GCA DIGEST
(A publication of Government Contract Associates)
Second Quarter 2006 Vol 9, No. 2

INACCURATE ESTIMATES

(*Editor's Note. We have often seen contractors take an overly conservative approach to estimating costs for proposals. When we have asked about it, we hear that there is a fear of being accused of inaccuracies, defective pricing and even fraud or a sense that the government wants contractors to use "objective" data like prior costs rather than more uncertain projections of future costs even though the more objective data does not fit the new products or services well. This article will address the vulnerability of contractors to using inaccurate estimates. We have relied on a recent article by David Bodenheimer of the law firm Crowell & Moring LLP in the December 2005 issue of Briefing Papers.*)

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

Role of Judgmental Estimates in Pricing

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

♦ Government Recognition of Judgmental Estimates

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

♦ Contractor's Right to Decide How to Estimate

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

Common Fallacies in Allegations of False Estimates

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

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

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

Judgments and Estimates Under TINA

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

♦ TINA is Inapplicable to Judgments and Estimates

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

♦ Use of Data

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

Estimates as a Basis of Fraud Claims

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

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

Federal standards for fraud. A threshold requirement to be liable under the False Claims Act is the requirement that the false claim be "objectively" false. Courts have ruled that a false claim must be "objectively false" meaning "expressions of opinions, scientific judgments or statements as to conclusions about which reasonable minds can differ cannot be false" under the FCA. The test must be based on the existence of a verifiable fact which must be "adjudged as true or false in a way that permits empirical verification." In contrast, a judgmental estimate is not verifiable, by definition. The CPRG recognizes the subjectivity of judgmental "round table" judgments and notes that different perspectives on risk can result in differences in what constitutes a reasonable price.

Conclusion

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

Classic Oldie...

IMPACT OF SMALL BUSINESS FINANCING DECISIONS ON COST AND PRICING REQUIREMENTS

(Editor's Note. One of the advantages of being a small business is the considerable financial flexibility they have. Unlike publicly held companies subject to a world of constraints imposed by the investor community – keeping stock price high, maximizing profit, maintaining an ideal capital structure of debt and equity, staying within pre-established financial measurements (e.g. ROE, ROA, ROI), keeping wealth within the company, substituting short term growth for long term health, etc. - small companies can and do follow different objectives resulting in a wide variety of behavior. Owners' decisions significantly impact the cost and pricing of government contracts. Though we reference no particular source, the small business behavior described and the impact on government requirements are based upon our observations of hundreds of companies during our consulting engagements.)

Small Business Behavior

The unique behavior decisions facing owners of non-publicly traded companies often differ significantly from what the "ideal" business behavior described in various business textbooks. This behavior is usually no less sensible and includes:

What profit levels to maintain. Some companies may choose to maximize reported profit to satisfy banks, investors or potential buyers while other companies may choose to hire lots of family members or spend lavishly on recreation activities that can be write-offs of the business. Or, companies may choose to make heavy investments in research and development even though such high up front costs can hurt reported profit.

Ideal capital structure. Textbook financial theory prescribes ideal levels of equity versus debt to maintain which are generally followed by publicly traded firms. Maintaining this ideal capital structure is less important than other considerations to smaller privately owned firms. For example, since most debt for small businesses require personal guarantees many smaller companies care less about capital structure and more about their personal risks, making them more reluctant to borrow. Also, equity investments are frequently disguised as debt to allow greater access to funds. Or, though financial theory prescribes matching long term borrowing to long term assets and short term borrowing to short term assets, such prescriptions go out the window when the need to finance growth spurts or keep the vendors paid motivates owners to obtain any kind of financing they can get.

Also with respect to what level to keep retained earnings, traditional finance theory prescribes keeping this equity component high while business owners have other priorities. Decisions to keep retained earnings high are usually made so wealth stays in the company and payment of taxes are kept to a minimum while decisions to keep it low are a result of either paying more expenses from the company or transferring wealth out of the company.

Use of Assets. The assets of some companies may be bloated with not only business assets but also "personal assets" while other companies may include little or no assets where owners prefer to own the assets and rent them to the business.

Essentially, many of the business decisions affecting small privately owned companies come down to the personal preferences of the owners. The first decisions owners must make are where should the wealth of the company go – how should it be split between the owners and the company. That basic decision will heavily influence whether funds remain in the company or distributed out, whether assets remain business assets are become assets owned by the owners and family and leased to the business, how much and when are taxes paid, etc.

Implication for Government Contracting

These basic decisions have major implications on the cost and pricing rules government contractors must follow:

♦ **When personal assets are part of the business**

Many owners keep as many assets as possible in the business that include not only the essential assets needed to conduct business but additional ones from autos to hunting lodges and chalets. Many of these assets can be a source of additional cost recovery on government contracts through depreciation, cost of money, etc. Of course, contractors should be prepared to demonstrate the assets have a business purpose and the advantage of added cost recovery must be weighed against the resulting higher contract prices that can make contractors noncompetitive. If the owners do decide it is in their interests to keep wealth within the company yet fear their cost structure makes their government pricing too high, they may voluntarily delete the costs associated with many of their assets when computing their indirect rates.

♦ **Leasing business assets to the company**

Many business owners choose to transfer wealth out of the company, buying then leasing to the company assets needed to run the business. The amount the company (government contractor) pays the owner of the asset is often problematic, especially when owners want to maximize the cashflow they receive from the business. Auditors consider such arrangements as related party or less-than-arms-length transactions and they receive considerable scrutiny. Where the contractor often rents the use of assets at market value, the government usually requires the lower of "cost of ownership" or market value. However, rental costs may be allowable when the same asset is rented to non-affiliated entities so as to constitute a commercial rate.

The allowable costs of ownership the contractor pays the related party is supposed to be the same costs as if the company owned the asset. Such costs include depreciation, taxes, insurance, repairs and maintenance and cost of money.

Depreciation costs are primarily covered by FAR 31.205-11 and CAS 404 and 409. There is considerable latitude how these costs are computed. For example, the period of capitalization of the asset can vary depending on its "economic life". Also the method of depreciation (e.g. straight line, accelerated methods) can provide considerable latitude. The level of audit scrutiny will often vary by class of asset. Real estate arrangements are almost always examined (auditors will ask to see copies of leases) while other classes of assets may be scrutinized less, especially if the amounts are not significant. Be aware that arguments that the rental amount is the "going market rate" is seldom accepted unless you can show (1) there is a "commercial market" for your assets – you lease the same assets to non-related parties or (2) the market rate is less than the ownership costs.

If the assets are older, and fully depreciated, then cost of ownership costs must be replaced by unique rental arrangements. Like usage rates of fully depreciated assets in the company, use charges of assets owned by related parties and leased to the company need to be negotiated and documented in advance agreements. FAR 205-11 states that in computing a reasonable use charge, consideration should be given to (1) the replacement cost and estimated useful life at the time of negotiation (2) the effect of increased maintenance costs and decreased efficiency because of the age of the asset and (3) the amount of previous charges made to government contracts and subcontracts. Many government departments maintain schedules of costs they charge contractors who use government furnished property on commercial contracts and those schedules might be useful in providing bases for usage charges. As previous board cases have ruled (e.g. *S.S. While Dental Manufacturing Co., ASBCA No 4102*) use charges need not be recorded in the books and records of the contractor for it to be charged to the government.

♦ **Family members and friends on the payroll**

Compensation of business owners of closely held firms are closely scrutinized by the government. As we discussed in "Executive Compensation" (Vol.4, No.4 of the GCA DIGEST), DCAA has rewritten its guidance to ensure senior executives and owners of small companies receive close inspection. First, "high risk" individuals have been broadened to include employees who can exercise influence over their compensation to include owners, partners, individual executives and officers as well as their family members. Auditors are told to determine if the individual level of compensation is "reasonable" where the burden of the reasonableness test often falls on the contractor to demonstrate their level of compensation is reasonable. Auditors are instructed not to limit their review to only those employees holding high level positions. Auditors attempt to determine if the level of compensation is matched to the job class and to ensure high risk individuals have the same duties as other members of the same class. For example, if the President's son is an engineer the auditor must confirm (sometimes with technical assistance) the son is not over-graded at a higher level of engineer or is overpaid for the work they perform.

♦ Award of perks

Certain perks (e.g. memberships, etc) will likely be scrutinized closely while others (e.g. auto leases) may not. We have seen auditors attempt to disallow many perks, claiming they are unallowable "entertainment" expenses or they should be included as compensation and then disallowed as "excess compensation" if the total exceeds certain benchmarked amounts or is a "distribution of profits." You should be able to defend the expenditures as business related. You should also be able to defend your compensation level as "reasonable" if the perks are included as compensation. Comparison of your practices with those in your industry would also help.

♦ Spend on recreation

Certain recreation costs are clearly unallowable costs while others would likely be considered appropriate business expenses not considered unallowable according to FAR cost principles. For example, sporting events, golf club membership, etc are explicitly unallowable as entertainment costs. Others may be allowable such as meals where business is conducted (unlike IRS guidelines, 100% is allowable). Others fall into gray areas and contractors take varied approaches to including or deleting such costs. Those more conservative will identify all gray area costs as unallowable while others will consider a hint of business purposes as justification for maintaining the costs are allowable. Remember, auditors will most likely select certain expense accounts, examine all or a sample of transactions and make determinations of allowability from there. If a transaction is subject to penalties (e.g. "explicitly" or clearly unallowable costs) contractors may want to take a more conservative approach with those while other costs that may not subject to penalties (e.g. open to reasonable dispute) could justify a less conservative approach.

♦ Financial capability audits

Auditors are now instructed to conduct more frequent financial risk and capability reviews of contractors. One of their first steps is to obtain financial statements, compute common ratios (e.g. profit margins, return on equity, return on assets, working capital levels, asset levels, etc.) and compare the results against established standards to determine if there is any financial risk. If your ratios are outside of the norm, you want to avoid any assertions that you do not have the financial wherewithal to perform your contract. The guidance followed by auditors has, in the main, been drafted to reflect sound financial decisions found in the public sector rather than less optimal but nonetheless sensible financial decisions taken by smaller business owners. If the resulting financial ratios cause concern, the auditor may need to take into account certain decisions made by the business owner. For example, if the owner chooses to minimize assets in the company and instead buys them outside the firm and leases them back then the auditor needs to reflect this in the report. Or, for instance, if return on equity is low, you may want to indicate the reasons retained earnings are higher than normal. Or, again, if equity levels are excessively low, you may need to demonstrate how certain "loans" are really disguised equity.

THREE RECENT CASES

(*Editor's Note. The following three cases are more detailed accounts of three important decisions we reported on in the first couple of issues of the 2006 GCA Report.*)

Allowability of Dividends Paid to Shareholders of Subchapter S Corporations

♦ Background

Most corporations (normally "C" Corporations) are charged federal and state income taxes and when dividends are paid, shareholders also pay federal and state income taxes. The state income tax portion paid by the corporation is an allowable cost for government costing purposes. This double taxation is eliminated for Subchapter S Corporations where the income is passed tax free to shareholders who then pay their share of federal and state income taxes as part of their individual income taxes. In *Information Systems and Networks Corporation* (INS) the US Court of Federal Claims (COFC) ruled the state income taxes paid by its lone shareholder was an allowable contract cost under FAR 31.205-41, federal, state and local taxes. In its ruling, the COFC stated that unless an "exemption" is available to a contract as stated in section (b) of the cost principle, state taxes are allowable if they "are required to be and are paid." COFC ruled that the term "exemption" means "freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." The COFC concluded that the state income taxes were required to be paid and were paid and because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by ISN for reimbursement are allowed.

♦ The Federal Circuit Reverses COFC's conclusion

The COFC decision was reversed on appeal.

1. The Federal Circuit rejected COFC's "narrow interpretation" of FAR 31.205-41(b) and held that the regulation makes clear that "exemption" means "freedom from taxation in whole or in part." After establishing that standard (b) states that "'exemption'…includes tax abatement or reduction" the Federal Circuit concluded nothing in FAR 31.205 supports COFC's interpretation of "exemption" being limited to tax abatements and reductions. Rather, these are "only two examples" of exempt taxes.

2. The Federal Court also rejected COFC's holding that the shareholder's taxes "were required to be paid and were paid" and were therefore allowable. This interpretation is wrong because allowability under (a) applies to taxes paid by the *contracting entity*. Only ISN's shareholder paid state income taxes and because the shareholder is not a contracting entity, FAR 31.205-41 does not apply to her tax payments.

3. The Federal Court also rejected COFC's contention the tax payment was allowable since the state tax codes makes the corporation subject to penalties and encumbrances if the corporation does not pay its income taxes, no matter what type of corporation it is. The Federal Court held this analysis was not important because state requirements do not address allowability of shareholder tax payments on federal contracts. Further, COFC's analysis would appear to make the costs unallowable anyhow because FAR 31.205-15, penalties and fines make penalties unallowable.

The Federal Court concluded that the "plain language" of (b) states the taxes from which the contracting entity is exempt are not allowable costs. ISN, the contractor here, is free of taxation on the shareholder's dividend income and hence those tax payments are not allowable costs for ISN (*Information Systems & Networks Corp. v. United States, Fed. Cir., No. 04-5151*).

♦ Commentary

We have seen a couple of comments and expect more in the near future. Typical is Karen Manos', partner in Gibson, Dunn & Crutcher, comments in the February 22 issue of The Government Contractor. She does not provide an opinion of whether the Federal Court was right or wrong stating it is a very close question whether the cost is allowable. Rather, Ms. Manos challenges the rationale for the decision.

1. If ISN were a C corporation rather than an S, there would be no question its state income taxes are allowable. The fact ISN is an S does not relieve it of its state tax liability but merely passes it to its shareholders. Hence the tax liability should be allowed, no matter what form of corporation ISN is.

2. The Circuit Court inappropriately focused on the terms "abatement" and "reduction" making the Court "unfairly" conclude that because the state income tax was not a tax reduction or abatement, it was not an exempt tax. She states though ISN is "technically" exempt from paying the taxes due to its S status, unlike a normal exemption which results in freedom from paying the tax, an S rather transfers this liability to its shareholders.

3. The Federal Circuit did not adequately address the COFC's observation that S corporations may be liable for penalties if their shareholders do not pay the passed-through taxes. The COFC used this penalty issue to establish the tax liability of the shareholder is an allowable cost of the corporation. The Federal Circuit's alluding to penalties being unallowable is really irrelevant to the allowability of ISN's state tax reimbursement.

Accounting for IR&D Costs

The following case provides greater opportunities to charge unfunded research and development costs indirectly. IR&D comprises research efforts that a company undertakes on its own, rather than as part of work performed under a contract. Such efforts typically benefit more than one cost objective and are accounted for as indirect costs which are allocable to all its government contracts. It should be stressed that resolution of this issue not only impacts the allocation and allowability of costs but strongly affects the intellectual property rights of government contractors. The latter consideration is because Government rights to technical data turn on whether development occurred at government expense or private expense. If government expense, the government normally obtains "unlimited rights" to the data while if private expense it does not give rise to a government license, even if a portion of the costs are reimbursed by the government as indirect costs such as IR&D. Similarly for government patent rights. When the conception or first actual reduction to practice occurred "in performance of" a government contract the government obtains a perpetual, worldwide royalty-free license to practice the invention by or on behalf of the government while if research effort is IR&D, any inventions arising from it would not be "subject inventions" in which the government obtains a license.

♦ The Newport News Case

Over the last two years (e.g. GCA DIGEST, 2Q04) we have reported on and analyzed a recent case that significantly reduces the opportunity to charge research and development expenses indirectly, in spite of the fact that such costs cannot be recovered as a direct charge (which is quite often the case – customers tend to resist being charged non-recurring R&D costs as a direct charge of their contract). Both FAR 31.205-18 and CAS 420 covering independent research and development and bid and proposal costs (IR&D/B&P) prohibit charging these costs indirectly if they are "required in performance of a contract." Though prior cases usually limited the meaning of this term to those circumstances when the work was *explicitly* part of the contract, the Court in the *Newport News* case took an expansive interpretation of this phrase ruling that not only costs that were "explicitly" required in the contract could not be indirect but also "implicit" costs could not be IR&D. So even if such costs were not made part of the requirements of a contract and could not be recovered as a charge they still could not be considered indirect if the contract nonetheless "required" the R&D effort to be accomplished. The dividing line between IR&D and work either explicitly or implicitly required for the contract became based on whether the work was performed before or after the contract was signed. In our comments, we indicated that the strongest grounds that would justify charging R&D effort indirectly would be to (1) make the contract terms as clear as possible that the subject R&D effort is not included in the contract requirements (2) have the contractor's formal accounting policies and procedures clearly distinguish when costs would be charged indirect and (3) seek approval of the policies as soon as possible. The following case modifies the expansive prohibition of IR&D costs and points out that contract terms and disclosed accounting practices (whether CAS covered or not) provide the basis for determining whether R&D effort can be charged indirect.

♦ Basic Facts of the Case

In 1997 Mitsubishi Heavy Industries and ATK Thiokol entered into a contract where Thiokol would provide launch vehicle motors to Mitsubishi for Japan's space program. During negotiations, Thiokol informed Mitsubishi there would be various non-recurring costs related to the motor that would include (1) development effort (2) production equipment (3) acquisition costs for transportation and shipping of motors and (4) design of unique means to attach the motor to the space vehicle. The contract provided that Mitsubishi would pay Thiokol for the contract-unique efforts of adaptation (called Adaptation Effort) while development effort to upgrade the motors (called Development Effort) would not be part of the contract statement of work (SOW) or price. Thiokol at the time thought there were other potential customers that would be interested in the motors (e.g. McDonnell Douglas, Lockheed Martin, US Air Force) even though as of 2004, only Mitsubishi had purchased the motors.

After the contract was signed, Thiokol began work. Costs of equipment dedicated exclusively to the Mitsubishi contract were charged directly to that contract while equipment costs used in producing launch vehicle motors that could be sold to any buyer were capitalized and depreciated and included in indirect cost pools.

Thiokol was CAS covered and was required to submit a disclosure statement. Costs related to research and development were addressed in several sections of its disclosure statement. In Part III, costing practices for several costs such as design engineering and design drafting are described as "charged direct or indirectly." In that section Thiokol classifies a cost that is normally indirect as a direct cost only when (a) a contract specifically requires it to incur the costs (b) the contract pays for the cost or (c) at the time it incurred the cost, the cost had no reasonably foreseeable benefit to more than one cost objective. In Part IV, the Disclosure statement lists indirect costs that are assigned to its various overhead pools where depreciation costs are charged to indirect cost pools. In this section IR&D and B&P are examples of costs that are classified as indirect costs.

In March 1999, the government questioned $3.1 million of costs related to the Development Effort stating they were "required by and specifically benefit the Mitsubishi Contract" and hence should be charged to that contract only. It asserted that under CAS 420, IR&D/B&P and FAR 31.205-18, IR&D/B&P, a cost may not be treated as IR&D and charged indirectly if it is "required in the performance of a contract."

♦ Court's Decision

The Court ruled in favor of Thiokol declining to interpret "required in the performance of a contract". It asserted to do so would be to undermine CAS 402, which requires a contractor to consistently allocate like costs incurred in like circumstances. The court said the appropriate treatment of costs that are designated "sometimes direct/sometimes indirect" are to be determined by the contractor's disclosure statement not by an abstract definition of "required in the performance of a contract."

The Court said it recognized that the absence of a clear definition of the phrase "required in the performance of contract" had caused considerable debate, alluding to the *Newport News* case but stated the answer to the question "is not fixed" and should not be settled in the abstract but on a case-by-case basis where the express terms of the contract and the disclosed accounting practices of the contractor should be examined.

Examining Thiokol's disclosure statement, the court observed that IR&D costs typically are indirect costs and are allocated as a direct cost only when (a) a contract specifically requires that Thiokol incur the cost (b) the contract paid for it or (c) at the time Thiokol incurred the cost, the cost had no reasonably foreseeable benefit to more than one cost objective (e.g. contract). The Court concluded since none of these conditions were present here, Thiokol properly allocated the Development Effort costs as indirect.

Here, the Mitsubishi contract clearly demonstrates the parties did not intend the IR&D costs associated with upgrading the motor for the commercial market to be specifically identified with the contract. The definition of the motor in the SOW obligated Thiokol to "bring to the table" the updated motor. Also the SOW avoided any specific reference to the development effort and the detailed price structure of the contract contains no price for the development effort. Also, at the time Thiokol entered into the contract with Mitsubishi, a commercial market for the motor appeared viable. For these reasons, the Court ruled the contracting officer's denial of Thiokol's claim for $3.1 million in indirect costs was improper under CAS 420 (*ATK Thiokol, Inc. v. U.S., 68 Fed. Cl. 612*).

(*Editor's Note. The Thiokol decision is an important precedent that companies doing business in the commercial and government markets can use to their advantage. In some circumstances, more than one type of cost allocation for development work is possible and the preferred treatment should follow cost recovery and IP considerations. A company should have appropriate written allocation policies, whether or not they are CAS covered. They should make it clear in their policies that IR&D practices exist if development work is not explicitly part of a contract's scope of work and the work may ultimately benefit more than one project or customer (even if there is only one firm customer when development starts). If an indirect allocation is desired and possible, great care should be taken to ensure that the contract SOW and other terms use language such as "supply" items, not "research" or "development."*)

Use of One Pool for Allocating Costs to Government and Commercial Vehicles Violates CAS 418

♦ Facts of the Case

AM manufactured High Mobility Multipurpose Wheeled Vehicles (HMMWVs) for the Army and similar vehicles sold commercially under the trade name "Hummer." AM negotiated three fixed price contracts to provide numerous units of the HMMWVs to the Army. The proposed price was based on an accounting change that altered its method of allocating indirect costs to its government contracts. When the accounting change was divulged to the government, DCAA issued a draft audit report asserting the change violated CAS 418, Allocation of direct and indirect costs. Accordingly, the government included a "reopener clause" in the three contracts that provided for an adjustment of the prices in the event the accounting change was deemed CAS non-compliant and resulted in a higher price than an otherwise compliant method.

Prior to September 1995 AM allocated manufacturing overhead using a direct labor base and allocated its material overhead using a direct material cost base. In May 1995 it informed its ACO that effective September 1995 it would accumulate all manufacturing costs, including fixed and variable costs for both its military and commercial vehicles, into one singe indirect cost pool (called the "one pool" method). In addition, as of September 1995, it would allocate its manufacturing and material overhead costs using the number of vehicles manufactured, no matter whether they were HMMWVs or HUMMERs (called the "unit-method"). The single overhead pool consisted of indirect costs incurred at two of its manufacturing facilities. The majority of its production efforts for both vehicles were conducted at its Mishawaka, IN plant where the assembly work for all vehicles and finishing work for the HMMWVs were performed there while the finishing work on the HUMMERs was performed at another plant in Armour, IN. The cost of the Armour facility, which were easily identifiable, represented about 11 percent of the total manufacturing overhead pool. AM included the costs from both facilities in its overhead pool and used a unit of production method of allocating the indirect costs to each unit.

The government asserted that the negotiated price was based on a methodology of allocating indirect costs that was non-compliant with CAS 418 and based upon an analysis conducted by DCAA, invoked the reopener clause provision of its contracts and claimed a price adjustment of $18 million plus $5.7 million in interest. AM asserted its practices were compliant with CAS.

♦ The Decision

Though much of the decision centered on whether or not the contracts were actually covered by CAS, the relevant discussion addressed whether AM's practices were compliant with CAS 418. The Board summarized the requirements of CAS 418 by quoting from certain passages. The purpose of the standard is to provide (1) consistent determinations of what is direct and indirect costs (2) criteria for what is to be included in indirect cost pools (they are to be "homogeneous") and (3) guidance relating to the selection of allocation methods that are based on the "beneficial or causal relationship between indirect cost pool and cost objectives." A cost pool is "homogeneous" if each significant activity whose costs are in the pool has the same or similar "beneficial or causal relationship" to the cost objectives as the other activities. Alternatively, if there is not the same or causal beneficial relationship, a cost pool can still be homogeneous if the separate activity costs were allocated separately but the result was not "materially different."

The government did not take exception to the new allocation unit method noting it represented one of the four acceptable methods the standard pointed to as compliant but it contended the "one pool" method of combining all manufacturing overhead in a single pool causes an inequitable allocation of costs and causes the government to carry more than its fair share of these expenses. It contended the Armour building costs are "commercial costs only" and do not benefit the government contracts. The government asserted the issue was similar to one of the non-compliance illustrations in CAS 418-60(d) where combining machining and assembling activity would result in significant differences if the two were allocated separately.

In its arguments, AM argued that what constitutes a "homogeneous indirect cost pool" should not be defined by the class of customer (e.g. military versus commercial). The government disputed AM's contention it was using a "class of customer" to define whether the pool was homogeneous but rather argued it was looking at the function and activities in the pool.

The Board noted it was undisputed that the single manufacturing overhead cost pool included indirect costs from the Armour building and the HMMWVs derived no benefit from these costs because none of the HMMWVs were manufactured there. It concluded that since the single overhead pool included indirect costs from both the Mishawaka plant activities (both HMMWVs and HUMMERs) and the Armour building activities (HUMMERs only) and because the Mishawaka plant activities did not have the same or similar beneficial or causal connection to the cost objective (vehicles) as the Armour building activities, the single manufacturing overhead pool was not homogeneous and hence AM was in noncompliance with CAS 418.

Though it ruled on the entitlement of the government to a price adjustment, it stressed it was not ruling on the quantum portion due. It noted there were numerous methods of computing the appropriate overhead allocation that were compliant with CAS 418 and left it up to the parties to determine the quantum of adjustment (*AM General LLC, ASBCA, No. 53610*).

MANAGING YOUR FLOOR CHECK

The following article is a continuation of our article in the last issue on proper timekeeping requirements. From time to time we have reported on what to expect during a floor check by government auditors but recent critical reports by the GAO and DOD Inspector General offices on the lack of sufficient audit scrutiny over timekeeping practices has made the floorcheck audit a priority of most audit agencies. An extensively revised DCAA audit program in June 2006 has focused the need to update what to expect from an unannounced floorcheck. We have used the audit program and DCAA Contract Audit Manual and have added some lessons learned from our experience working with contractors.

You should expect a floorcheck if you are performing on federal cost type or time-and-material/ labor hour contracts or subcontracts. The stated purpose of labor floor checks is to determine the contractor's compliance with its timekeeping controls and procedures and the reliability of employees' time records. Auditors are asked to verify whether employees are actually at work, they are performing in assigned job classifications and time is properly charged to the appropriate cost objective (i.e. contract, subcontract, task order). Auditors are told to consider "audit risk" of each contractor to determine the scope of the review but we have found the scope of review is less dependent on perceived risk assessment and more on the thoroughness of the individual auditors conducting the floorcheck.

An audit team (usually two) will show up without prior notification. Procedures should be in place for such an event that, at least, includes (1) assurance that an entrance conference is held where the scope of audit is discussed (e.g. auditors should be reminded to focus on direct employees engaged in government work) (2) requirement that the auditors are accompanied by a trained point of contact who is well versed in the company's timekeeping procedures and can be alert to employee comments that may be misinterpreted (3) instructions to a receptionist on where to seat auditors and who to notify and ensure they are not free to wander around the facilities and (4) an exit conference is held (discussed below).

Auditors are instructed to obtain an understanding of the contractor's timekeeping procedures and will be evaluating the adequacy of such areas as (1) how employee attendance is controlled by clock cards, timecards, etc (2) identifying the process for time keeping of manual or electronic records (3) procedures in place for notifying employees of assigned job numbers and whether there are procedures in place that all changes are properly initialed by employee and supervisor (4) determine whether hours shown on timecards or input electronically are periodically reconciled with hours identified on attendance and payroll records (5) whether there is a division of responsibility between personnel responsible for preparing and approving time records and those responsible for preparing payroll (6) whether there is a division of responsibility between those personnel preparing time records and those responsible for operating within budgets and (7) procedures in place for coding and recording idle time.

Auditors will usually pre-select a list of employees by identifying location and concentration of employees working on relevant government contracts. Alternative employees will also be identified and auditors have recently been urged to follow-up on unavailable employees by attempting a follow-up interview or if not practical, at least verify employee's existence by observing their work area, examining personnel files or a follow-up telephone interview. Each selected employee will be asked to provide some form of identification and auditors will ask for their timesheets or time cards to review. The auditor will seek to determine whether the timesheets are (1) in the employee's possession (2) completed in ink (3) completed through the previous day's date (4) signed by the employee or supervisor and (5) are free of alterations or if altered, made in accordance with proper procedures (e.g. crossed out and initialed by employee and supervisor).

We have found the following list to be typical of questions asked and what is being evaluated:

1. Employee name, ID number, current job title and position description - existence of employee and charging proper labor categories
2. When does employee receive manual timesheets and from whom – adequate control over access and distribution of timesheets

3. How do they know what projects to identify – proper procedures over establishing project numbers and ensuring appropriate projects are charged.
4. Does employee prepare their own timesheets – tight control over who charges jobs.
5. Does employee always sign timesheets and when – validate hours charged
6. Who approves them – ensure a supervisor signs off
7. How are errors corrected – proper treatment of corrections
8. Does anyone else make changes – alert for improper changes by someone else
9. What happens when overtime is worked – determine whether total time worked is tracked
10. Will employees working on one project ever charge another – alert auditor for potential "gaming" the system (e.g. not charging overrun contracts).
11. What training did the employee receive – ascertain "internal controls" over timekeeping
12. When working multiple projects, how does employee determine how much to charge – accuracy of time charged

Supervisors will often be asked additional questions such as: what project numbers were authorized, how errors are corrected and does the supervisor initial changes.

Since auditors want to verify that hours recorded on timesheets tie into the books of account they will ask for additional documentation (often at a later period) such as copies of payroll records for period reviewed, labor distribution reports, cost ledgers and/or general ledger postings.

Sometimes the auditors will take the time to compile their findings while at the site and present deficiencies noted at an exit conference. Other times they may leave and later present a draft report of their findings. Both circumstances as well as pointed questions during the floor check that reveal suspected irregularities should be taken as opportunities to learn of perceived deficiencies, correct mistaken interpretations and provide additional documentation and information. The contractor should make a strong point of requesting to see a draft report before it is sent to the CO and incorporate their responses to any final report. If there is additional information that is not incorporated into the auditors' conclusions, particularly if there are many errors identified, a meeting with the auditor and their supervisor should be requested. An adverse report can have significant consequences down the road such as a judgment the contractor's labor charging system is inadequate.

Lastly, some contractors may question the auditors' right to access. These questions have been heavily litigated and the conclusion is that auditors have the right of access under the audit clauses of their cost and firm fixed price contracts. Denial of access, with the risk of disapproval of costs, rejection of invoices and strained relations with the customer must be carefully considered.

RECENT DECISIONS ON TRAVEL AND RELOCATION COSTS

Employees Park at Airports at Their Own Risk

Rather than taking a taxi to the airport for his temporary duty in Guam, Sandy parked his car at the airport and left it in long term parking. While in Guam, his agency notified him his duty would be extended and when he returned to Virginia, a full 100 days after departing, he found his car was impounded by the airport because its 60-day maximum limitation for parking was exceeded. He had to pay $686 for parking fees plus $95 towing charge and when he requested reimbursement from the Navy the agency refused. Citing JTR C4657, the Navy said for employees electing to drive to the airport rather than taking a taxi, they were entitled to mileage and parking fees up to the cost of two one-way cab fares. The Board sided with the Navy agreeing the JTR expressly limits entitlement to parking expenses equal to "alternative transportation" such as a taxi (*Sandy Aubertine, BSBCA 16759-TRAV*).

No M&IE When Relocating to an Area Where Employee Owns a Home

Donald was transferred from Key West, Florida to Tampa, Florida where he was entitled to relocation benefits including temporary quarters subsistence expenses (TQSE) for 60 days. At the time of transfer, he owned two homes, one in Key West and the other in Tampa. When he transferred to Tampa, he simply moved into his Tampa home and when he sought reimbursement for his meals and incidental expenses

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(M&IE), the Air Force refused asserting he was ineligible for TQSE when he moved to his home in Tampa. The Board ruled against Donald saying TQSE ends when an employee or his immediate family occupy permanent residence. Recognizing that M&IE are paid to employees who stay at their second home when on temporary duty assignment, the Board ruled those practices apply only to temporary status not as part of their relocation effort (*Donald Fithian, GSBCA 16712-RELO*).

Employee Should Not Rely on Shipper's Estimate

When Steven was going to move, the moving company came to his house to inspect his household goods (HHG) and estimated a total weight of 17,172. After the goods had been loaded and obtained a certified truck scale measure, it turned out the actual weight was 18,900 pounds. When he sought reimbursement his agency said he would have to pay the costs of shipping for anything over 18,000 pounds, citing FTR 302-7-2 that authorizes agency to pay the shipment of HHG up to that amount. The Board sided with the agency saying though Steven had relied on the mover's original estimate, the accepted practice is to use "certified weight" as the measure of actual tonnage moved. The board indicated that the exception to a "certified weight" would be if the employee can demonstrate it was incorrect (*Steven W. Anderson, GSBCA 16744-RELO*).

Subleases Must Be Appropriate Business Transactions

In her temporary transfer to Washington DC Teresa arranged to sublease an apartment for most of her stay where the amount paid was appropriate for the area rather than incurring the cost of a hotel. Her agency denied payment citing FTR 301-11.12(c) that prohibits payment to friends or relatives other than the additional costs of accommodation. The Board first looked into Theresa's relationship to the subleasor to determine whether the expenses were legitimate or simply a devise to receive payment from the government. The Board said there was no reason to assume Theresa had arranged to stay with a friend. It found other clues to indicate the sublet was a business transaction – sublease period was for the summer when student-occupied apartments are commonly subleased and cancelled checks including a security deposit were provided. The Board concluded there was no proof that the sublease was not a bona fide business transaction and ruled Theresa should be reimbursed (*Theresa Kanter, GSBCA 16770-TRAV*).

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