized costs of purchasing a patent necessary for performing a contract are allowable. 31.205-37). However, these costs are unallowable if the government has a license or right of free use to the patent, the patent has been adjudicated or administratively determined to be invalid or unenforceable or has expired.

24. The guidance recognizes that selling costs is a "generic term" that includes many meanings, some of which are covered in other sections of the FAR such as advertising, corporate image enhancement, B&P, market planning and direct selling (FAR 31.205-38). The guidance does not identify specific "selling" activities considered to be unallowable and subject to penalties but it is probably safe to assume if auditors deem selling costs to be unallowable they will also be considered expressly unallowable. (*Editor's note. See our articles on selling expenses.*)

25. Certain taxes are unallowable (31.205-41) and when they are, they are subject to penalties. Common taxes that are unallowable include federal income and excess profits taxes, taxes in connection with financing or reorganization, special assessments on land representing capital improvements, taxes on real or personal property used solely in connection with other work other than government contracts, excise tax in Subtitle D of IRS code, income tax accruals to account for differences between income and pretax income as reflected in books of accounts and financial statements and taxes that are exempt or given "preferential treatment" that are available to contractors unless the CO rules the effort to obtain the exemption outweighs the benefit.

26. Employee training and education (31.205-44). Unallowable training and education costs include (a) overtime payments (b) costs of salaries to attend undergraduate level or part time graduate level unless unusual circumstances do not allow for attendance outside regular work hours (c) costs of tuition, fees, books, salaries, etc for full time graduate level education exceeding two years or length of program (d) grants to educational institutions (they are considered "gifts") (e) training and education for other than bona fide employees where an exception is for dependents who are overseas and suitable education is not available and (f) contractor contributions to college savings plans for dependents.

27. Travel costs (31.205-46). Reasonable and allowable lodging, meal and incidental travel costs are considered to be those set forth in the Federal Travel Regulations. The guidance does provide for exceptions for actual costs exceeding FTRs as long as the higher amounts do not exceed those costs provided in (a)(2)(i), (ii), or (iii) or air travel exceeding lowest price airfare is justified (e.g. circuitous routing, prolonged delays, physical or medical reasons).

28. Legal proceedings (31.205-47). The guidance references section (f) as well as (b) that identifies legal and settlement costs that are unallowable. (*Editor's note. We invite the interested reader to our article accessible at our website using the key word search.*)

29. Additional FAR related costs are referenced including costs that are in excess of contract or grant price (31.205-48), costs of amortizing, expensing or writing off goodwill (31.205-49) and costs of alcoholic beverages (31.205-51).

A few costs referenced in the DFARS include:

30.. Monies paid to the government for leasing of government equipment including payments for leases and support are considered to be unallowable advertising and public relations costs (DFARS 231-205-1(f). This provision does not apply to foreign military sales.

31. Restructuring bonus costs (DFARS 231.205-6). Bonus or other related costs exceeding normal salary for restructuring costs associated with a business combination are unallowable on defense contracts. This limitation does not apply to severance payments or retirement incentive programs.

32. Fringe benefit costs (DFARS 231-205-6) that are contrary to law, employer-employee agreement or an established policy are unallowable.

33. Major contractors (all business segments allocating more than $11 million of IR&D/B&P costs) must report IR&D projects generating IR&D costs to the Defense Technical Information Center (DFARS 231-205-18) with inputs and updates provided to the ACO and DCAA. Failure to follow these report requirements will make the costs expressly unallowable.

34. Restructuring costs will be explicitly unallowable unless certain actions are taken (DFARS 231-205-70(c). In addition to provisions in FAR 31.205-27, contracts to prepare projections of restructuring costs and savings to be performed which are to be audited where the projected audited savings, on a present value basis, must exceed the costs by a factor of two to one and the business combination will result in preserving critical capabilities. .

35. Costs of counterfeit electronic parts or suspect parts and the cost of rework or corrective action are unallowable unless (a) the contractor has a system to detect and avoid such parts (b) the parts are government furnished property and (c) the contractor provides timely notice to the government (DFARS 231-205-71).

Case Study….

QUESTIONING COMP POLICY LABOR COSTS AND SUBCONTRACT COST FEES

(Editor's Note. Several of our subscribers have told us of recent instances of DCAA questioning costs related to their comp policy where employees are allowed to "bank" certain hours and either use them or be paid for the hours at a later date. We are also seeing instances of DCAA questioning pass-through fees that were originally negotiated where prime and higher tier subcontractors add negotiated fee to direct subcontract costs. The following article is a continuation of our policy to present real life case studies from our consulting practice where it addresses the two instances reported by our subscribers. The following represents a highly edited response we prepared when DCAA questioned costs related to our client's (1) comp policy and (2) a non-cost based fee they charged on their subcontract costs. We have disguised many of the dollar figures as well as the identity of our client. We find many of the arguments presented below may be relevant to challenging other costs that the government is disallowing.

Background

Comp time. Contractor's only contracts are exclusively with the US Navy. Contractor has had an "accrued compensation" policy for close to 20 years. The policy, which is spelled out in both its employee handbook and a separate written policy and procedure, compensates its regular full time salaried employees on an annual work year of 1824 hours paid bi-monthly. With few exceptions, the employees perform direct efforts on government contracts. The 1824 hours paid is premised on each employee working 76 hours for each pay period (1824 hours divided by 24 pay periods). Contractor believes all employees should have the freedom to take or not take holiday, vacation or sick leave so it does not offer the traditional paid time off for such days. Instead, when a Contractor employee works in excess of the 76 hour pay period that employee become entitled to "accrued compensation" in the form of compensatory or comp time. Contractor's policy provides that the comp time accrued may be used by these employees for holiday time, vacation time, sick leave or other personal leave or as additional income if they choose. In practice, most employees use their comp time in the period it is earned but if not they are allowed to carry over a balance of hours to the next year not to exceed 80 hours. In addition, when an employee terminates their employment they are paid for any comp time that has accrued.

All hours worked by an employee is charged as direct labor and charged to the client. Any accrued comp time (hours in excess of 76 hours) are booked as a liability. So, for the standard 76 hours, Contractor debits contract costs for direct labor and credits cash at the employee's hourly rate; when hours exceed 76 hour pay period, Contractor debits contract costs (direct labor) and credits the employee's accrued comp time liability at the employee's hourly rate.

Pass-through fee. Contractor's major contract is a cost type contract under the Navy's Seaport contract. Under that contract, in order to limit pass-through costs, the Navy allows contractors to apply a mark up on each subcontractor's or purchase order price, not to exceed 8%. The Seaport contract clearly states that contractors are entitled to choose whether the mark-up is comprised of fee, cost or both. So, for example, if a contractor uses a cost input base to compute its general and administrative (G&A) it can only charge up to 8% on subcontract costs even if its G&A rate is higher. Alternatively, if a contractor does not have a G&A rate or is not allowed to apply its G&A rate on subcontract costs because it has, for example, a value added base that does not include subcontract costs it may nonetheless apply a fee up to 8% on those costs. Because it has a significant amount of subcontractor costs but does not use a G&A rate that includes subcontractor costs in its base, Contractor limited its add-on fee to 5% and billed that amount for the five years it had the Seaport contract.

DCAA Position

Comp time. Despite numerous audits of Contractor's comp time practices throughout the years all of which resulted in acceptance of the policy and no questioned costs, the auditor during the 2006 incurred cost proposal audit questioned $350,000 representing all of the year end accrued comp time liability costs for that year. The DCAA draft audit report stated though these costs were charged to the government as direct labor costs in 2006 they were nonetheless not paid in the ordinary course of business. DCAA characterized these costs as "uncompensated overtime" where it asserted that the hourly rates charged on cost type contracts should have been adjusted downward to reflect the additional hours worked but not paid. DCAA used an example, where an employee with a salary of $90,000 was charging the government $49.34 per hour ($90,000 divided by 1824 but the comp time accrued for 100 hours should have been added to the standard work year amount resulting in an hourly rate that should have been invoiced of $46.78 (($90,000 divided by 1924 hours). In addition, the DCAA report stated Contractor violated FAR 31.201 and FAR 52.216-7, allowable costs and payments.

Pass-through fee. DCAA questioned $275,000 of pass through fee representing the entire amount of pass-through fees of 5% applied to subcontractor costs during the year. DCAA stated the fees were "unreasonable and excessive" because Contractor "did not perform any value added effort managing its subcontractors and did not record in its books and records any of the indirect costs associated with the management of its subcontractors." The report stated that Contractor's said its G&A did not identify subcontract handling costs in its pool nor direct subcontract costs in its base and the audit report thereby concluded Contractor "did not incur any subcontract management costs and hence it appears Contractor added no or negligible value to its claimed subcontractor charges." Since Contract did not identify a "pass-through effort" it was not entitled to apply a fee to claimed subcontractor costs.

Contractor Response

Pass-though fee. The audit report does not address any of the facts presented in the Seaport contract nor does it acknowledge the facts we presented to the auditor concerning the language in the contract, mainly that contractors are entitled to a choice of whether the mark-up represents cost, fee or both. The report states the fee is "unreasonable and excessive" in accordance with FAR 31.201-1(a) but it nowhere explains how a fee set forth in a contract could be unreasonable or excessive where the relevant amount was mutually negotiated between Contractor and the government and was applied on a consistent basis. The ACO certainly did not believe the fee was unreasonable or excessive.

The cited FAR reference provides no support for any assertions the fee was unreasonable or excessive. FAR 31.201-1(a) is a cost principle that defines the "composition of total costs" of a contract which is incorporated into FAR 52.21607, allowable costs and payment. This contract clause, which the report relies on, does not address what is an appropriate fee and therefore FAR 31.201-1(a) is irrelevant.

- **Mistaken Application of New FAR rules**

Though the audit report does not reference new FAR provisions addressing subcontract pass-through charges, we believe the audit erroneously considers these provisions in deciding to question the pass through costs. In the 2009 National Defense Authorization Act (NDAA) called for limiting "excess pass through charges" when a contractor or upper-tier subcontractor "adds no or negligible value to a contract or subcontract." This provision was later implemented by the adoption of two FAR clauses – a solicitation clause at FAR 52.215-22 and a contract clause at 52.215-33. Until these two FAR clauses were adopted, there was no provisions in the FAR or DCAA guidance addressing subcontractor pass through charges.

Under the solicitation clause if the offeror intends to subcontract more than 70 percent of the total cost of work to be performed under the contract, the offeror must describe the added value provided by the offer as related to work to be performed by the subcontract. Under the contract clause, the contractor must notify the government that it will exceed the 70 percent threshold even if it did not originally believe it would and then the government will verify that the contractor will provide added value.

Neither of the two FAR clauses apply to Contractor. First, the audit covers the proposed costs for 2006, before either the 2009 NDAA was passed and years before the FAR provisions were adopted. Before that time, there was never any allusions to subcontractor pass-through costs. Second, the provisions apply only to solicitations and contracts whose subcontract costs exceed 70 percent of total costs. Never did Contractor's subcontract costs on any of its contracts exceed 50%.

Comp time. In our opinion, for the reasons cited below, we believe Contractor's comp time policy costs are allowable contract costs in the year accrued.

- **DCAA Guidance Allows the Costs**

A policy permitting employees to carry forward a portion of their accrued compensation time is generally referred to as "banked vacation." Though there is little law or regulatory guidance addressing this category of cost, the DCAA Contract Audit Manual at 7-2112.1 specifically recognizes that "banked vacation" is the practice of "allowing employees to carry forward and accumulate (bank) all or a portion of vacation time not taken within the year in which entitlement is earned." Under this type of compensation policy, "the banked vacation can be taken at a later date or not taken at all, in which case the payment for the amount of banked vacation time is usually made when the employee terminates employment."

- **The Comp Time Costs are Not Uncompensated Overtime**

The comp time Contractor keeps track of is not uncompensated overtime (UOT). We provided a detailed analysis of the definition of UOT and how the costs in question were not UOT. In summary, UOT applies to primarily salaried employees who are exempt from the Fair Labor Standards Act (FSLA) where employers are not required to pay these salaried or exempt employees for overtime. The definition of UOT per new solicitations and the FAR contract clause at 52.237-10, Identification of Uncompensated Overtime defines it as "hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act." Here, Contractor employees are compensated for all hours worked in excess of the standard 76 hour work week. There is no UOT at Contractors. As we show below, the amount of compensation meets all the conditions for allowability in the FAR.

Even if the comp time was considered to be UOT, which it is not, the audit report erroneously assumes there is only one acceptable method of treating UOT. The audit report states for UOT, Contractor does not adjust the hourly rate. DCAAM Chapter 6-410.4 provides for three, not one, acceptable accounting methods for treating UOT: (1) computing a separate average labor rate for each labor period divided by total hours worked during the period (this is the method the audit report states must be used which is commonly referred to as the "labor compression" method) (2) determining a pro rata allocation of total hours worked during the period and distributing salary using the pro rata allocation (referred to as the "pro-rata" method) and (3) computing an estimated hourly rate for each employee for the entire year based on the total hours the employee is expected to work during the year and distributing salary costs to all cost objectives worked on at the estimated hourly rate where any difference between actual salary costs and amount distributed is charged or credited to overhead (this is the "standard/variance" method).

- **FAR References Allow For the Costs**

(*Editor's Note. The following analysis was provided by an attorney colleague of ours at the law firm of McKenna Long & Aldridge who addresses the assertion that costs are unallowable in accordance with FAR Part 31.2. We summarize his arguments here.*)

Under FAR subpart Part 31.2 costs are allowable when they satisfy the following five criteria: (a) reasonableness (b) allocabiity (c) Cost Accounting Standards (CAS) or if not applicable, generally accepted accounting principles (GAAP) (d) the terms of the contract and (e) any limitations put forth in FAR Part 31.2. The comp time costs Contractor incurred are allowable because they comply with each criteria.

1. Reasonable. A costs is "reasonable" so long as it results from the contractor's prudent business judgment under the circumstances (FAR 31.201-2(a)(1). See also *Boeing Aerospace Ops., Inc. ASBCA No. 46724*, As established by the Boeing case, the government may not substitute its judgment for a contractor's judgment regarding business decisions made within the contractor's discretion absent proof the decision was made arbitrarily. Further FAR 31.205-6(b)(2) provides that compensation costs are "reasonable if the aggregate of each measurable and allowable element sums to a reasonable total." The DCAAM mirrors this when it states "determine if the contractor's method of accounting for banked vacation accruals is proper and then look at the reasonableness of the vacation policy and costs as a component of total compensation."

Here, Contractor made a prudent business decision to permit its employees to accrue comp time in lieu of traditional fringe benefits such as holidays, vacation time or sick leave. The policy allows employees flexibility to

either use comp time, liquidate it as cash compensation upon request or liquidate when departing the company. The comp time is "banked" based on the employee's hourly rate used for charging contracts and it ensures Contractor's employees receive compensation for each hour of work performed which makes it reasonable under FAR 31.201-3 and the associated compensatory costs are reasonable under FAR 31.205-6(b)

2. Allocable. FAR 31.201-4(a) provides that "a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship." Also, in accordance with CAS 402-30(a)(2) costs identified specifically with a contract are direct costs of that contract. Contractor classifies the comp time costs under its Compensation policy as compensation arising direct from the company's performance of government contracts. As such, Contractor's government contracts cause and benefit exclusively from these compensation costs.

3. Complies with GAAP. Each year over the last 25 years, Contractor's costs have been audited by an independent financial CPA firm which assesses compliance with GAAP. None of these audits have ever questioned Contractor's compliance with GAAP regarding its accounting for the costs of its comp time policy. Here, GAAP is determinative since CAS does not address accounting for such costs.

4. Contract does not prohibit the comp time costs. There is no term in Contractor's contract that establishes any conditions regarding the allowability of its costs arising from its comp policy. However, FAR 31.216-7(b)(1)(ii)(C) expressly permits Contractor to invoice the government for direct labor costs incurred but not immediately paid to its employees. The clause states "for the purpose of reimbursing allowable costs…, the term costs include only –when the Contractor is not delinquent in paying costs of contract performance in the ordinary course of business, costs incurred, but not necessarily paid for –direct labor." Even DCAAM 7-2112.2 reflects the acceptability of this cost being incurred but not paid when it states direct labor costs that result in "banked" or compensatory time "it is appropriate for a contractor's books to reflect the liability that will have to eventually be paid."

5. The comp time costs are not prohibited by FAR Subpart 31.2. Per FAR 31.205-6(a)(1) compensation for work performed in the current year and paid pursuant to an agreement with employees, included practices, policies and procedures are allowable. Relevant decision law makes clear that unused leave benefits, such as comp time here are allowable fringe benefit costs under FAR because there is an obligation to pay the benefits earned. (See *Penn Enters, ASBCA No. 52234; Space Gateway Support, LLC ASCA No. 56592.)* Also CAS 408-59(c)(1) states "the estimated liability shall include all earned entitlement to compensated personal absence which exists at the time the liability is determined."

Moreover, to the extent comp time costs are not expressly allowable under FAR 31.205-6(a), FAR 31.201-4 provides that not every cost element is described in FAR 31.2. It provides that when a cost is not addressed specifically, the determination of allowability will be based on the principles of "similar or related selected items." This is reflected in *Boeing N. Am, Inc. v Roche, 298 F.3d 1274* that ruled costs that are similar costs specifically addressed in FAR Part 31.2 are treated consistently. Contractor's comp time costs are similar to the type of costs that are expressly allowable as fringe benefit costs under FAR 31.205-6(m). Although Contractor does not offer its employees fringe benefits the comp time is essentially a substitute for such benefits as seen in its Employee Handbook where it states Contractor "does not pay its salaried employees for holidays, vacation, sick leave or other time off." FAR 31.205-6(m) allows for fringe benefit costs – they "are allowable to the extent they are reasonable and are required by law, employer-employee agreement or an established policy of the contractor… which include cost of vacations, sick leave, and holidays." As shown above, the comp time cost are reasonable and result from a written policy that has been applied for decades.

The Audit Report Fails to Conform to Proper Audit Requirements

We believe the audit report's failure to rely on correct facts that were clearly presented and to apply irrelevant contractual terms regarding cost allowability is inexcusable. Contractor explained the facts several times during the audit. In addition, our white paper described the relevant facts and contract terms where Contractor accounted for these costs appropriately. The white paper even emphasized that DCAA contract audit manual recognizes the costs of banked hours as allowable costs. However, the audit report nowhere (1) recognizes that DCAA received the white paper (2) states why the white paper's facts and conclusions are incorrect or (3) why DCAA's own policy regarding bank time is not applicable. We strongly believe

the audit report's conclusion is clearly unsupported and is contrary to Generally Accepted Government Auditing Standards.

RECENT TRAVEL AND RELOCATION COST DEVELOPMENTS

(*Editor's Note. About once a year we recount some of the more important developments affecting reimbursement of travel and relocation costs. This article is a continuation of our effort to present new changes or decisions likely to affect contractors' travel and relocation expenses. Most of the issues arise in board decisions or issued regulation changes. Though only three parts of the Federal Travel Regulation provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidentals and conditions justifying payment of up to 300% of per diem rates – many contractors choose to follow the FTR either because some contracts call for incorporation of it or auditors and contractors consider it to be the basis for determining "reasonableness."*

GSA Issues New Definitions of "Marriage" and "Spouse"

Following several court cases and administrative actions by the Obama Administration, the General Services Administration has proposed changing the Federal Travel Regulation to include expanded definitions of "marriage" and "spouse" that would extend travel and relocation benefits to same sex partners. The term marriage would include any marriage between individuals of the same sex entered into in a state or country whose laws authorize that marriage where the marriage would be recognized even if the partners live in a state that does not recognize same sex marriage. The term "spouse" would include any individual entered into such a marriage.

R&R Benefits Denied For Family Members Staying in the US

(*Editor's Note. The following is significant because it shows risks of incurring travel and relocation expenses that though initially approved by agency representatives nonetheless are contrary to FTR rules.*)

Luis, who was stationed in Bogota, Columbia for the DEA, became eligible for rest and recuperation (R&R) travel following a year of service where he requested R&R travel for himself, wife and three children to fly to Bogota and back home to the US. The Agency approved the request and reimbursed Luis for the expenses where after a subsequent audit the agency ruled Luis's family was not entitled to R&R travel because they did not live on the post in Bogota and requested him to repay $9,265 for the related expenses. Despite assertions that he would not have incurred the costs had not the DEA administrative people approved the expense the Board was not swayed stating the Department of State Foreign Affairs Manual states that unless exceptional circumstances exist "eligible family members must reside at the post for the entire tour to qualify for the R&R benefits" (*CBCA 3688-TRAV*).

GSA Rewrites Tax Allowance Policy

The General Services Administration has rewritten the Federal Travel Regulation policy of relocation income tax reimbursement to keep "relative simplicity" in mind. The revision provides guidance explaining that that the withholding tax allowance (WTA) and relocation income tax allowance (RITA) are the two allowances through which the government reimburses employees for substantially all of the income taxes they incur as a result of their relocation. The revision amends FTR Part 302-17 and eliminates Part 301-11, Subpart E and replaced Part 301-11, Subpart F. The rewrite makes significant policy changes where some include: (1) adopts a question and answer format (2) eliminates the use of two government unique tax tables and substitutes use of the IRS and state and local tax authorities (3) clarifies that expenses for transportation of household goods are not taxable (4) corrects the withholding rate for supplemental wages to 25 percent and (5) establishes new guidance for employees to recalculate their relocation income tax allowance. The new rules apply to employees who relocate beginning Jan 1, 2015 (*Fed. Reg. 49640*),

TDY Lodging Reimbursement for Apartment Rent is Approved

Paul was given three separate temporary duty travel (TDY) assignments to West Point, NY where the Army Corp of Engineers paid him for an apartment he was renting in West Point by computing a daily rate (dividing the monthly rental of $1,800 by days in a each month) and charging the resulting $58.07 per day rate. Subsequent to his payment an audit determining Paul should not have been paid and ordered him to repay the amount of his reimbursement. When he appealed he asserted the apartment was used only for TDY travel and the Board sided with him. It noted that the way his

rental costs were computed and paid was correct and consistent with FTR 301-11.14 (*CBCA 3827-TRAV*).

GSA Proposes a Rewrite of POV and Rental Car Rules

In a move to "fine tune existing guidance" on the use of personally-owned vehicles and rental cars the General Services Administration is proposing revision to federal travel policy. Changes include: (1) require federal agencies to maintain an internal policy for determining when employees are authorized to use their POV where the "default" option will be for car rentals when on TDY (2) a cost comparison between POV and car rentals should be conducted by taking into account car rental, fuel, taxes, parking and other associated costs (3) for those choosing to use their own car they will be reimbursed at the applicable POV mileage rate up to the constructive cost of the authorized mode of transportation plus per diem (4) new rules would be in place authorizing car rental where (a) travelers will choose the least expensive compact car available (b) exceptions will be allowed to accommodate, for example, medical disability, multiple employees traveling in the same vehicle or need to carry large amounts of government material and (5) prohibit reimbursement of "pre-paid fuel" provided by car rental companies, contrary to some agencies currently allowing it (*Fed. Reg. 62588*).

Board Weighs Safety Concerns in Reimbursing Local Lodging Expense

(*Editor's Note. The following illustrates some exceptions to the rule that prohibits reimbursement of lodging expenses near an employees permanent duty station (PDS*).

Daniel was scheduled to board a 6 AM flight for his assigned temporary duty station and fearing his poor night vision would affect his driving to the airport decided to stay at an airport hotel the night before the flight. Though employees are ordinarily not reimbursed for lodging within the vicinity of their PDS, Daniel argued the JTR and court cases have provided exceptions to this rule when weather conditions beyond the traveler's control preclude car travel, or safety concerns such as being too tired to drive after a long day of government related work. In response, the agency claimed Daniel did not consider other options to avoid the early morning drive such as changing his flight where Daniel claimed it was advantageous to the government for him to fly on the date scheduled. The Board sided with the agency stating Daniel "had control over the circumstances of his travel" where he had alternative travel options and ruled the government cannot reimburse travelers for unauthorized costs on the basis that their actions saved the government money (*CBCA 3885-TRAV*).

DOD Merges JFTR and JTR

(*Editor's Note. The following consolidation of two travel regulations are most welcome to help simplify the rules.*)

The Defense Department has combined the Joint Federal Travel Regulations (JFTR) and the Joint Travel Regulations (JTR) into a single set of regulations which will be called the Joint Travel Regulations. Previously the JFTR applied primarily to military or uniformed employees while the JTR applied to civilian DOD employees.

What Happens When You Miss Your Flight

Diane was scheduled to fly from Washington DC to Savannah, GA. She arrived at the airport at 9:55 where she missed her 11:15 flight due to long airport security lines. She later secured a flight to Atlanta but couldn't get on a connecting flight to Savanna so she rented a car. Her invoice for $216 for the rental car and fuel was rejected where the government asserted she should have planned to arrive at the airport earlier and offered to pay $77 for the unused ticket from Atlanta to Savannah. The Board noted that Delta Airlines recommends travelers arrive 75 minutes prior to departure which was less than the airport parking records showed she had arrived 80 minutes before. The Board stated though "she cut her arrival a bit close" she was nonetheless entitled to the rental car expense since she met the requirements of federal travel "must exercise the same care in incurring expenses that a prudent person would exercise if travelling on personal business" (FTR 301.2.3) (*Diane L. Kleinshmidt, CBCA 4054-TRAV*).

Possible Base Closure Does Not Guarantee a Relocation Expense Extension

Scott was issued a permanent change of station (PCS) to relocate to a new facility in California. He delayed purchasing a new residence stating rumors were spread that the new facility would be closed and asked for an extension of the 60 day storage period for furniture from his old house citing the Joint Travel Regulation

C5190 that allows extensions of less than 90 days due to circumstances "beyond the employee's control." The Board rejected Scott's request saying it was his, not the agency's, decision to delay purchase of a new house resulting in the storage costs where it recognized that though Scott reacted to the possibility of a base disclosure he was neither required nor instructed to postpone seeking a permanent residence (*CBCA 3616-RELO*).

Knowing Your Cost Principles…

ARE RESTRUCTURING COSTS ALLOWABLE?

(*Editor's Note. During the recession many of our clients were going through extensive efforts to reduce costs and become more efficient to better compete in the crowded government market. During that period, we wrote articles on the distinction between allowable restructuring costs incurred by a company to become more efficient and cost effective and unallowable organization costs incurred during a corporate reorganization following an acquisition or divestment. As the economy has been improving more and more of our clients have been going through mergers, acquisitions or divestments where we frequently get involved in due diligence and contract novation efforts. As a result we are finding more frequent questions related to whether any of the resulting reorganization costs are allowable where we have been looking into the issue. We were quite happy to come across a recent article by Andy Howard and Jake Dean of Ashton & Bird's Construction & Government Contracts Group in the Feb 3, 2015 issue of the Federal Contracts Report that addresses business restructuring costs incurred as a result of a reorganization where we summarize many of the points they make. It should be noted our reading of the relevant FAR and DFARS section does differ somewhat and in those cases, where we have divulged our different interpretation.)*

Business combinations have been increasing recently where the authors ask whether a company has the ability to recoup corporate restructuring resulting from the combination. The authors make a distinction between restructuring costs that may be allowable and hence reimbursable and organization costs which are not. FAR 31.205-27(a) defines unallowable "organization costs" as costs that are expended in connection with planning or executing the organization or reorganization of the corporate structure of a business including (1) mergers and acquisitions (2) resisting or planning to resist the reorganization of the corporate structure, and (3) raising capital. Examples of such unallowable costs include costs of attorneys, accountants, brokers, etc. Simply stated, the costs incurred to form a business or to combine two or more businesses into a new corporate structure are almost always unallowable. On the other hand, common types of costs a contractor is likely to incur that may be reimbursable are certain restructuring costs that include but is not limited to (1) costs to maintain facilities or costs resulting from idle capacity (FAR 31.205-7) (2) employee retraining and relocation costs (31.205-35, 44, 46) (3), employee severance costs (31.205-6(g) and (4) new employee recruiting costs (31.205-34).

Under defense contracts the DFARS further provides the ability of contractors to recover "external restructuring" costs resulting from a business combination where some cost savings to DOD will result from the restructuring (DFARS 21.205-70(b). "Restructuring activities" are considered to be those activities occurring after a business combination that affect operations of companies not previously under common ownership or control. They are defined as "a transaction whereby assets or operations of two or more companies not previously under common ownership or control are combined, whether by merger, acquisition or sale/purchase of assets." "Restructuring activities" are defined as "nonroutine, nonrecurring or extraordinary activities to combine facilities, operations, or workforce in order to eliminate redundant capabilities, improve future operations and reduce overall costs." However, contrary to the authors assertions, allowable "restructuring activities" are allowable if they are ongoing repositionings or redeployments of productive facilities or workforce (e.g. plant rearrangements, relocation costs) or if they include ordinary or routine activities charged as indirect costs that would have otherwise been incurred (planning and analysis, contract administration or recurring financial and administrative support) (231.205-70(b)(3). The authors clarify that some costs after a business combination may nonetheless be allowable if they affect only one of the companies not previously under common ownership. Of course, if there had been no business combination, restructuring activities undertaken solely by one company are allowable (231.205-70(b)(2). In addition, restructuring costs under the DFARS that may be allowable include but are not limited to severance pay for employees, early retirement incentive payments, employee retraining costs, relocation costs for retained employees and relocation and rearrangement of plant facilities.

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Practical Considerations

1. The process of seeking reimbursements of otherwise allowable restructuring costs can vary depending on whether the contractor is seeking reimbursement under a civilian or defense contract. For example, under a DOD contract, for restructuring costs to be allowable the projected savings must exceed projected costs by a factor of at least two to one or the business combination must result in the preservation of a critical capability that would otherwise be lost to DOD. In addition, the process usually includes a DCAA audit of the projected restructuring costs as well as the projected savings. The FAR does not have similar detailed procedures where the criteria is they be reasonable meaning they not exceed the amount a prudent person would incur in the conduct of competitive business. The authors state though the FAR does not explicitly adopt the procedures in the DFARS Part 231.205-70 they are implicit meaning contractors seeking reimbursement under civilian contracts should seek an advance agreement from the CO. Though such an agreement is prudent it is still not an absolute requirement where failure to obtain one will not affect the reasonableness, allocability or allowability required under FAR 31.109.

2. A contractor needs to also consider the effects of a contract novation whether there are differences in the FAR and DFARS. The model novation in the FAR may foreclose the possibility of recovering restructuring costs because the model agreement contains broad waiver language that may arguably prevent recovery of restructuring costs (FAR 42.1204).

3. On the other hand, the model novation agreement provided in the DFARS recognizes restructuring costs due to a merger or acquisition, where it may be in the interests of the government. Accordingly, all costs associated with a restructuring would be reimbursable as long as the restructuring will reduce overall costs to the DOD.

4. To reduce uncertainty, contractors are advised to seek an advance agreement, they should be ready to prepare a restructuring proposal that would probably be audited, complete forward priced restructuring costs and implement separate charge codes to capture actual restructure costs against estimates. The steps should be done in advance of the close of a merger or acquisition.

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