GCA DIGEST

(A publication of Government Contract Associates)

Third Quarter 2001 Vol 4, No. 3

Knowing Your Cost Principles... DIRECT SELLING COSTS

(Editor's Note. In our consulting practice, we frequently encounter numerous challenges to the way contractors allocate selling costs. Imprecise rules and conflicting appeals boards decisions provide opportunities for the government to challenge allocations of otherwise allowable selling expenses to government contracts. We have relied on one of our favorite texts, Accounting for Government Contracts Federal Acquisition Regulation by Lane Anderson as well as our own experiences as consultants for this article.)

Selling is a generic term that includes all effort to market a contractor's goods and services. Individual portions of the Federal Acquisition Regulation cover various aspects of selling and marketing activities: advertising and public relations – FAR 31.205-1, bid and proposal costs – FAR 31.205-18, market planning – FAR 31.205-12 and direct selling costs – FAR 31.205-38. We will focus on direct selling costs which are defined as actions to induce particular customers to purchase a contractor's goods and services. These efforts are usually characterized by person-to-person contact with potential customers. Selling activities include identifying potential buyers, learning of buyers' needs, convincing potential buyers to purchase the contractors' goods and services, negotiation and liaison between contractor and customer personnel, technical and consulting activities and individual demonstrations.

Allowability

Selling costs are allowable if they are reasonable. There are certain prohibitions: (1) if they are considered advertising costs such as sales promotion or (2) sellers' agents' compensation – whether called commissions, fees, percentages, retainers, brokerage fees – is not provided by "bona-fide employees or established selling agencies." The latter simply means that compensation must be for actual legitimate sales services rather than that considered "influence" payments.

Other than challenges to non-allocability, if these prohibitions are not met then the only other basis to question the expenses is they are unreasonable. In determining reasonableness, the government considers the nature and amount of expense in light of expenses a prudent person would incur, the proportionate amount spent between government and commercial business, the trend and comparability with historical costs, general level of selling costs in the industry and nature and value of the expense in relation to contract value.

Allocability

Unlike CAS 420, where allocation of bid and proposal costs are spelled out, none of the cost accounting standards address selling. The original CAS Board did consider addressing selling and marketing expenses but decided against it. Though the CAS Board did not assert sales expenses were a general and administrative cost, CAS 410 states the expenses may be included in G&A costs.

In general, the government views selling costs as being more closely related to commercial business and it is not uncommon to see the government (i.e. auditors) attempt to single out selling expenses as applying to commercial work only. Where some selling costs produce a clearly recognizable "benefit" to the government (say, cost of service incurred to adapt a commercial product to government use), other costs demonstrate less direct benefit. Auditors may suggest several methods to exclude allocation of selling costs to government contracts (e.g. they should be direct charged to commercial contracts, two or more selling cost pools should be created) and contractors need to counter with arguments that justify allocation to government. For example, to the direct charge to commercial contract contention, contractors can argue that selling costs are not incurred specifically for a contract because no contract exists when the costs are incurred – after all, the purpose of the expenditure is to secure a contract. *(Editor's Note. Auditors are prone to more aggressively question costs in certain areas with the understanding they may have to soften their stand if the contractor appears adamant in challenging their position.*

Allocation of selling costs is one of those areas and contractors should be prepared to state their position with authority.)

♦ Inconclusive Board Decisions

The appeals boards decisions are not always consistent and there seems to be enough decisions to be cited on both sides. On the side justifying allocation of selling costs to government contracts, the appeal boards have sympathized with the position that selling costs included in the G&A pool that are allocated to all work is appropriate due to the fact that as the business expands all contracts benefit because G&A is allocated over a broader base. Since there is no definite cause and effect selling costs are reasonably considered an overall cost of doing business. Acceptable allocation of indirect cots to a contract often depends on whether "benefit" to that contract, in general, can be demonstrated. *In Lockheed- Georgia Co. (ASBCA 27660*), which cited an earlier case – *Lockheed Aircraft Corp v. US 375 Fwd 786* – the Board concluded the requirement to allocate costs on a benefit basis is established by any sound method of allocating indirect costs to government and commercial work. Similarly in *General Dynamics Corp (ASBCA No 18503*) the requirement to distribute costs in proportion to benefit may be satisfied by any reasonable method of allocating costs to both government and commercial work. Its selling costs for a commercial contract was allocable to government work because its success would reduce fixed overhead expenses on a prorata basis. In *Daedalus Enterprise Inc. (ASBCA 43602*) bid and proposal costs for a foreign contract was also allocable to a government contract because the government benefits from a lower G&A rate as a result of foreign business. The Board understands that benefit exists when fixed expenses are allocated over a larger base.

Aydin Corp (West) (ASBCA 42760) provides further justification for allocating sales expenses to government contracts. The contractor's practice was to record all commissions as an indirect cost and in one year when a non-government contract represented 91 percent of all commissions while the contract represented only 19 percent of the G&A base costs, the government and Appeals Board asserted allocation of 81 percent of the commissions to the government contract was inequitable. The US Court of Appeals reversed this position ruling the mere size of the commissions was not sufficient to justify a different allocation method of the same costs – commissions – and to do so would be to violate CAS 402.

Though the cases discussed above support the conclusion that increasing a contractor's overall business base justifies allocation of selling costs to government contracts it is not always a "slam dunk." In *Capital Engineering Corp (ASBCA 11453)* and *Phillips Petroleum Co. (ASBCA 6830)* the appeals board held new business ventures were so clearly commercial that an allocation to government work was not appropriate. In *KMS Fusion (24 Cl. Cl. 582)* and *Sanders Associates (ASBCA 15518)* certain selling costs were also not allocable to government contracts. Numerous ASBCA cases have held that salaries of sales people who are not involved in government contracts are not properly allocable to government contracts (see *Century Title Co. ASBCA No. 1733, Wichita Engineering Co. ASBCA 2522* and *Habney Brothers, Inc. – ASBCA 3629).*

♦ Other Allocation Issues

Deferral. In order to better match revenue and expenses many contractors are tempted to defer selling and marketing expenses to future periods for future contracts. Most authorities will reject this deferral because they view selling and marketing as period costs. Their similarity to bid and proposal costs where FAR 31.205-18 prohibits such deferrals supports their conclusion that selling costs should not be deferred.

Foreign Selling Expenses. Foreign selling expenses related to foreign military sales (FMS) have created special problems because of the changing regulations covering them. We often encounter confusion by both government and contractor representatives. A summary of the cost rule provisions are: Before March 1979 foreign selling costs were allowable. From March 1979 to January 1986, these costs were considered "unallocable" to US government contracts. Between January 1986 and May 1991 the FAR made these costs unallowable because a court decision confirmed the earlier "unallocable" position and the FAR Council said their unallocability made them "unallowable." After May 15, 1991 these costs are allowable if they consist of significant efforts to export products normally sold to the US government.

Commissions and Retainers. Commissions were once unallowable but are now considered allowable. The government has frequently tried to insist contractors treat them as direct costs. In *Cubic Corp (ASBCA 8125)* the government contended that all commissions should have been treated as direct costs of the applicable contracts but the appeals board ruled that commissions, like other selling costs, be treated as

indirect expenses. In *Daedalus* the same issued was addressed with the same conclusions.

CAS 402 (as well as FAR 31.203 for non-CAS covered contracts) requires expenses, such as selling costs, be allocated either as direct or indirect to prevent double counting where a contract is allocated its share of selling costs as a direct cost and also receives an indirect cost allocation of the selling costs related to other contracts. The *Cubic* and *Daedalus* cases discussed above ruled that selling costs are incurred for the same purpose under like circumstances whether or not the selling effort was successful in obtaining new business. If the cost of successful selling efforts are allocated direct and those unsuccessful efforts allocated indirect, the Board rules a violation of CAS 402 and FAR 31.203 results.

Retainers, which are payments for general representation without regard to sales levels (most commissions are based on actual sales made) are considered a type of commission and follow the same rules of allowability and allocability.

Separate cost pools. In one form or another, the government may propose that several selling cost pools be created. When new work – government or commercial – is performed in an indirect cost pool where the base includes government and commercial work, both types of customers reap the benefit of increased volume. The author suggests it is generally inequitable to require separate selling cost pools for government and commercial work when the work is performed in the same indirect cost pool and hence the suggestion should be resisted.

JUSTIFYING ONE COMPANY-WIDE OVERHEAD RATE OVER MULTIPLE OVERHEAD RATES BY LOCATION

(Editor's Note. The following article is based on a position paper written in response to an assertion made by the Defense Contract Audit Agency that a systems engineering firm working out of multiple offices should use multiple indirect rates coinciding with its geographic locations. DCAA usually has a preference for such multiple rates, especially when it believes such a practice will save the government money. When they express their preference, the burden often falls on the contractor to justify another approach. The position paper in support of his client's practices was written by Len Birnbaum of Birnbaum & Associates to the local DCAA office and presented as "supplemental information for your consideration." Len Birnbaum is one of the most imminent consultants and attorneys in the government contracting field and we are happy to report he is a member of our "Ask the Experts" panel where subscribers can email cost, pricing and contracts questions and have a member of our panel respond at no charge. This article is part of our continuing effort to present position papers addressing cost allowability and/or allocability issues in defense of contractors' practices, particularly when challenged by the government.)

Background

The contractor had been in business for over 20 years where their business has not fundamentally changed. They provide systems engineering support primarily to the federal government or federal prime contractors in such areas as program management and support, aeronautics-satellite-communications services and hardware debugging. About 85 percent of the firm's government business is cost type or time and materials contracts. The company operates as a single business out of multiple offices.

The firm is labor intensive and the nature of its services require the same type of technical discipline and administrative support. It uses two indirect rates - a company-wide payroll burden rate applied to direct labor and a single company-wide overhead rate applied to direct labor and labor burden. Though the company has grown considerably, its indirect rates have remained fairly constant over the years which is attributed to the fact that all personnel receive identical fringe benefits and the infrastructure (e.g. office space, computers, administrative support) that supports labor activity is directly related to direct labor. DCAA challenged its use of a company-wide overhead rate asserting such a practice was in violation of CAS 418 and said the company should, instead, use multiple overhead rates corresponding to its varied geographic locations.

Analysis of CAS 418

(Editor's Note. Though the paper addresses cost accounting standards 418 and 410 partly because the client is CAS covered, we believe the arguments are equally valid to non-CAS covered contractors because (1) the substance of the standards are replicated in FAR 31.203 and (2) CAS are the most authoritative standards over cost allocation issues.) CAS 418 provides an overall framework for accounting for and allocating direct and indirect costs. The CAS Board defines a direct cost as "any cost which is identified specifically with a particular final cost objective." Indirect costs, by default, are simply all costs that are not direct costs. The standard, per se, does not

establish criteria for distinguishing direct and indirect costs but requires contractors to develop their own criteria, demonstrating the CAS Board's intention to provide contractors the flexibility to distinguish their own direct form indirect costs and allocate their indirect costs. Rather, the CAS Board provides guidelines using concepts of "homogeneity" and "materiality" to be applied after the contractor has established its own policies for classifying costs as direct or indirect.

What is an Appropriate Indirect Rate Structure

Authoritative texts indicate the following factors need to be considered when developing an indirect rate structure (see "Accounting for Government Contracts Cost Accounting Standards" by Lane Anderson):

1. *Organization structure*. A company's organization should be designed to meet its strategic objectives. For example, some companies organize around types of customers regardless of geographic location. The client's organization is frequently reshaped to meet customer program requirements which makes a company-wide rate compatible with its organization structure.

2. *Diversity of Products or Services*. Companies with few products or services usually adopt simple accounting systems. The client, for all practical purposes provides only one service – systems engineering. The services are practically the same and consequently, the absence of diversity in services make two indirect pools quite sufficient.

3. *Customer Mix*. Doing work with the federal government is usually more expensive than for commercial customers. For example, maintaining an adequate accounting system, supporting government audits, keeping up on security requirements are all expensive. Since 85 % of the business is devoted to providing services under government contracts, the government receives the benefits of using a company-wide rate since some of its relatively high indirect costs are allocated across all work.

4. *Pricing strategies*. A contractor operating in a cost reimbursement environment must be able to fully recover its costs but must also maintain competitive pricing and keep a stable rate structure to adequately administer its contracts. A broad company-wide direct labor base as opposed to frequently changing labor at particular locations helps stabilize rates over a long period of time. Some of the client's contracts extend over 10 years.

5. *Administrative ease*. Unduly complicating the accounting system will unnecessarily increase costs over use of a company-wide rate.

♦ Fundamental Requirement of CAS 418

CAS 418 requires "a business unit shall have a written statement of accounting policies and practices clarifying costs as direct or indirect, which shall be consistently applied." The client complied by preparing a CASB Disclosure Statement that described its basis for classifying costs as direct and indirect which was deemed adequate by DCAA.

Next, CAS requires "indirect costs shall be accumulated in indirect cost pools which are homogeneous." The homogeneous requirement is satisfied by the fact the individual elements included in the client's labor burden and overhead pools have the same or similar beneficial or causal relationship to its direct labor base. The homogeneity of the pools may best be demonstrated by grouping the cost elements into the following broad categories:

- Directly related payroll costs – payroll burden
- Personnel support – overhead
- Facilities and office expense – overhead
- Costs necessary for overall operation of business – G&A

Payroll related costs. Payroll taxes, health insurance, holiday, vacation, and other fringe benefits apply equally to all personnel. There is a "direct causal and beneficial relationship" of such costs to salaries and wages paid to employees.

Personnel support costs. These expenses include supervision, human resources, accounting and management information services. These services are provided on a company-wide basis and there is a direct causal and beneficial relationship between the direct labor and related support.

Facilities and office expense. The office facilities and equipment required to support system engineers are very similar because, for practical purposes, the company supplies the same type of services to all its customers. Regardless of where the employee is located, they require adequate office space and equipment. Hence there is a similar causal and beneficial relationship.

Cost related to overall operations. These costs include professional fees, general administration, state taxes and licenses and other minor operating expenses whose total as a percentage of direct labor and payroll burden is 3 percent. Pursuant to CAS 410, the G&A expense pool may be combined with other expenses

for allocation to final cost objectives provided the allocation base used for the combined pool is appropriate for both the G&A expenses and other expenses. CAS provides that G&A expenses should be identified and requires that G&A type expenses be allocated on a base representing the total activity of the company. Both criteria are met: (1) the chart of accounts clearly identify G&A type costs and (2) total direct labor dollars reflect the total activity of this labor driven client company.

The Litton Case

A seminal case, *Litton Systems, Inc. ASBCA 37131*, explicitly established that CAS 418 does not require separate indirect expense pools be established for each location. The Board stated, in part " the standard does not mention the location of cost incurrence as a relevant factor, nor is it relevant from a purely conceptual view." Further, "nothing in CAS 418 or any other standard indicates that location of facilities or cost levels of operations has any effect on the characteristics of homogeneity of indirect cost pools."

The client prevailed.

NEW RULES ON UNBALANCED BIDDING

(Editor's Note. Unbalanced bidding is a powerful pricing weapon to use against other bidders and its use by others must be anticipated. The rules on unbalanced bidding have become more liberal. As a result, unbalanced bidding can now be used more often because it provides great flexibility of pricing and in many cases, allows contractors to use government funds without paying interest or providing security. An article in the July/August 2001 issue of the Lyman Report by Joseph Petrillo of the firm Petrillo & Powell tracks recent changes in rules covering unbalanced bidding, how the rules have been interpreted in bid protest decisions and how the rule changes and decisions impact bidding strategies.)

What is Unbalanced Bidding?

Unbalanced bidding can arise whenever the government is ordering more than one separately priced item. Individual items can be overstated or understated and usually arises under one of the following common circumstances:

1. When there is uncertainty about how many individually priced items the government will actually order. This arises regularly under indefinite-quantity and requirements contracts where the government might use estimated quantities for bidding and evaluation purposes but where actual orders can and often do vary from estimates used for price evaluation.

2. Where the contract provides for option periods for increased quantities or additional periods. An example is for supply contracts where only one portion of the items are awarded initially and the balance is subject to the placement of orders later while for service contracts a scope of work awarded for one term is followed by a succession of options for additional periods of performance. The government often provides estimated quantities to be used for evaluation purposes but since they are not obligated to order the estimated amounts, considerable uncertainty exists over how much of the individually-priced items will be supplied.

In either of these circumstances, offerors have flexibility in how they distribute their total price among the various contract line items. "Unbalanced bidding" refers to cases where there is an unusual or discrepant distribution of price among the line items. For example, if performance of services are expected to cost about the same each year, a price for one period which is much higher or lower than others might be unbalanced.

Earlier Responses to Unbalanced Bidding

The law regarding unbalanced bids grew out of bid protest decisions of the General Accounting Office which became formalized in procurement regulations like the FAR. As the rules evolved, a bid could be rejected if it was both "mathematically" and "materially" unbalanced.

"Mathematically unbalanced" means some prices are significantly less than cost while others are significantly overstated. If a bid was unbalanced it did not need to be rejected unless the unbalancing was "material." "Material" usually hinged on a calculation of the chance a bid would not remain low if actual conditions varied from what was expected from the evaluation model.

The GAO also expressed concerns regarding "front loaded costs" – those where payments are shifted to the early part of a contract and away from later periods. The front loaded prices were to be rejected when they were "tantamount" to illegal advanced payments.

New Rules in FAR 15 Rewrite

As GAO decisions accumulated, there were numerous articles in law journals pointing out that the decisions were often inconsistent and difficult to apply. A lawyer at the GAO named Dan Gordon suggested a different approach in 1994. Rather than the traditional analysis of "mathematically and materially" unbalanced price, he recommended using a "risk" approach where if risk was acceptable, the offer could be accepted.

The rewrite of FAR Part 15, effective October 1997, adopted Gordon's approach. The old concepts of material and mathematical unbalance are gone and now the critical issue is an assessment of risk. The new FAR 15.404-1 regulation still defines unbalanced price as one where one or more contract line items are significantly overstated or understated. When a bid is unbalanced the contracting officer must consider the risks by determining whether the award "will result in paying unreasonably higher prices for contract performance." If the CO determines the risk is "unacceptable" then the offer can be rejected. Gone from the revised regulation is any mention of "material" unbalancing or the possibility an unbalanced bid can constitute an advanced payment.

Impact of the New Rules on GAO Bid Protests

One would expect fewer successful bid protests alleging unbalanced bidding following the new rules. The new test of "unacceptable risk" seems more vague and subjective than the objective "mathematical and material" unbalance. To prevail a bid protest does not depend on a numerical analysis of price but on overcoming the discretion of the award decision makers. Indeed this is the case – in a dozen cases since the rewrite of FAR, no protestor has won.

In three decisions the GAO determined there was no unbalanced bidding while in the others the GAO affirmed the agency's risk analysis in spite of unbalanced bids. Various factors have been cited as upholding agencies' risk analysis: confidence in estimates used for bid evaluation (*J&D Maintenance & Svc., B-282249*); a relatively small amount of the bid price was unbalanced (*Kellie W. Tipton Const. Co., B-281321*); alleged unbalanced items would net out because they would be ordered in pairs *(Beldon Roofing Co., B-282970*); other bids included a similar amount of risk (*So. Atlantic Constr. Co. B-286592.2*) and; a special provision in the solicitation prevented the government from paying an excessive price early in the contract (*Enco Dredging, B-284107*).

Other interesting recent decisions include:

It helps when the agency discusses the unbalanced pricing with the offeror. When the agency asked about their unbalanced prices, the offeror responded the prices were based on its "own pricing strategy and years of experience" and the agency and GAO accepted it (*Red River Service Corp., B-282634*).

With or without an adequate risk analysis, it helps to show it would be the low bidder. The GAO disagreed with the agency's assertion no risk analysis needed to be conducted because there was no unbalanced bidding. The GAO ruled there was unbalanced bidding but still denied the protest ruling estimates were not unreliable and the winning offeror convincingly showed it was the low bidder (*Citywide Managing Services of Post Washington, Inc., B-281287*).

The GAO seems to have retracted from the prior FAR rule that front-loaded unbalanced prices were potentially illegal advanced payments. Noting the removal of the advanced payment provision the GAO suggests if risk is not unacceptable then there is no advanced payment problem. The GAO confirmed there was no unacceptable risk since it found the government was paying a reasonable price for each line item and therefor since the line item prices are reasonable these is no advanced payment *(Reece Contracting, Inc., B-284605*).

Front loaded pricing is easier to get away with. Under a five year contract for computer hardware maintenance in four separate locations, the winning offeror proposed a first year price which was about 40% of the total price while its fifth year price was 5%. In the unsuccessful protest, the GAO said the agency made a proper assessment of risk before accepting the front-loaded price proposal. In rejecting the argument the proposed price constituted illegal advanced payments the GAO said there was "no showing the agency payments to the awardee in one year were to be applied to another year" (*CCL Service Corp. v United States, No. 00361*).

Implications of the New Rules on Bidding Strategies

The new rules are changing the competitive environment. There is less chance a competitor's bid will be rejected as unbalanced and, similarly, bidders may put forth more aggressive bidding strategies under the new rules.

There are several ways a bidder can seek an advantage using an unbalanced bid. Most common is when a

bidder perceives an error in the estimated quantities used for bid evaluation, it can inflate prices for those items where the quantities may be underestimated and maybe offset them with lower prices where quantities appear to be overestimated. This strategy can result in a bid that is artificially low in the evaluation but just as profitable, if not more, than a balanced price during performance.

Under another method, a bidder has more opportunities to "front-load" its bid price since the new rules have eliminated reference to the practice. In such a bid, the contractor will, in effect, receive advanced payment for later contract work resulting in interest free use of money with obvious cost benefits for contract financing. Advanced payments are still illegal but the rules have been liberalized.

NEW DCAA GUIDANCE ON REVIEWING COMPENSATION COSTS

(Editor's Note. Audit guidance on contractor's compensation practices has been extensively revised over the last year and a half. Areas receiving most revisions are how contractors determine appropriate levels of compensation (e.g. internal controls) as well as how to assess the reasonableness of compensation for various categories of employees. The effect of these changes is to expand the scope of compensation reviews at large contractors and initiate various types of reviews at mid-sized and smaller contractors. The "revisions and clarifications" are the most extensive changes we have seen DCAA make in one area and we thought it would be a good idea to inform our readers of some of the important ones since they are more likely than ever to undergo some level of compensation review.

We intend to parse this topic into "adequate controls", senior level compensation (not executive compensation caps discussed in earlier articles) and in this article, how DCAA evaluates compensation levels of non-senior categories of labor. We have used the July 2000 edition of the DCAA Contract Audit Manual (DCAM) and our own experience first working on special compensation teams in our prior lives as DCAA auditors and then as consultants helping contractors challenge government assertions of excess compensation. We intend to insert some of our experiences into these articles. We recognize this series of articles will be of interest to other functional areas of your organization (e.g. human resources, project management, business owners, etc.) so feel free to reproduce and distribute them to people you feel will benefit.)

DCAA indicates the changes were made in response to changes in FAR 31.205-6(b) that now provides for determining reasonableness of compensation costs by job class of employee and FAR 31.205-6(b)(1)(i) that allow for offsets in allowable elements of employees compensation packages (1) within the same job class or (2) at the same job grade or level in different job classes. Job *class,* which in the parlance of compensation are sometimes called job families, include jobs involving work of the same nature but requiring different skill or responsibility levels. For example, a job class could be engineers consisting of junior, intermediate, senior or principle engineers. *Grade* or level refers to a grouping of different jobs by the same value to the firm. So, for example, one grade may include all jobs having no supervisory requirement while other grades will reflect higher levels of supervisory requirements. DCAA indicates the changes were also updated to "reflect current compensation theory and practices."

Once it is determined that a contractor has some internal control deficiencies *(as we will see in future articles, virtually all contractors have some)* but they are not severe enough to "prevent a demonstration of reasonableness" then auditors are told to follow certain assessment steps. Chapter 6-413 of the DCAM addresses reasonableness of compensation costs for non-senior executives. It is designed to determine whether contractors' compensation costs are allowable in accordance with FAR 31.205-6, Compensation for Personal Services.

Labor Management Agreements

Compensation made under an "arms length" negotiated labor management agreement (LMA) is considered reasonable unless some or all of its provisions are "unwarranted or discriminatory" against the government. Conditions of unwarranted or discriminatory provisions of the LMA might include:

1. Under unique circumstances, work conditions may vary significantly from those contemplated by the LMA that are inequitable to the government. For example, if pay rates are based on hazardous employment conditions while the government contracts call for less hazardous conditions.

2. Provisions of an agreement are considered discriminatory against the government when the agreement calls for differing wages under commercial and government contracts for similar work under similar circumstances. For example, an agreement which requires higher pay levels for work on a government contract than for rates applicable to

commercial work under similar circumstances would be discriminatory.

When unwarranted or discriminatory agreements are found the costs will not automatically be disallowed but the contractor will be given the opportunity to justify its costs and explain why the unusual conditions require higher compensation to attract or hold necessary personnel.

If no unwarranted or discriminatory provisions exist, the auditor is to assume all compensation is reasonable and not pursue any other steps discussed below. Also, when wage increases for employees not covered by an LMA are comparable to those for the bargaining unit employees, the auditors are to assume they are reasonable and no further tests are required.

Evaluating Reasonableness of Non-Union Agreement Compensation

FAR 31.205-6(b) requires each allowable element making up an employee's compensation package must be reasonable. The allowable elements commonly include wages and salaries, bonuses, deferred compensation and fringe benefits (e.g. pensions and savings plans, health and life insurance and compensated absences). Each allowable element of the compensation package will be compared with data of other firms as long as they are representative of the labor market for jobs being evaluated. The most likely medium for obtaining compensation data is market pay surveys. When evaluating reasonableness of the elements there should be general conformity with its compensation practices of other firms of the same size, in the same industry, the same geographic area, those engaged in predominately non-government work and the costs of comparable services obtained from outside services. DCAA defines these bases of comparability as follows:

Geographic area. Compares firms in the same locale or regional area.

Size. Refers to number of employees or sales volume.

Industry. Means comparisons with firms producing similar products or providing similar services. Examples of industries cited in the guidance includes shipbuilding, aerospace, electrical/electronics, office equipment and computers or research and development. Contractors' specific industry may be identified by its Standard Industrial Classification (SIC) codes or as of January 1997, its North American Industry Classification System (NAICS). The guidance reminds auditors that compensation survey data often combines several SIC or NAICS codes into groups that are surveyed.

Non-government work. Refers to firms with non-government annual sales of 50 percent.

Comparable services from firms outside of the contractor. Refers to services which are readily provided by outside contracting services (e.g. janitorial services).

DCAA recognizes that different factors may more heavily influence the relevant market. Generally the contractor competes with other firms for similarly skilled employees or the source of supply. So the geographic area may be key but need not be the same for each labor category. For example, non-exempt clerical or production workers may compete in local markets while exempt jobs (administrative, professional and management) may compete on a regional or national level. For salaries and benefits, size of firm may be critical for executive pay but less for other categories.

♦ Common Areas of Contention

Inappropriate benchmarking is the greatest area of dispute between DCAA and contractors. For example, under the geographic area, DCAA may compare national data when contractors believe more regional data needs to be compared or regional data may be examined (e.g. West Coast) by DCAA where contractors feel unique areas need to be examined (e.g. Silicon Valley). Size criteria often becomes quite contentious because there may not be enough distinction by the government of company size where contractors feel surveys are often very imprecise in terms of focusing on relevant size. For example, absence of survey data for smaller firms resulted in auditors inappropriately taking data from one size firm (e.g. smallest firms in the survey were $20 million of revenue) and projecting on a linear curve benchmark data for a different size organization (e.g. $1 million revenue). Under industry criteria disputes arise because most surveys track large industry groups but do not distinguish between significant sub-industry groupings. For example, in the case of non-profit organizations, we have often seen DCAA use a survey tracking "non-profits" that make no distinction between social services and technology transfer organizations that must hire highly skilled high tech veterans.

Using Surveys

As we will discuss in a follow-up article, the auditor will evaluate the validity of survey data the contractor used. If they determine it is not adequate, they can

either use one available to them or if they cannot locate one, cite the contractor for system deficiencies, indicate corrective action is needed and put the burden on the contractor to demonstrate the reasonableness of its compensation by use of an adequate survey. More commonly, the auditor will use surveys DCAA has determined are appropriate. The auditor will make a comparison test with benchmarked jobs within a "pay structure job class" or "grade."

The new guidance specifies comparison tests are to be made by comparing the weighted average wage or salary of either the contractor's job class or grade with that of the acceptable survey. Surveys can be updated to a common data point using appropriate escalation factors. More than one survey may be used. DCAA is instructed to ask the ACO whether the tests are to be made at the job class or job grade level.

Citing the new FAR 31.205-6(b)(1)(i) that now provides greater flexibility to the contractor because reasonableness can be established at either the job class or job grade with offsets within each allowed, the new guidance suggests less audit effort can be expended:

1. Benchmarking effort made by the contractor should be relied on where audit effort should only supplement the contractor's work.

2. Ask the contractor to make a preliminary assessment of any offsets it can make available since more offsets of questioned costs can show compensation costs are reasonable.

3. If a contractor has a majority of commercial or competitively awarded government fixed price work it is presumed its compensation under such contracts provide considerable pressure to be competitive and hence low. This will reduce risk that compensation is high.

♦ Procedures for Determining Reasonableness

A contractor's element of compensation is considered unreasonable if it exceeds the survey data by 10 percent. Each allowable element of compensation is benchmarked within a job class or grade to survey data. The evaluation of a fringe benefit element is made at the total payroll level. When some jobs within a class or grade cannot be benchmarked (e.g. low number of jobs, unique jobs), the non-benchmarked jobs are to be considered unreasonable by the same degree as the benchmarked jobs. All individual elements (wages and salaries, bonuses, etc.) are each subject to tests and considered unreasonable when they exceed 10 percent of survey results. The procedures are illustrated in the exhibit presented below.

♦ Fringe Benefits

FAR 31.205-6(m) states fringe benefits are allowable to the extent they are reasonable, required by law, employer-employee agreement or an established contractor policy. *(Editor's note. It is a good idea to make sure you can justify each fringe benefit element by, at least, one of these criteria.)* Benefits are considered reasonable if the total allowable benefit package rate calculated as a percent of payroll does not exceed the average rate of the compensation survey data by more than 10 percent. Auditors are instructed to evaluate each element during their compensation review only if the average rate is higher than 10 percent. *(Editor's Note. Of course, individual elements may and often are audited as part of other audits such as forward pricing or incurred cost proposals. Findings from these reviews may be incorporated into the compensation review.*) Note the guidance says allowable costs – other sections of FAR 31.205-6 may determine certain fringe benefit costs are unallowable. For example, severance costs (FAR 31.205-6(g), ESOP (31.205-6(j)(8), certain bonuses such as sign-on, relocation, retention bonuses and incentive compensation based on changes in the price of securities (31.205-6(f) may be unallowable.

♦ Grounds for Justification

Interestingly, DCAA recognizes legitimate grounds for having excess compensation. For example, compliance with federal and state laws, employee relations concerns or labor shortages may be legitimate grounds for paying excessive amounts. The contractor needs to provide "sufficient documentation" to establish the basis for the exceptions. When a contractor wants to justify costs determined to be unreasonable the guidance states the conditions in FAR 31.201-3 should be considered, namely:

1. The costs do not exceed what a prudent person in conduct of competitive business would incur.

2. The cost is generally recognized as ordinary and necessary for the conduct of a contractor's business or contract performance.

3. What are generally accepted sound business practices, arm's length bargaining and federal and state regulations.

4. Considerations should be given to the contractor's responsibilities to the government, other customers,

owners of the business, employees and public at large

5. Significant deviations from the contractor's established practices should be considered.

Offsets

Per the new FAR 31.205-6(b)(1)(i), the contractor may present offsets between otherwise allowable employee compensation elements such as wages and salaries, bonuses, deferred compensation and fringe benefits as well as within classes and grades. By using offsets, the contractor can demonstrate its total compensation package is reasonable. Conditions for offsets include:

1. An element of compensation proposed as an offset must be otherwise allowable and quantifiable. For example, deferred compensation introduced as an offset must be based on an allowable deferred compensation plan.

2. Offsets are calculated by comparing the amount by which one element of compensation exceeds 110 percent of the survey weighted average to the amount by which the offsetting element is less than 110 percent of the survey weighted average. For example, employees' unreasonable salary exceeding the survey by 15 percent could be offset by bonuses that exceeded the survey result by 5 percent.

3. Offsets can apply within job classes or within job grades. Under offsets by grade, for example, compensation for any jobs in a grade that exceed the survey by more than 10 percent can be offset by other jobs in the grade if less than 110 percent. For an example of offsets at the class category that illustrates most procedures we have discussed we have included a similar exhibit produced by DCAA (we have simplified some of it):

1. Determining Reasonableness of Salary

	(1)	(2)	(3)	(4)	(5)	(6)
CLASS 4	NO. OF EMPLOY	TOTAL SALARY	AVG SALARY	TOTAL SALARY BENCHMARKED	SURVEY AVG	WEIGHT SALARY	EXTEND SURVEY AVG (1 x 5)
MACHINIST 1	20	500,000	25,000	500,000	21,000	420,000
MACHINIST 2	6	162,000	27,000	162,000	23,000	138,000
MACHINIST 3	10	300,000	30,000	300,000	25,000	250,000
MACHINIST 4	7	231,000	33,000	231,000	28,000	196,000
MACHINIST 5	2	70,000	35,000	NOT BENCHMARKED		
MACHINIST 6	3	114,000	38,000	NOT BENCHMARKED		
TOTAL		1,377,000		1,193,000		1,004,000

Extended Survey Average	1,004,000	
Level of Significance	1.10	Multiply
Survey Level of Significance	1,104,400	
Total Salaries of Benchmarked Jobs	1,193,000	Subtract
Amount Exceeding Level of Significance	88,600	
Total Salaries of Benchmarked Jobs	1,193,000	Divide
Ratio	0.074	
Total Base Salary Dollars	1,377,000	Multiply
Total Base Salary Unreasonable Cost	101,898	
Payroll Taxes = 15% of Base Salary	1.15	Multiply
Total Unreasonable Salary With PR Taxes	117,183	

2. Offsets – Using Fringe Benefit for Offset Purposes

Survey Fringe Benefit Rate	40%	
Level of Significance	1.10	Multiply
Survey Level of Significance	44%	
Contractor Fringe Benefit Rate	41%	Subtract
Amount Under Level of Significance	3%	
Total Base Salary Dollars	1,377,000	Multiply
Total Fringe Benefit Offset	41,310	

3. Calculating Total Unreasonable Compensation

Unreasonable Salary with Payroll Taxes	117,183	
Fringe Benefit Offset	41,310	Subtract
Total Unreasonable Compensation	75,873	

REVERSE AUCTIONS

(Editor's Note. Starting April 2000, many federal agencies have conducted online reverse auctions. A wide variety of products and services have been offered and agencies have been praising the results, quoting up to 30 percent savings under estimated costs. Representatives of Congress, the Department of Defense and other departments are proclaiming support for the auction techniques and position papers are being drafted on how to apply the techniques to more complex products and services. Since it is new there has not been a lot published but we did come across one article in the October 2000 issue of Briefing Papers written by Thomas Burke of the law firm of McKenna & Cuneo. The article defines the process, explores the current regulations governing auctions in the light of how a previously prohibited practice has become not only accepted but praised and suggests a few concerns contractors and agencies that use the new technique need to be aware of.)

Definition

In a "reverse" auction, prospective sellers bid the price down as they compete to provide the products and services sought by the buyer. Typically, a reverse auction held online is hosted or managed by a private company. Offerors submit proposed prices electronically over the internet, often by means of proprietary software and web-based connections provided by a host company. The software and connections permit sellers to see each others' bids "real time" while concealing the offerors' identities.

Regulatory Framework

For many years the Federal Acquisition Regulation prohibited the use of "auction techniques" in negotiated procurements. Prohibited conduct included (1) indicating the cost or price it must meet to obtain further consideration (2) advising offerors of their relative standing to another or (3) otherwise divulging information about another's price. Despite the FAR prohibition, the General Accounting Office ruled in protest decisions there was "nothing inherently illegal" in conducting an auction in negotiated procurements. Over time, there was a softening of the prohibition against auctions and when the GAO did find a violation of the prohibition on auctions it was when such action allowed an offeror to gain an unfair competitive advantage due to disclosing information about another's bid. Outside of protests, the US Court of Appeals held that when a contractor alleged the government engaged in auctioneering techniques in formation of a contract, the FAR violation allowed the contractor to reform the contract. The rationale was that every bidder and potential contractor needs to operate with equal knowledge of its competitor's position.

The GAO and Federal Circuit decisions also indicated the rationale against auctions were (1) auction techniques can place *undue emphasis* on price in relation to other evaluation factors and (2) can *dilute* competition by depriving an offeror with the lowest cost or price of a competitive disadvantage. In addition, the decisions have recognized auctions may, but not always do, undermine the integrity of the competitive bidding process, particularly when a bidder has information about its price standing and others do not. It appears that the concerns against auctions were not so much against the techniques in themselves but a violation of a more fundamental principle – full and open competition. The lesson for federal agencies that may want to use auctions is they may be used as long as the integrity of competitive bidding is maintained.

♦ 1996 Proposed Rule

The first step in permitting auctions occurred in 1996 when the FAR Council issued a proposed rule providing simplified acquisition procedures for commercial item purchases exceeding $5 million. Among other things the new rule, intended to implement the Clinger-Cohen Act providing for a pilot program, would permit the CO to disclose during negotiations a price or other consideration an offeror would have to meet to remain competitive. The proposal would allow COs to use "alternative negotiations" or auctions but it was removed from the final rule following criticisms from attorney groups with a note to study and analyze the auction concept.

♦ FAR Part 15 Rewrite

By September 1997, the FAR Council completed a rewrite of FAR 15 which governs negotiated procurements. One of the stated goals was to create innovative techniques to encourage more dialog between government and contractors. The rewrite removed any mention of auction techniques and instead sought to prohibit revealing other offerors' prices without their permission and thus allowing disclosure of price if an offeror authorizes it. The FAR continued to prohibit conduct that favored one offeror over another or that revealed an offeror's technical solution or other innovations that would compromise its intellectual property rights. Otherwise

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experimentation with auction techniques would be allowed.

The authors recommend that ***contractors***:

1. Understand the ground rules for each online auction and its relative importance in the evaluation scheme.

2. Should immediately request a debriefing from the agency if they do not receive an award to determine the basis for the award and to preserve their ability to bid protest.

3. Need to learn to avoid being "caught up" in the adrenaline of the bidding process by offering prices below cost.

Agencies should:

1. Ensure the solicitation outlines clearly how the auction results will be used in the evaluation scheme.

2. Take all reasonable steps to prevent offerors from obtaining unfair competitive advantage to preserve the integrity of the competitive bidding process. The technology used in online auctions that allow all offerors to see the same information "real-time" should meet this condition, absent technical difficulties.

3. Pay careful attention to the potential of contractors "buying in" or submitting mistaken bids. Agencies need to be wary of contractor "buy-ins" – submitting below cost bids with the expectation of increasing contract amount through excessive change orders or high priced follow-ons. Though protest allegations of buy-ins are rarely sustained, agencies need to take appropriate steps to minimize their effect.

4. Determine how the auction and disclosure of the participants' prices will be treated in relationship to the "Certificate of Independent Price Determination" clause (FAR 52.20302). The clause requires that offerors must certify for buys exceeding $100,000 they have not disclosed their prices to other offerors for purposes of collusive bidding or other anti-competitive purposes.

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