GCA Digest

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GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

(Editor's Note. With the cessation of the Wind2 survey we used to summarize each year we were very happy to find a couple of years ago Grant Thorton's Annual Government Contractor Industry Survey that benchmarks primarily professional services firms. The 14th Annual GT survey for 2008 provides a variety of very useful information. You can contact the firm at 703-847-7515 to purchase a copy of the survey.)

♦ Company Profile

81% of the approximately 120 surveyed firms are privately owned, 13% are publicly traded and 6% are not-for-profit concerns. 47% of the companies are classified as large and 47% as small where 27% had sales less than $10M, 12% between $10M-20M, 30% between $20M-50M, 15% between $50M-100M and 16% over $100M. The primary customer of the respondents is the federal government where 90% of the revenue comes from the federal government. 65% of their revenue came from the Defense Department, 25% from other federal agencies while 6% came from state and local government and 4% was commercial. 55% of respondents had increased revenue over the prior year, 27% had no significant change while 18% had reductions. 29% of the companies have been in business between 1-10 years, 29% for 11-20 years, 18% for 21-30 years and 24% over 30 years.

♦ Indirect Headcount Breakdown

16% of total headcount represented indirect labor with the following breakdown of functions: finance and accounting (2.7%), human resources (1.3%), IT support (2.0%), contract administration (1.3%), legal (.7%), pricing (.7%), procurement (1.35%), sales and marketing (2.0%), corporate officers (2.0%), office maintenance (1.38%) and security (.7%). The 16% percent is an increase from last year's 13.8% and 9.9% in the prior year which Grant Thorton ascribes to both increased costs of compliance and audit requirements and replacement of consultants with permanent employees as growth evened out.

♦ Government Contracts

The breakdown of Revenue by Contract Type. 45% revenue from federal contracts come from cost type contracts, 20% are fixed price and 35% are time and material. The percent of cost type contracts has substantially increased each year apparently putting to rest the impression that the government is moving more toward commercial practices where fixed price or T&M contracts predominate.

Fees. Average negotiated fees for cost type contracts averaged 6-7%, T&M contracts had an average of 9-10% while firm fixed contracts had 10-11%. It should be noted that these negotiated profit rates are computed after deducting unallowable costs and before income taxes so actual profit rates are lower than negotiated rates.

Billing Retention Withholds. The fixed fee clause in cost reimbursable contracts require that 15% of the negotiated fixed fee be withheld from contract billing during contract performance up to a maximum of $100,000 per funded contract vehicle. The clause directs the government to release 75% of the withhold after receipt of the incurred cost proposal for the year the contract work was physically completed and up to 90% based on the contractor's past performance in the settlement of final indirect cost rates. The survey found that 32% do not bill for fee retention until the final government audit is complete, 22% bill after the incurred cost submission is made and the remaining 46% bill some of the withheld fee before final audit and some after final audit.

Proposal Win Rates. Surveyed companies stated their win rate on non-sole source proposals was 30%. Reasons stated for loosing competitions was a combination of price and technical – 55%, price only – 16% and technical only – 20%.

Special Business Units. Companies often create special business units (SBUs) frequently to work around burden rates or cost accounting practices established at current organizations. The survey found that existing cost accounting practices are enhanced by populating the SBUs with the parties' own employees as opposed to providing services on a subcontract or intracompany basis. Special business units such as

joint ventures or limited liability corporations were established by 17% of surveyed respondents where they reported a 65% win rate.

Bid and Proposal costs. 73% of respondents reported spending less than $1 million while 19% spent between $1-2 Million.

Claims and Identifying Out-of-Scope Work. Identifying out of scope work, whether it comes from an easy to recognize direct change or sometime difficult to recognize constructive changes, provides an important opportunity to receive additional entitled revenue. 35% of the respondents said their procedures for recognizing out of scope work are vey effective, 65% said somewhat effective and 9% said not effective.

GSA Schedules and ID/IQ Contracts. The use of IDIQ contracts and GSA Schedule contracts have increased substantially where IDIQ contracts are awarded to multiple contractors after which contractors must compete with each other for actual work. Though agencies often issue their own IDIQ contracts the most common types issued are under the GSA multiple award schedules. When the GSA schedule is based on commercial pricing (as opposed to a cost buildup) companies must designate a target customer or category of customers required under the Price Reductions Clause (PRC) where contractor must notify the GSA of all special discounts offered to the targets where either they must offer the same discounts or justify why the special discounts are not offered to the GSA (contrary to popular belief, offering of a discount to a non-target client is not covered by the PRC.).

23% of the respondents do not have an IDIQ contract, 73% have 1-5 IDIQ contracts while 4% have more than 5. 70% report no significant impact on profits from having IDIQ contracts while 17% reported that profits had increased while 13% said they had decreased. For GSA contracts, 47% of respondents priced their GSA contracts on a cost basis while 53% used commercial pricing (we assume the survey means the GSA schedule billing rates were based on commercial versus cost build-ups). As for what companies are covered by the PRC, 51% said all commercial firms are the target companies while 26% named only a single target company and 23% used some but not all. (*In general, the fewer the better.*)

♦ Financial and Cost Statistics

Profit. Contrary to common public perceptions, government contracting does not generate abnormally high profits. 37% of survey companies had no profit or profit rates between 1-5% while 76% had either no profit or rates between 1-10%. Only 14% had profit rates over 15%. These figures would be diminished after deducting interest and taxes.

Fringe Benefit Rates. Fringe benefit pools consist of payroll taxes, paid time off, health benefits and retirement benefits (some include bonuses while others do not). Fringe benefit rates as a percentage of total labor averaged 36% when bonuses were included and 33.8% when excluded.

Overhead Rates. These costs are considered to be in support of direct staff working directly on contracts and hence are normally allocated as a percentage of direct labor costs. Some companies include fringe benefits associated with direct labor in the direct labor base while others do not – the result when they do is to lower overhead rates. Average overhead rates are as follows: (a) on-site direct labor - 84% (on-site means performed at company sites) compared to 81% last year (b) on site direct labor and fringes – 51% compared to 48% last year (c) off-site direct labor – 45% (off-site is lower because facility related costs are normally borne by the customer at their facilities) compared to 46% last year and (d) off-site direct labor and fringes – 17% compared to 13% last year. When companies used multiple overhead rates logic used for them were location (36%), labor function (39%), customer (17%) and products versus services (8%).

G&A Rates. The survey states that general and administrative rates are typically those incurred at the headquarters and include executives, accounting and finance, legal, contract administration, human resources and sales and marketing. (*Editor's Note. In our experience, the elements of costs included in G&A pools vary more than the survey implies.*) G&A costs are most often allocated to contracts on total cost input (direct operating costs, overhead, material, subcontracts) or a value added base that generally includes all the above costs except material and/or subcontracts. Average G&A rates under a total cost input was 11% while those using a value added cost input was 15%.

Material handling and subcontract administration costs. 25% of surveyed companies used a material handling or subcontract administration rate as a burden chargeable on material and/or subcontract costs. The survey notes that in service industries a handling rate is established in conjunction with use of a value added G&A base to reduce burden applied to pass-through subcontract and material costs. Average material

handling rate was 3%, subcontract administration rate was 4% and combined was 3.5%.

Special allocations. The FAR and CAS provide authority to negotiate special allocations of indirect costs when an inequitable allocation would result from its normal practices such as when there is an unusual dollar amount of material, subcontracts or equipment that does not commonly occur on its other work. It's often a good idea to adopt a special allocation for a contract that has an unusual cost mix rather than change the indirect rate structure to accommodate the contract. Interestingly, only 6% used a special allocation.

Service centers. Certain functions that support the company are accumulated in separate pools and then charged to users (e.g. clients, indirect cost pools) on a pre-established allocation method. The most frequently used service centers are facilities (used by 53% of the respondents), information technology (30%), human resources (28%) and printing/publications (18%).

Labor multipliers. Multipliers, a term commonly found in the commercial world, are fully loaded labor multipliers used to price out work and are derived by dividing total burdened labor cost by base labor cost. The average labor multiplier was 2.4 for on-site work and 2.0 for off-site work. Almost all respondents expressed a belief their labor multipliers were competitive with their industry.

Uncompensated overtime. (*Editor's Note. We have analyzed this issue in numerous prior issues of the DIGEST and we suggest using our word search tool at our website to find them. Uncompensated overtime refers to hours worked exceeding the normal 40 hour work week by those salaried employees exempt from the Fair Labor Standards Act.*) 64% of respondents said their employees work uncompensated overtime while 36% said no. 65% of the companies use total time reporting while the other 35% report only 40 hours per week. 84% use a rate (or hours) compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) compared to 64% last year while 16% use a "standard/variance method" that charges an hourly standard rate and then credits an indirect cost pool for the difference between labor costs charged to projects and compensation paid to employees compared to 36% last year.

Facilities Costs. 84% or respondents say their facilities costs are between 1-5% of revenue, 13% between 6-10% of revenue and the balance 11% or higher. As for location at company facilities, 34% reported that less than 20% of the staff are at company sites, 36% have between 20-80% on company sites and 36% report that at least 80% are located at company facilities.

Billings for Rate Variances. On cost reimbursable contracts, contractors bill the government at provisional indirect rates that are subject to adjustment to actual rates at year end when actual rates are determined. The difference between the two is called a rate variance. 50% reported that actual rates were higher than provisional rates (sharply higher than last year), 6% said actual rates were lower (sharply lower than last year) while 44% reported no significant difference. For companies where actual rates exceeded provisional rates, 34% collected all of the variance, 38% collected none and 28% collected some. Reasons cited for collecting either some or none reported insufficient funding (37%), customer relations (29%), capped or ceiling rates were in effect (24%) while 10% reported other reasons. 78% of surveyed companies said they waited for final incurred cost audits, contract closeouts or other formal approvals before billing for the rate variances while 22% billed the rate variances when the annual incurred cost proposals were made.

♦ Dealing with the Government

The Defense Contract Audit Agency, because of their Defense Department contracts or contracts with other agencies that use the audit agency, audits most of the contractors in the survey. 51% of respondents described their relationship as good, 37% as excellent while 12% described it as fair or poor. When asked if their relationship with DCAA has changed, 86% said it had stayed the same, 6% reported the relationship had deteriorated while 8% said it had improved. The most frequent types of costs questioned by DCAA are executive compensation (18% citing this as an audit issue), consultant costs (15%), legal expenses (5%), bonuses and incentive compensation (6%), employee morale (6%), indirect cost allocations (13%) and labor charging (16%). Most frequently cited violations of cost accounting standards were CAS 403, home office expenses (18% cited this as a compliance issue which was up significantly from 5% last year), CAS 405, Unallowable costs (11%), and CAS 410, G&A (15%) up from 3% last year. 93% of surveyed companies reported that DCAA did not question a significant amount of costs while 7% reported either a significant or very significant amount. Of those companies experiencing audit issues, 35% were very satisfied with the

resolution of the issues, 52% were somewhat satisfied and 13% were not satisfied.

♦ Workforce Compensation and Fringe Benefits

The shortage of skilled workers has forced most companies to offer a comprehensive package of incentive compensation and fringe benefits as part of a minimum compensation package to attract needed personnel.

Medical benefits. In response to questions asking what percent of health benefits are paid by the company the survey results were: 7% reported the company pays for less than half, 6% pays 51-60%. 24% pay 61-70%. 40% pay 81-90% and 12% pay 91-100%. With respect to health costs as a percentage of labor costs, 9% of respondents incurred health costs less than 4% of labor costs, 7% between 4.1-5%, 13% between 5.1-5%, 16% between 6.1 and 7%, 10% between 7.1-8%, 4% between 8.1-9%, 15% between 9.1-105 and 26% over 10% of labor costs.

Current Ratio. The current ratio is derived by dividing current assets by current liabilities where 2 to 1 or higher is generally considered to be healthy. 65% report a current ratio of 2 to 1 or less, 16% report between 2.1 to 3 while the remaining 18% report 3.1 or higher.

410(k) benefits. On average the company will match an employee's contribution up to 6% of their compensation and 85% of respondents reported they do not anticipate any changes in the near future.

Wages Increases. Surveyed companies state that the average increase was 3.5 -4.0 %, which is the same as 2007 results.

Paid time off. 66% of companies polled paid 10 holidays per year, 7% offered 9 and 9% offered 8. None offered more than 12. Though answers were not given the last two years, 2006 results indicated approximately 49% of responding companies combine vacation, holiday and sick leave into a single personal time leave package while 47% maintain separate leave benefits for each type of leave.

♦ Executive Compensation

(*Editor's Note. Care should be used if our readers consider substituting the following results for a bona fide compensation survey where hundreds of firms are surveyed. However, the results shown below are interesting.)* Surveyed companies provided information on the four highest paid executives in the company and the results are presented by company size measured by revenue for 25th, median and 75th percentiles. The following is a summary of the results.

Highest Position (in thousands)

Revenue	25%	Med.	75%
$1-10 M	200	260	300
$11-20M	193	320	374
$21-50M	213	345	425
$51-100M	400	470	550
>$100M	440	510	875

Second Highest Position

Revenue	25%	Med.	75%
$1-10 M	160	225	260
$11-20M	184	250	362
$21-50M	190	290	380
$51-100M	250	320	410
>$100M	320	395	440

Third Highest Position

Revenue	25%	Med.	75%
$1-10 M	150	220	235
$11-20M	178	250	291
$21-50M	185	275	320
$51-100M	230	290	350
>$100M	270	340	400

Fourth Highest Position

Revenue	25%	Med.	75%
$1-10 M	135	184	207
$11-20M	158	194	250
$21-50M	165	230	290
$51-100M	225	285	335
>$100M	250	320	380

♦ Charging Subcontractor Hours on T&M contracts

We have frequently reported on new regulations that provide when subcontract labor can be charged at fixed rates provided in the prime contract and when blended or separate rates may be used. 76% of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract while 24% bill on a cost reimbursable basis (i.e. as an ODC). As for subcontractor hours and costs for incidental activities not specified in the labor rates in the prime contract, 63% said they bill such costs on a cost reimbursement basis while 37% said they bill the hours at the fixed labor rate in the prime contract.

TEKNOWLEDGE CASE – BENEFIT TO A GOVERNMENT CONTRACT

(*Editor's Note. In the last couple of years we have been focusing on cases addressing "benefit to the government". This elusive, evolving concept has great practical significance on what costs are deemed to be allocable and hence allowable government contract costs. The following is a summary of a most recent case addressing this issue where it illustrates some of the factors that need to exist for an indirect cost to be allocable to a contract.*)

Basic Facts

Teknowledge is an internet transaction company providing service solutions for the government. (*Full disclosure – we have provided consulting services to the company unrelated to the current case.*) In 1999, Teknowledge began developing the TekPortal software program, a customer information aggregation service used in the financial services industry. The company intended for the TekPortal program to be dual use software for both commercial and governmental customers.

At the time, Teknowledge had two reporting segments – commercial and government. The commercial segment oversaw development of TekPortal and Teknowledge allocated a portion - $285,000 - of the amortized development costs of $885,000 to the government segment's G&A pool based on headcount of the two segments. From 2001 to 2005, Teknowledge proposed use of TekPortal software in response to three Government RFPs but the government never purchased the program. The Contractor admitted that none of the government contracts utilized the TekPortal technology "per se."

The Government asserted the costs associated with developing the TekPortal program were not allocable to the Government and even if allocable, they are not allowable because they are not reasonable and do not comply with generally accepted accounting principles (GAAP). The contractor argued the costs are allocable because (1) they benefit the government and can be distributed to the government in reasonable proportion to the benefit received and (2) are necessary to the overall operation of its business. Further, it states the costs are allowable because they are reasonable and comply with GAAP. In July 2005 the Defense Contract Management Agency issued a notice of intent to disallow the amortized software costs from TekPortal and issued a final decision Jan. 2006 where upon in April 2006 Teknowledge filed a compliant to the Court challenging the disallowed amortized software costs of $285,000.

Contractor's Costs Are Not Allocable

The Court stated a cost is allocable to a government contract if it is "assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship" (FAR 31.201-4). Alluding to recent cases, the court stated allocability is an accounting concept involving relationships between incurred costs and contract to which they are charged and the test for allocability is whether there is a sufficient "nexus" between the cost and the contract. Accordingly, the cost must meet one of three factors to be considered allocable: (1) incurred specifically for a contract (2) benefits both the contract and other work and can be distributed in reasonable proportion to the benefit received and (3) is necessary for the overall operation of the business, though a direct relationship to a particular cost objective cannot be shown (FAR 31.201-4).

♦ First Prong - Is the Cost a Direct Cost

To determine allocability, the Court says it must first assess whether the costs are direct or indirect. The Government asserted the costs are direct costs and since it had never purchased the software there was no specific contract to charge the direct costs to. Teknowledge stated it could not meet the direct test because there was no contract for the software and argued the costs were indirect. The Court agreed that the costs were not direct and ruled the indirect costs must be subject to the second and third prongs of allocability.

♦ The Second Prong – Benefits the Contract and Other Work

Teknowledge claims the software development costs are allocable as indirect costs because they benefit the contract and other work and can be distributed in a reasonable proportion. Citing two cases, *General Dynamics Corp.(ASBCA No 18503)* and *KMS Fusion v US (24, Cl. Ct 582)*, the contractor asserts the courts have taken a broad view of the meaning of "benefit" to the government that includes any cost that increases business or reduces indirect costs benefits the government. Teknowledge argued that the TekPortal costs allow it to both maintain its ability to perform government contracts and spread the financial risk of the development costs across both commercial and government segments. The government countered by saying the test for allocability is not

"some vague, prospective benefit to the government" and cited *FMC Corp. v US* that held "remote and insubstantial benefits to the government" do not meet the benefit test. The government contended the government never purchased TekPortal and admits the costs were not related to any contract but was rather a speculation in anticipation of acquiring both commercial and government contracts.

The Court concludes the government did not receive benefit from the TekPortal technology. Citing two cases – *Boeing and Lockheed* – it stated the test for allocability is where there is a sufficient "nexus" between a given cost and a government contract and the word "benefit" for an allocability test requires some showing the cost relates to a government contract, not that it promotes the government public policy interests. The Court stated that in the cases Teknowledge put forth there was a nexus exiting between the cost incurred and some underlying government contract. In *KMS Fusion*, marketing consultant costs benefited the contract because additional business brought in reduces the indirect costs allocable to the contract. In *FMC Corp* the bid and proposal costs associated with an Arctic tanker program was allocable to the government because the B&P costs maintained the viability of the commercial enterprise of the company. In *Lockheed*, personal property taxes assessed on facilities were allocable because the government benefitted from Lockheed's fulfillment of its responsibilities as a corporate citizen to the local community.

As opposed to these cases, the Court found no nexus. The only benefits cited by Teknowledge are the general viability of the company and reduced indirect costs to its government segments where the Court said Teknowledge misconstrued the definition of "benefit" under the FAR and failed to show any connection between the TekPortal program and a current government contract, concluding the asserted benefit to the government was too remote and insubstantial to be allocable.

- **Third Prong – Necessary to the overall operation of the business**

Citing FAR 31.201-4(c) and *Caldera v Northrop Worldwide Aircraft Servs. Inc, (192 F.3d 962, 972)* Teknowledge asserted the development costs are allowable because they are "necessary to the overall operation of the business." The contractor maintains the TekPortal costs were necessary to create a product that could be sold in the marketplace, which were similar to the *KMS Fusion* case where consultant costs were deemed allocable because they brought in new business. The government rejected this argument stating Teknowledge provided no factual evidence showing how the TekPortal program kept the company viable.

The Court ruled against Teknowledge. First, it omitted a key part of the allocability test even under the third prong where a nexus to a government contract must be shown. Unlike *KMS Fusion* where a benefit was shown how the consultant costs benefited the DOE contract by lowering indirect costs allocated to the government, no such nexus was shown here. Second, Teknowledge offered no evidence showing how the TekPortal keeps the company afloat or will bring in new business in the future. The Court concluded since the costs are not allocable to a government contract they are not allowable.

RELOCATION EXPENSES OR BONUS INCENTIVE TO RELOCATE

(*Editor's Note. Continuing our practice of providing "real world" case studies from our consulting practice, we are offering the following memo we prepared for a client whose payment of an incentive bonus for relocating an employee was being audited by DCAA as reimbursement for relocation costs rather than focusing on the bonus as a one-time allowable bonus payment. We decided to present an edited version of the memo here because it provides some interesting insights into allowable relocation incentive bonus payments as well as certain relocation costs.)*

Dear DCAA:

In your earlier memo, you indicated you have been requested to audit Contractor's (the client, employee names and dollar amounts have been disguised) "claimed relocation costs of $110,000" and requested supporting documents for that amount. Before going much further, you should realize that the amount you are calling "relocation costs" is really a combination of incentive pay for encouraging Donald to move himself and his family to Washington DC as well as reimbursement for anticipated relocation costs. In our opinion, the amount given to Donald was very conservative and is significantly lower than the amount both industry and government offer to their employees as incentive relocation pay as well as what is allowable as relocation costs according to the FAR cost principles.

Incentive Pay

In creating a Washington DC office and not being able to entice qualified employees to uproot themselves to run the office, we had to offer an incentive bonus of $110,000 to Donald to relocate for the estimated five year period. We examined numerous sources to determine a range of what was considered to be an acceptable incentive package and learned that 100% of salary at the time was typical in the private sector. In our Google search, we also discovered that the federal government, most federal agencies and many state and local governments also provided incentive relocation packages to new and existing employees. For example, the federal Office of Personnel Management provides incentive pay equal to 25 percent of base pay multiplied by expected years of service not to exceed 100% of pay while the Department of Defense offers a relocation incentive plan with a similar calculation of benefits (Exhibit 1, not presented here). A Google search of relocation incentive pay demonstrates similar wide-spread use of incentive pay equal to 100% of base pay in numerous other federal, state and local agencies. It should be emphasized that this incentive pay is separate from allowable relocation costs which are covered by FAR 31.205-35 for government contractors.

Donald's payment of $110,000 represents 72% percent of his base salary, an amount significantly less than maximum amounts allowed by the government and practices common in industry. Even if the entire amount of $110,000 was attributable to incentive relocation pay that amount would be far less than even the federal government allows for its employees. However, part of the payment is for allowable relocation costs.

Relocation Costs

FAR 31.205-35 provides for allowability of certain relocation costs. Though the company paid for Donald's movers, several other costs made allowable in FAR 31.205-35 are included in the $110,000 payment. These costs include:

1. FAR 31.205-35(a)(4). Costs incident to the disposition of the actual residence owned by the employee, not to exceed 14 percent of the sales price. The sales price for the California house was $1,650,000 where closing costs were $82,000, representing brokers fees of $50,000 and other escrow expenses.

2. FAR 31.205-35(a)(6). Costs incident to acquiring a home in the new location is limited to 5 percent of purchase home. The purchase price were $1,450,000 where costs related to purchasing the Maryland home was $65,000 which included $48,000 for sales commission and other related escrow expenses.

3. FAR 31.205-35(a)(7)(ii). Mortgage interest rate differential equal to the difference in interest rates between the old and new home times the mortgage for the old property times 3 years. Interest rate on the old mortgage was 4.25 on a mortgage amount of $600,000 while interest rate on the new home mortgage was 8.25%. So the differential of 4.0% times the old mortgage time three years equals $72,000.

4. FAR 31.205-35(b)(4). Miscellaneous amount, $5,000.

Additional allowable costs were also incurred where the $110,000 was intended to cover them such as house hunting trips to Washington DC – (FAR 31.205-35(a)(2)), tax gross ups for the additional compensation – (FAR 31.205-35(a)(10)) and $45,000 in costs to fix plumbing and dry rot problems in the new home before moving in - (FAR 31.205-35(a)(5)).

In sum allowable relocation costs discussed above exceeds $300,000.

Conclusion

The $110,000 was intended as both an incentive payment to encourage Donald to uproot his family and move to Washington DC where other eligible employees had refused to go as well as an amount to reimburse him for certain anticipated relocation expenses. The amount is significantly less than what Donald would have been entitled to had he been reimbursed for all allowable costs according to FAR 31.205-35 as well as incentive relocation pay commonly practiced in both industry and government.

SIGNIFICANT GUIDANCE ISSUED BY DCAA IN LAST YEAR

(Editor's Note. This past year involved more significant guidelines issued by the Defense Contract Audit Agency than we can remember. The following summarizes some of the most important guidelines DCAA issued to its auditors.)

Executive Comp Cap to Be Applied After Deducting Unallowables

The guidance stressed that the Federal Acquisition Regulation cap on unallowable compensation on

federal contracts should be applied only after the executive's compensation has been adjusted to account for unallowable cost elements. Executives subject to the compensation cap at FAR 31.205-6(p) – contractor's five most highly compensated executives (or those five executives at each business unit) – may sometime perform activities or be compensated amounts which are unallowable. For example, unallowable activities for which related compensation needs to be adjusted might be for significant lobbying, advertising, reorganization or merger activities which must be deducted as well as unallowable compensation amounts such as stock appreciation rights or changes in the price of corporate securities. In determining whether the senior level executives' compensation are below the cap – currently $684,181 – auditors are told to make sure that all unallowable cost elements are first deducted from the salary being benchmarked (08-PAC-010(R). (*Editor's Note. Though the audit guidance explicitly addresses OMB caps established for larger companies, informal inquiries we made to DCAA indicate the provisions of the guidance will apply equally to reviews of smaller companies where lower caps are in effect.*)

Guidance on Auditing Commercial T&M/LH Contracts

DCAA has traditionally been interested in auditing time and material and labor hour contracts where now it has added commercial T&M/LH contract to its list of contracts to be reviewed. This coverage is to include provisionally approving interim vouchers and reviewing final amounts billed under contracts for compliance with contract terms. As for what costs should be approved for payment the guidance reminds auditors that acceptability of costs billed under commercial T&M/LH contracts are not subject to FAR cost principles or CAS but are determined based on the terms and conditions of the contract.

The guidance alludes to DCAA earlier guidance of July 31, 2007 addressing allowable costs on commercial T&M/LH contracts that provides:

- Hourly rates will be paid at the rate specified in the contract and blended rates (combined prime, subcontractor and/or interdivisional rates) may be used
- Hourly rates will be paid only for contract labor meeting labor qualifications specified in the contract
- Material, subcontracts not included as part of the labor schedule and other direct costs will be based on actual costs and other direct costs should be listed in the contract by type of expense (e.g. travel, computer usage, etc.)
- Indirect cost, as applicable, will be reimbursed at a fixed amount prescribed in the contract on a pro rata basis over the contract period
- For labor hours, including subcontract hours reimbursed at the hourly rate in the schedule, access to original time cards (electronic or paper), contractor timekeeping procedures and labor distribution reports showing distribution of labor between jobs and contracts will apply
- Access to invoices, proof of payment and subcontract agreements for any material and subcontract costs that are reimbursed on an actual cost basis

The guidance also alludes to a contract clause that allows reimbursement to the government for any payments later found to be not payable under the terms of the contract and requires submission of a final voucher within one year of contract completion. The guidance reminds auditors that for contractors with incurred cost audit activity (i.e. submitted an incurred cost proposal) the DOD T&M/LH commercial contracts should be part of their overall audit coverage and the vouchers should be governed by the same billing system applied to other work. Also the contracts should be included in the universe for transaction testing for system reviews and the employees charging time should be included in the universe for floor checking. At contractor locations where DCAA has no current incurred cost audit scrutiny, audits are limited to provisional approval of vouchers, floor checks and audits of final vouchers. Auditors are told to consider reviewing the first voucher submitted to DCAA then review subsequent vouchers on a randomly selected basis (08-PPD-014(R).

Guidance on Reporting Suspected Contractor Irregularities to Investigative Agencies

(*Editor's Note. We have been seeing incidences where individual DCAA auditors have been referring contractors to governmental investigation agencies for possible criminal or fraud investigations when they have concerns about a contractor's cost allocation or screening of unallowable cost practices identified during an audit. We are particularly concerned about these because we have seen little DCAA management review of such referrals.)*

DCAA issued an audit alert reminding their auditors of agency policy to report suspected contractor fraud and other contractor irregularities encountered in the performance of their audits. Suspect contractor fraud and irregularities should be reported promptly using DCAA Form 2000 in accordance with the DCAA

Contract Audit Manual 4-700 and DCAA Instruction No. 7640. Auditors are told, in bold letters, "There is no requirement for the auditor to prove the existence of fraud or other contractor irregularity in order to submit a DCAA Form 2000." The guidance also states that DCAA management reviews of Form 2000 prior to formal submission "should be limited to that necessary to ensure clarity. No attempt should be made to dissuade an auditor from completing and submitting a DCAA Form 2000." Examples of irregularities cited in the guidance includes labor mischarging, submitting false claims, repeated overbilling, falsifying labor charges, improper transfers of costs between contracts and bribes/kickbacks. Any other suspected irregularity may be referred (*09-OTS-004(R*).

Annual Testing of Contractor Eligibility for Direct Billing

The DCAA memo addresses auditors' annual testing of contractors' on-going eligibility for direct billing. The name and focus of the revised audit program is to ascertain whether there can be continued reliance on contractors' internal controls for direct billing purposes as spelled out in the DCAA Contract Audit Manual (DCAM) 6-1007.6. The guidance includes a proforma memo for the record that provides auditors will select a sample of paid vouchers submitted directly to the government paying offices and will (1) test the contractor's procedures for preparing vouchers on flexibly priced contracts (including T&M and labor hour contracts) and (2) verify the contractor is current in submitting its incurred cost proposals and final vouchers. The proforma memo will state that the tests were made, continual reliance can be placed on the contractor's procedures and the incurred cost proposals and final vouchers are submitted on time. If the tests indicate the vouchers cannot be relied upon the memo should so state, a flash billing system report should be issued and the memo should state the direct billing program will be rescinded. Similarly with untimely submittals, the memo should state the incurred cost proposals or final voucher are not timely submitted, a flash estimating system report should be issued and direct billing will be rescinded (*08-PPD-034(R*).

Alert Concerning Compensation Consultant Results

DCAA issued an alert addressing concerns about executive compensation reasonableness when a contractor uses a compensation consultant. The guidance notes contractors frequently use compensation consultants to establish executive pay and states these consultants may not be independent, especially when they perform other services for the contractor. Auditors are told not to rely on the consultant's determination on reasonableness of compensation without performing a review of the survey data used in establishing the compensation. They are told that the consultant's data should be "based on reliable and unbiased surveys that are representative of the contractor's relevant market or industry." They are also told that no one survey is sufficient to determine the market value of pay for all contractor positions and the memo suggests that a primary survey may be selected with secondary surveys used to collaborate the results of the primary survey. If risk is disclosed, auditors are told to perform their own assessment using available survey data within DCAA by going to regional DCAA compensation specialists (08-PPD-035(R). (*Editor's Note. We believe this represents a step away from the traditional practice of allowing contractors to make their own determinations of what is reasonable executive compensation where DCAA primarily validates the controls used to make the determination to now coming close to having contractors use both the same and number of surveys it uses to determine reasonableness of compensation. DCAA survey data is quite expensive to obtain and, in our opinion, often yields less accurate results than other means contractors use.)*

Risk Alerts on Current Economic and Financial Conditions

DCAA has issued guidance reminding its auditors to be on the lookout for unfavorable or adverse financial conditions that could affect cash flow, produce inefficiencies and impede contractors' ability to perform their contracts. (*Editor's Note. The guidance points to CAM 14-300 and we also refer our readers to prior articles we have written on contractors' financial risk – use our search function at govcontractassoc.com.*) Auditors are told to be continuously alert to any indication of unfavorable financial conditions that would especially arise in progress payment audits, annual testing of eligibility for direct billing, billing system reviews and interim voucher reviews. Examples of possible unfavorable financial conditions include (1) increases in aging and amounts of accounts payables (2) defaults on loan and line of credit agreements (3) denial of usual trade credit from suppliers (4) restructuring of debt with higher interest rates (5) noncompliance with loan/line of credit covenants (6) loss of principle customers or suppliers (7) unpaid or late payments of state, local or federal tax liabilities (8) deteriorating bond ratings (9) failure to fund pension plans (10)

loans from employees or issuing stock in lieu of salary (11) significant unpaid debts or other liabilities (12) unusual progress payments or other billing concerns or (13) poor physical condition of facilities. When these or other indicators of financial risk are present, auditors are told to initiate a financial condition risk assessment (*08-PPD-036(R*).

Eliminates "Inadequate in Part" Opinion

In a very significant departure from traditional practice, DCAA will no longer allow "inadequate in part" opinions on internal controls related to system reviews. In the past, when DCAA conducted a system review (e.g. accounting system, estimating, billing, purchasing) it would commonly assess the internal controls practices related to that system (e.g. written policies and procedures, training, division of responsibilities and authority) and would then express one of three opinions on the system – "adequate", "inadequate in part" or "inadequate." Now that second opinion will no longer be issued. From a practical standpoint, the "inadequate in part" opinion was not considered nearly as bad as "inadequate" and generally offered opportunities to make necessary fixes quickly and soon receive an adequate opinion. Now, internal controls and evaluation of the system will receive only one of two opinions – adequate or inadequate. (*Editor's Note. We were uncertain whether the inadequate opinion is to apply only to internal controls of a system or the system as a whole so we made several inquiries to authoritative sources who all indicated that a negative assessment of internal controls during a system audit would result in an opinion of inadequate to the system itself, not just specific internal controls.*) Once a system is deemed inadequate, the audit report will recommend to the contracting officer they disapprove the system and pursue suspension of either a percentage of progress payments or reimbursement of costs. (*In our experience, even worse consequences result from inadequate opinions such as failure to win new awards.*) The guidance also states an opinion of inadequate internal controls does not have to have a direct relationship to charging unallowable costs to government contracts but can be any significant internal control where poor ethics and integrity controls are cited as an example. In addition, DCAA will no longer report on minor discrepancies that were entitled "Suggestion to Improve the System" because these practices caused "confusions." For now, the guidance appears to be applicable to only major contractors (*08-PAS-043(R*).

Emphasizes Flash Reports and Institutes Limited Scope Internal Control Audits

On the same day the above guidance was issued, DCAA issued another set of guidelines on what auditors should do if they identify internal control deficiencies during one of their non-system audits (e.g. forward pricing proposals, incurred cost submittals). The auditors are told to (1) issue a flash report addressing potential deficiencies within seven days if they do not receive comments from the contractor (a long established though not often followed guideline) and (2) establish a limited scope audit assignment to review the cited internal control weakness and all other "related" internal controls, preferably within 30 days after the condition is identified. If the limited scope audit determines that internal controls are not adequate, the auditor is to issue a report stating the relevant system is inadequate and recommend the CO disapprove of the system and suspend progress payments or reimbursement of costs. The guidance states it is applicable "generally" to major contractors, a term that often is later extended to non-majors if significant "risk" is identified (*80-PAS-04(R*).

Eliminates "Quick-Closeouts" for T&M and Labor Hour Contracts

Effective immediately, DCAA has decided to discontinue the Time & Material and Labor Hour Contract Closeout Initiative it began in 2005. The closeout initiative was established to allow for the closeout of low risk T&M and LH contracts of $1 Million or less prior to completion of the incurred cost audit. Though it did not specify why, the guidance states it was discontinuing the quick closeout practices "based upon a reassessment of the initiative and risk associated with closing T&M contracts prior to completion of the incurred cost audit" (*08-PPD-038(R*).

Contractors Will be Cited for Denial of Access to Records if There Are Delays in Providing Requested Documents

In an apparent attempt to speed up provision of requested documentation during audits, auditors are now told if requested documentation is not provided in a timely manner they are to (1) follow procedures for denial of access to records (2) take appropriate actions to withhold any unsupported costs billed to the government until the data is received and (3)

question the unsupported costs in the audit report if the documentation is not received prior to the completion of the auditor's fieldwork at the contractor. These procedures are to be followed even if the contractor concurs to the questioned costs resulting from lack of support and if the records are alleged to have been destroyed, lost or stolen auditors are to obtain a written statement from senior management (i.e. no lower than business segment vice president or CFO) detailing the circumstances. If the auditor concludes the contractor cannot support its assertions on a timely basis they are to consider whether an internal control deficiency exists (providing as an example if cost transfers or adjusting entries are not provided in a timely manner), the contractor's accounting system should be cited as a significant deficiency or material weakness.

The guidance spells out what is considered to be reasonable expectations of timely support where the auditor has the obligation to clearly state what support is needed and when it should be provided and the contractor should be provided a reasonable time to provide the data. The assumption is that documentation supporting a contractor's assertions in a proposal or submission should be readily available (e.g. support for proposed hours should be provided the same day since the proposal is based on it) unless there is extenuating circumstances such as the data is stored off-site where additional time will be permitted. Costs that cannot be evaluated due to denial of access to data will be questioned and if unsupported costs are pervasive, the auditor should issue either a "qualified or adverse opinion."

COMPLIANCE IMPLICATIONS OF TRANSITION FROM RECESSION TO POTENTIAL GROWTH

(*Editor's Note. In the past we received praise for a couple of articles we wrote that linked good management practices with compliance issues. As we did in the past, we selected an interesting article written by McKinsey consultants in the July 2009 issue of the McKinsey Quarterly called "What Next? Questions for CFOs." The article addresses actions needed as the recession fades and recovery seems to be more likely. So as government contractors implement the types of advice offered here, what type of compliance issues are they likely to encounter?*)

The credit crisis and shocks to the economy have put chief financial officers at the front lines to implement measures to help companies survive. Now that an eventual recovery is beginning to be in sight, the CFO's tasks become more complex because the future is still uncertain and credit is still tight yet there may be some great opportunities.

1. What shape will the recovery take? Though the worst seems to be over much uncertainty remains about the nature and pace of the recovery. There are no assurances where other McKinsey studies see the very real possibilities for either significant inflation due to large deficits being incurred now or alternatively a long recovery with the likelihood of more recessions. Companies need to project, for example, the possibility of wage and price inflation due to heavy deficits, high unemployment and lower international trade.

Compliance implications. Such significant uncertainty calls for frequent monitoring of indirect rates (altering projections as needed and updating projections with actual data) so as to forecast annual estimates of rates at least, quarterly, if not monthly. For pricing purposes, careful considerations of uncertainties need to be taken into account without running afoul of unallowable contingency costs. Creative use of alternative categories of labor (e.g. full time, variable, temp, subcontract) with flexible pricing possibilities will generate lots of audit scrutiny.

2. Have you restructured enough?. A weak economy makes it easier to implement unpopular operations changes and to make divestitures. Companies may have more leverage over their suppliers, unions and regulators who may be more cooperative where employees understand the need for change. Also, there should be a short list of acquisitions to take advantage of good deals before the recovery is apparent, driving up acquisition prices.

Compliance Implications. Restructing activities will likely increase. A hot audit area will probably be identifying "external" restructuring activities to ensure contractors are carefully accumulating and reporting such costs, including associated costs. Contractors also need to be mindful of the distinction between unallowable external restructuring (related to acquisitions, divestments and financing) costs and allowable "internal" restructuring efforts (related to bring about economies and efficiencies). Restructuring activities also create new company

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structures resulting in new business units with potentially different pricing opportunities and home office allocations of costs. Indirect rate structures also need to be evaluated.

3. Is your supply chain sufficiently flexible? Whereas 2008 led to questions about what would happen if the downturn was worse than expected, in 2009 it is worth considering what happens if the surprise comes on the upside. Can they respond without bringing back high costs or cutting quality?

Compliance Implications. In a period of change, the government is looking to see whether pricing proposals adequately reflect changing economics. Auditors are expected to be particularly sensitive to making sure low estimates of business growth in the recent past do not result in unreasonable low estimates of business and hence excessively high indirect rates (i.e. lower base costs generate higher rates).

4. Should you restart conversations with potential alliance partners? Whereas there was a big increase in interest to seek out strategic partnerships to go after government business much of this activity was put on hold last year. This year, as long as the underlying logic is still sound, many partners may be closing deals. Moreover, many businesses may have been hurt during the downturn and become competitively disadvantaged so joint ventures may be more attractive than ever.

Compliance Implications. Contractors need to dust off their knowledge of particular cost and pricing rules as they relate to joint ventures and strategic business units (see our article in the 3Q08 issue of the DIGEST if such activity is planned.) For example, whether a separate segment or a new joint venture entity is preferable needs to be decided and how the choice will affect indirect rates charged to contracts. Also special attention needs to be paid to IR&D/B&P, intercompany transfers, rental and legal costs

5. Can you sell your recovery plan to investors? Whether it be meetings within (strategy) or outside parties (investors, bankers) communications will likely proliferate.

Compliance Implications. Where do allowable business meetings become unallowable entertainment events? When do unallowable brochures become allowable communications with investors and meetings with the public? When do insignificant internal efforts not requiring monitoring of hours become significant requiring identification of internal costs related to unallowable activities?

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