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PRICING CONTRACT MODIFICATIONS
Part I

(*Editor's Note. There are more reasons than ever for contractors to become capable of identifying and quantifying contract modifications or in everyday terms, changes to existing contracts. Severe federal budget constraints, efforts to obtain more for less or need for new arrangements such as consolidating work for some and deleting work for others create a variety of change scenarios that contractors need to be able to identify and quantify to maximize their profitability. We have addressed this issue in the past but more acceptable techniques are now available. We have decided to write a two part article in order to provide some detailed useful information when it comes to preparing a request for equitable adjustment to contract prices or a subsequent claim rather than a mere overview of this important topic. We are using Darrell Oyer's text on Cost Based Pricing and our own experiences helping clients prepare and negotiate requests for equitable price adjustments.*)

Change scenarios may be a result of a unilateral change by the government, agreed to changes by both parties where compensation is negotiated or those where the buyer does not believe there is any entitlement to more money but the seller does, resulting in a constructive change to the contract. The last scenario results in a request for additional compensation called a request for an equitable adjustment (REA) which if not resolved by the parties evolves into a claim.

If the modified work has already been performed then it is similar to pricing cost type work where actual costs will need to be identified. If there is a deletion of work then several pricing issues arise. Other times a constructive change may cause a delay in performing the work where then other cost issues come into play such as idle capacity, unabsorbed overhead and price escalation.

Like any proposal, there are several elements of costs that need to be included in an REA – direct labor, both hours and rates, direct material and subcontracts, other direct costs, applicable indirect costs and profit. We will address issues related to each one of these categories where direct labor and direct materials and subcontracts are discussed here.

Direct Labor Hours

When the contract work has already occurred, then the issue becomes identifying how many additional hours were required because of the modification. However, establishing what the actual hours for the modification is usually involves an estimate since the hours for the modification are usually not segregated. There are many reasons for this – the contractor may not have been aware at the time there was a constructive change, there may have been a reluctance to press for an REA or there was lack of knowledge about what is a changed condition.

Despite the difficulty, a modification usually involves additional work (e.g. larger crews, overtime payment, acquiring different employees with different skills, time to identity the changes). For deleted work under a change, direct labor hours may be reduced but hours also tend to increase because of inefficiencies of remaining labor.

Cost accounting standards (and their duplications in the FAR) need to be considered. CAS 401, requiring consistency in pricing and accounting for labor, require the same labor categories used to price a modification must be used in recording the costs of the modification – if they are different, then a CAS 401 violation can be asserted. CAS 402, which addresses consistency in direct versus indirect costing, requires that a labor category that is normally indirect must not be charged direct under a modification. Under many circumstances such indirect costs are actually direct so the contractor needs to show there were differing circumstances justifying the different treatment.

Supporting documentation is difficult for contractors and often a bone of contention with auditors who audit the REAs. Ideally, time records would provide a record of the extra hours caused by the mod. When possible, a contractor should establish separate project numbers to collect the additional hours and to distinguish it from

the non-modified work. Compliance with these time records are often a major problem where constant monitoring of employee compliance needs to be in place.

Timesheets alone are usually not sufficient documentation. Estimates are usually required based on employees' knowledge of what they were working on when the mod events kicked in. Employees need to be interviewed where memories may be far less than perfect or they may either exaggerate or underestimate hours involved. Signed statements by employees is usually a good idea because if it turns out they were inaccurate or change their mind later the contractor has the statement it relied on for its estimate. In addition, employee memories may be enhanced by employee calendars, notes, log books, emails, etc. Also documents independent of the employee can be helpful such as travel records, visitor logs, meeting minutes, correspondences, activity reports, etc.

When prospective pricing is called for, providing an estimate of hours is best left to technical people who have a sound understanding of the labor needed to produce the product or service. If the item is produced for the first time the technical personnel will rely on drawings or the proposal. If it was produced previously, there is likely considerable data available on how many hours are needed such as estimates on previous contracts if actuals are close to estimated hours.

Be aware that auditors and/or a price analysts like to review history. They may compare actual and estimated hours for previous items. If actual hours are consistently close to estimates the reviewer may conclude the mod's estimates are reliable. If actual hours turn out to be less than budgeted hours for historical items they may conclude there are no damages because actual hours will likely be less than estimates. If actual hours are greater the reviewer may opine the estimates are not reliable and question them. You will need to show that comparisons of actual to budgeted hours are not an accurate measurement of damagers caused by the mod.

Loss of Efficiency. Case law has long provided that contractors are entitled to recover additional costs caused by a government's delay or disruption of costs. Where there is no other comparable work to transfer employees to contractors are entitled to costs which could not be avoided by good management. Sometimes a delay may not completely stop a contractor but can significantly impede its work and reduce efficiencies of its labor. For example, cases or our experience have allowed costs for such activities as interruption of sequencing of jobs, additional rework caused by less efficient labor, changed conditions requiring movement to other facilities, delay caused movement of work into winter, where freezing weather reduces efficiencies. To recover these costs the contractor must prove the government caused the delays and that those government-caused delays impacted other work.

Also, loss of efficiency from government caused delays and interruptions can result in failure to take advantage of the so-called improvement or learning curve benefits. The curve is usually expressed as a savings of labor hours (though dollars can also be used) as production of an item or provision of an activity is increased that usually result in improvements and efficiencies. In its audits of proposals, DCAA auditors are instructed to look for proposed lower hours caused from the learning curve and it has software, accessible by contractors, to compute such learning curve effects.

Also costs of idle labor (as well as idle capacity discussed below) are generally allowable contract mod costs. Fear of expensive firing and rehiring, loosing valuable skills, remote site locations and expensive mobilization efforts are common justifications for not laying off employees and accepting idle labor costs. Care should be taken creating "busy work" for idle labor where some auditors may conclude any work they performed is valid company business and hence not allocable to the modified contract.

Direct Labor Rates

Labor rates can also increase due to such factors as different skills may be required for the modified work or increased need for more workers may cause rates to increase due to local shortages of labor.

If the work has already been performed actual rates should be used. If the mod is for future work, then estimates of the rates will need to be made and justified to auditors. For either actual or estimated work, contractors are allowed to use various composite or average rates computations – for example, average rates within departments, across departments, across labor categories and even standard costs have been accepted for purposes of mod costing as long as proposed wages are reasonably consistent with skill levels needed. Cases have allowed fringe benefits such as payroll taxes, in-

surance, etc. to be included as direct costs provided any "double counting" is avoided (e.g. these costs are removed from overhead that may be added to relevant direct costs). Other miscellaneous labor costs may also be charged to a contract such as job site expenses, supervision and non-productive labor as well as idle labor. Effort to avoid "double counting" needs to be taken where these costs need to be eliminated from relevant overhead and G&A pools. We have seen some auditors insist not only the labor costs being charged to the mod must be removed from the pools but all the same categories of labor costs must be removed and charged directly to other contract work so judgment should be used to decide whether to charge these miscellaneous labor costs directly to a mod.

Labor rate escalation. Delays may require work be performed in later periods than originally anticipated. For estimated work, use of an escalation factor is appropriate. If the company has either a union contract or history of escalation of rates for labor categories being proposed that should provide ample documentation for a selected rate escalation. DCAA uses very expensive surveys which are not practical for most contractors to use. In our experience, escalation rates of 3% or less are generally not challenged by DCAA so either use that rate or if higher, be able to justify it by prior experience.

Direct Materials and Subcontracts

Direct materials includes raw materials, purchased parts and subcontracted items needed to manufacture or assemble a completed product. A direct material cost is the cost of material used to make a product and for mods is directly associated with the change in the product. It should generally be significant enough to justify accounting treatment of the cost. As in the other costs we are discussing, we are addressing either costs that have been incurred which involves examination of books and records or costs that will be incurred where estimates need to be reviewed.

There will likely be either increases or decreases in material costs where many factors should be considered such as: (1) elimination or addition of work that may require more, less or different materials (2) new material requirements may require minimum buys (3) market prices may have changed (4) different quantity will affect unit prices (5) schedule changes may require premium costs (e.g. accelerated delivery) (6) cancellation charges for previous orders (7) increased costs for later purchases result in material price increases and (8) costs of storage for materials that were planned to be used earlier.

For incurred costs, the actual costs of labor, equipment and materials is usually presumed to be reasonable and hence used as the basis for the REA. Estimated costs are a different story. A contractor or subcontractor will support its costs usually by preparing a priced billed of materials which are, in turn, based on quotes from suppliers or charges from inventory. Attrition in the form of scrap, spoilage, rework, pilferage, yields and obsolete materials need to all be considered. Though veteran contractors will likely have methods in place to charge material overhead – transportation, handling, inspection, storage, insurance – newer contractors will need to establish rates to apply to direct material costs to be able to recover these costs.

Finally, prime contractors or upper-tier subcontractors will need to have in place a way to assure their subcontractors' costs are adequately supported. Cost or pricing data will need to be requested and reviewed and a decision to use its in-house resources, government resources (it's questionable whether auditors or other government reps are now responsible) or experienced third party auditors will need to be made.

♦ Intercompany Transfers

FAR 31.205-36 places certain restrictions on the pricing of work performed by other divisions of a company that is under common control. When the item is considered to be a commercial item then it is transferred at a price based on its catalog or market price. That price then should be adjusted for quantities or actual cost of modifications that may be required by the contract change. Sometimes it may be a company practice to establish intercompany transfers at a price that is neither a cost nor commercial selling price but somewhere in between. This transfer price is higher than the manufacturing costs but less than the commercial selling price based on the logic that certain commercial selling costs would not be applicable to a transfer such as credit reviews, financing, bad debt losses, and sales expenses).

(We will address other direct costs, allocations of indirect costs and profit considerations in Part 2 of this article).

ALLOCATION OF SALES & MARKETING COSTS

(*Editor's Note. We have occasionally addressed the allowability of sales and sales commission costs in prior issues of the GCA DIGEST and REPORT but lately we have had two consulting engagements that address the allocation of sales and marketing costs where one includes providing expert testimony to a client's attorney in a government investigation. We have done some research on the issue and thought we would provide a few of our insights to our subscribers since the accounting treatment of sales related costs has become a key area of auditor scrutiny. Though our research was quite extensive we decided here to use the one of our favorite texts, Accounting for Government Contracts, Cost Accounting Standards edited by Lane Anderson as well as Karen Manos's Government Contract Costs & Pricing for the cases referenced.***)***

The accounting profession tends to associate marketing costs with "order getting" activities and selling costs with "order filling" activities. Current government regulations do not distinguish between the two where both types are generally treated as selling costs. Selling and marketing activities are viewed as a bundle of activities where the seller attempts to (1) locate the buyer and identify the buyer's needs (2) promote buyer familiarity with the seller's product (3) persuade the buyer that a need exists for the seller's product (4) complete the sale by delivering the product and by fulfilling the contract and (5) follow up to promote the buyer-seller relations to ensure buyer satisfaction and to obtain further sales.

A common problem occurs not just in defining S&M costs but also distinguishing them from certain other costs. For example, some contractors include the costs of market research and development, direct selling, selling administration and sales promotion as S&M costs. Other contractors expand S&M costs to include business planning, contract administration (e.g. negotiation, pricing), subcontract administration, technical marketing (work done by marketing engineers), program management, spares administration, logistics support, warranty obligations and field services not included in a contract. Other contractors assert that S&M costs should exclude costs arising independently of selling and marketing activities such as contract and subcontract administration, spares administration, logistical support and warranty obligations. There are often spirited debates where, for example, those in favor of separating contract administration argue it is a result of a contract award and not part of making a sale while those in favor of including such costs as S&M argue (a) the same personnel are involved (b) the two activities are difficult to distinguish and often overlap (c) personnel assigned to contract administration often are involved in follow-up sales and field service efforts and (d) S&M costs are higher on commercial work than government but the opposite is true of contract administration for government work so combining the two produces the same result as if they were separate allocations. It should be stated there is no "one right way" to treat these costs where we recommend a written policy and procedure be drafted to identify the activities included as S&M costs. Such a written policy (or disclosure statement for those who choose to complete one) goes a long way to prevent subsequent challenges by auditors where the contractor can show a given accounting treatment is documented in such a policy.

Summary of Allowability Principles

The cost principle at 31.205-38, which has changed eleven times since its inception, states selling activities includes the following five activities: advertising, corporate image enhancement, bid and proposal costs, market planning and direct selling. Advertising is covered in 31.205-1(b) and is subject to allowability limitations provided in 31.205-1(d) and (f). Corporate image enhancement, with the exception of advertising, is included in the definition of public relations covered at FAR 31.205-1(a) where those costs are subject to the allowability limitations at 31.205-1(e) and (f). Bid and proposal costs are defined at 31.205-18 where that cost principle addresses allowability provisions. Long range market planning is addressed at 31.205-12 where all other types of market planning (e.g. research, analysis, general management business development activities) are allowable.

Direct selling is considered to be actions to induce a customer to purchase items where it is characterized by person-to-person contact and includes such activities as familiarizing a potential customer with the contractor's products and services, conditions of sale, service capabilities, negotiating, liaisoning between customer and contractor personnel, technical and consulting activities, individual demonstrations and other activities whose purpose is to show the application of the contractor's product or service to a customer's needs. All of these costs are allowable. However, be aware that is not at all uncommon for auditors to assert such costs are really unallowable public relations or adver-

tising costs. The only potential selling cost that may be unallowable because it is considered to be an improper influence payment are sellers' or agents' commissions or other payments. Such payments are allowable when paid to bona fide employees or an established commercial or selling agency secured by the contractor for purposes of securing business.

Selected Issues on How to Allocate S&M Costs

(*Editor's Note. Most of the rules covering allocation of costs are explicitly addressed in the cost accounting standards. Many CAS provisions are duplicated in the FAR and most auditors consider CAS provisions to be the criteria for proper allocation practices so reference to specific CAS standards below, as a practical matter, applies even to contractors who do not have CAS covered contracts or subcontracts.*)

♦ Identifying S&M Costs With the Business Unit

The CAS Board from its inception stressed the need to group indirect costs into logical and homogeneous pools. CAS 410 and CAS 418 make clear that the appropriate organizational unit for accumulating costs for allocations to contracts is the business unit. So, all S&M costs, no matter where in the company they were incurred, must be accumulated at the business unit level before those costs may be allocated to contracts. The Board also indicated that, in some cases, S&M costs have a similar relationship to final cost objectives as G&A expenses and when this is the case, they may be accumulated and allocated with the G&A expenses of the business unit.

♦ Selecting a Base for Allocating S&M Costs to Final Cost Objectives

Guidance for selecting an allocation base for S&M costs was initially put forth in CAS 403 and was refined to include CAS 410 and 418. Since S&M costs are in many cases similar to G&A expenses, CAS 410 specifies that a contractor should usually use a cost input base similar to G&A.

♦ Allocating Home Office S&M to Segments

Accumulating S&M costs at corporate or group home offices is quite common where the techniques for allocating such home office costs are established by CAS 403 where the flow-down procedures prescribed there apply to these costs.

♦ Allocating Business Unit G&A Expenses to S&M Costs

Some contractors choose not to include S&M costs in the G&A pool but rather to allocate those costs separately, often using a different base such as sales for S&M costs. If S&M costs are allocated separately from G&A costs the question arises whether G&A expenses should be allocated to S&M costs. CAS 410 states G&A expenses must be allocated to only final cost objectives (products, services, contracts). Since S&M effort does not constitute a FCO no G&A expenses are allocated to them. However, if they are not part of the G&A pool S&M costs must be included in the total cost input base of G&A.

♦ Allocating S&M Costs to Work Done by One Segment for Another

Allocating S&M costs to work done by one segment for another involves two issues. First, should work done by one segment for another during a cost accounting period receive an allocation of that period's S&M costs and second, should the costs of S&M activities performed by one segment on behalf of another be charged to the benefiting segment? For the first case, CAS states that S&M costs, whether they are pooled with G&A costs or are pooled separately, should not be allocated to work performed by one segment for another unless the work constitutes a FCO of the performing segment. Under the second situation, CAS 410 suggests that costs of activities performed specifically for and at the direction of another segment – the benefitting segment could do the work on its own but has requested the other segment provide a service to it – should be removed from the cost pool and charged to the benefitting segment.

♦ Current Expensing or Deferral of S&M Costs

In accounting circles it is recognized that S&M costs are initially incurred at a time of uncertainty because the hoped for business may or may not be obtained and the time between cost incurrence and realization of the potential benefits can be substantial. Also, it is a well known fact that the majority of S&M efforts are unsuccessful. This uncertainty raises the questions of how should the S&M costs be related to benefits of successful effort and

how should they be allocated to unsuccessful effort. Many accountants have argued that if successful effort results in a contract award that effort should be accumulated and allocated to that contract award while for unsuccessful effort the S&M costs have no definitive award to charge and therefore should be considered a period cost. The CAS Board resolved this question by requiring contractors to allocate all costs, including S&M costs, to the cost objectives in the current cost accounting period. In addition, the Board emphasized that the allocation base used to allocate costs to FCOs must not include costs of earlier or later cost accounting periods.

Case Law Interpretation

The allocability of selling costs, which of course determines its allowability, has been a source of dispute. Despite repeated challenges by government auditors that continue to this day, the cases have been fairly consistent in holding that all allowable selling costs may properly be included in contractors' G&A pool and allocated to government contracts.

Federal Electric Corp. (ASBCA No. 11324) allows for allocation of "field marketing" costs through the company's overhead rate. In *Blue Cross & Blue Shield (ASBCA No. 41255*) the board ruled that sales commissions paid to sales reps with the Federal Employees Health Benefit Program were allocable to government contracts because the commissions were necessary for the overall operation of its business and thus there was a "reasonable benefit to the government."

In *Daedalus Enterprises Inc. (ASBCA No. 43602*) the board held the costs of foreign sales commissions were allocable through the contractor's G&A pool to an Army contract rejecting the government argument the costs should have been charged directly to the foreign contracts. In *Aydin (BCA 26899*) the board held that inclusion of a large foreign sales commission in the G&A pool violated CAS 410 because the government contract at issue received significantly less benefit from the foreign sales commission than the foreign contract received. Aydin argued that treating the foreign sales commission differently than its other sales commissions violated CAS 402, which requires consistent treatment of like costs. The Federal Circuit (F.3d at 1579) reversed the Board's decision and sided with Aydin stating though the government may order prospective changes in a contractor's cost accounting practices if there are inequitable results it cannot order such a change if it forces the contractor to violate CAS 402.

United States v Vector Corp (No. C93-0045) raises some interesting issues. The government alleged that the subcontractor (1) falsely characterized sales commissions paid to another company as "engineering consulting services" and (2) violated its established accounting practices by charging normally indirect sales commission costs directly to a sole source contract. The court ruled against the government's contention the "sales commissions" were unallowable costs quoting FAR 31.205-38 that provides sales commissions are allowable if reasonable where reasonableness depends on such considerations as are they ordinary and necessary expenses of conducting the contractor's business, are they a generally acceptable business practice and are they significant deviations of the contractor's established practice. The court also ruled against the government contention that direct charging of the costs were inconsistent with the contractor's practice of charging commissions indirectly in its general ledger. Relying on accounting experts the court ruled the accounting practice of charging commissions as indirect costs in its general ledger is not inconsistent with classifying the commissions as direct costs in a contract proposal unless it results in double counting where here, Vector clearly subtracted the commission costs from its G&A pool in calculating its G&A rate.

In *Garrett Corp. (ASBCA No. 13024*) the board ruled that reimbursement to a contractor that entered into a sales agreement with its wholly-owned subsidiary is entitled to only the *costs* incurred by the subsidiary, not the *fixed price* reflected in the representation agreement. The board alluded to what is now FAR 31.205-36 and FAR 31.204(c) which limits the reimbursement of material and supplies produced by a subsidiary to the basis of costs incurred unless certain circumstances are met (e.g. the items supplied are considered commercial items) which was not the case here.

In *General Dynamics v. US (202 Ct Cl. 347*) the appeals board ruled that costs incurred in developing a prototype aircraft to demonstrate short take-off and landing concepts were independent research and develop costs and not sales commission costs. In addition the court held that if the demonstrator aircraft was considered to be "media" for sales promotion purposes, its costs would be unallowable under the cost principle for advertising and public relations.

WHEN DOES AN OFFERED PRODUCT OR SERVICE QUALIFY AS A COMMERCIAL ITEM

(*Editor's Note. In a recent article we wrote about pricing considerations for commercial items which generated a great deal of inquiries from clients and subscribers on clarifying what are the rules for eligibility of characterizing an offered product or service as "commercial" and what does the contractor need to do to justify using this powerful pricing tool. Offering the government commercial item pricing has become a hot topic where several clients and subscribers are asking about opportunities to charge their products and services at commercial prices rather than prices based on cost build up estimates. We also thought it would be a good idea to revisit this area since today, more than ever, there is increased resistance by the government to allow qualifying items as commercial. Commercial item opportunities can exist for the entire products and services offered to the government, some elements offered even when the entire item does not qualify such as certain supplier offerings or even intracompany transfers from other segments. The source of this article is a recent seminar we participated in offered by Public Contracts Institute and presented by Jason Workmaster and Phillipp Seckman of McKenna & Long as well as our own experience helping clients qualify their products and services as commercial items.)*

Designating an item as commercial has significant appeal to both the government and contractors. From the buyer's perspective, it allows for streamlined procedures (FAR 12.6), minimizes administrative costs and limits the need to obtain certified cost or pricing data. From the seller's perspective it means the contract is not subject to CAS, Truth in Negotiations Act (e.g. defective pricing allegations) or business systems rules, allows commercial firms that would normally not be able to participate in the procurement process to do so and perhaps most significantly, to realize higher prices than a cost build-up approach would allow.

The seminar presenters start out with a decision chart and then fill in the important elements during most of the presentation. The first step of making a commercial item determination (CID), whether supplies or services are offered, is to see whether there was a prior determination of commerciality. If the determination was yes and there are no clear reasons to the contrary then the CID would be yes. If the answer is no then the second step involves a series of questions.

For supplies a "yes" means it is a CI:

Step 1. Is the item commonly used by the general public or is it "of a type" that is commonly used by the general public?

Step 2. Has the item been sold, leased or licensed or been offered for sale to the general public?

Step 3. Is the item an evolution from a Step 1 item but is not yet available in the commercial marketplace but will be to satisfy the government's needs?

Step 4. Is the item one that would meet conditions in Steps 1, 2 and 3 except it is undergoing modifications that are commonly available in the commercial marketplace or are minor mods needed to meet government needs?

For Services:

A CID would apply if the services are in support of one of items in Steps 1-4 above, such as installation, maintenance, training or are providers of the same work for the general public under similar terms and conditions.

In addition, any combination of the items in Steps 1-4 and qualifying service, if it is of a type commonly combined and sold to the general public, is a CI.

Finally, there is a key documentation step that must reflect your analysis of Steps 1-4 or a qualifying services assessment that would be contained in the prime or subcontract files.

The following discussion elaborates these concepts.

1. For a supply item or services, the term "offered for sale, lease or license" does not mean it must have been sold. Rather if market research (discussed below) indicates it is a CI then that is acceptable because it is presumed that commercial forces establish a price that is fair and reasonable.

2. A CID applies if "any service 'of a type' offered and sold competitively based on catalog or market prices for specific tasks performed or specific outcomes to be achieved and under standard terms and conditions." The term "catalog price" means a published price reflecting recent prices for sales to the public." Think Sears Catalog for the pure catalog while market prices means current or recent actual sales prices that the government

can use to verify the price is fair and reasonable.

3. The phrase "of a type" was intended to broaden the CI definition. It means an item need not be identical to the one being offered in the commercial marketplace to qualify as a CI. As discussed below, there has recently been considerable "pushback" to "of a type" grounds for establishing the commerciality of an item in response to perceived abuses of allowing an excess number of items to be classified as CI. The "of a type" item can be either one sold by your firm or offered by another firm. You can expect greater audit scrutiny of an item claimed to be "of a type" of item offered by another firm than one offered by your firm.

4. There is a hierarchy of justification for a CID determination. The closest to a pure CI is a catalog price. It should be noted the purest form of catalog is one provided to the public (again, think Sears Catalog) as opposed to say, an internally used price list. The next closest thing to a pure CI is a commercial off the shelf (COTS) item. COTS items are commodities, say a No. 2 pencil, which are sold in substantial quantities to the public and are not subject to any modifications. The farther an item or service is from this catalog or COTS item the more audit scrutiny can be expected and the tighter the documentation needs to be.

5. The definition of CI at FAR 2.101 also references commercial nondevelopmental items. The government wants to offer the advantages of CID to items that are not sold to the general public but rather sold exclusively to the government. A nondevelopmental item is any previously developed item used exclusively for government purposes by a federal agency, a state or local government or a foreign government in which the US has a mutual defense cooperation agreement. A nondevelopmental items may also include minor modifications of a type customarily available in the commercial marketplace in order to meet the requirements of the procuring agency. Such nondevelopmental items can be considered CIs if two conditions are met: (1) it was developed exclusively at private expense and (2) is sold in substantial quantities on a competitive basis to State, local or certain foreign governments. When we asked the presenters whether "exclusively at private expense" can include IR&D or other costs included in an indirect cost rate and allocated to government contracts the presenters answered in the affirmative.

A question arose during the presentation about whether subcontract items that are sold to prime contractors which are then ultimately charged to the government can be considered sales to the general public and hence a CI. The presenters said this is really a gray area which is being litigated now.

7. Documentation from the Buyer's Perspective. A CI is considered desirable because the presumption is that a commercial marketplace drives competitive prices down. In addition to increased resistance to CIDs, the biggest change we have seen is the emphasis on proper documentation by both the buyer and seller. From the buyer's perspective, a proper CID is based on market research which is considered to be the primary means of determining the availability or suitability of CIs and hence whether a price is fair and responsible. Market research is usually conducted before developing new specs and before soliciting bids or proposals. The extent of market research depends on the urgency of the procurement (e.g. less if more urgent), estimated dollar value, complexity of the item and past experience in procuring it. Market research topics include what are the sources, is the acquired item a supply or service and what are industry practices and trends. Market research techniques include contacting knowledgeable individuals regarding market capabilities, reviewing results or recent market research reports, publishing requests for information, internet research, gathering market pricing information, reviewing industry catalogs and product literature and attending trade shows.

8. Increased pushback and increased audit scrutiny. DCAA issued guidance in Sep. 29, 2011 requiring its auditors to assess prime contractor CIDs and their price and cost analyses. They are also cautioned not to place "excessive reliance" on prior CIDs. The presenters say contractors should be cognizant of other guidance in DFARS 244.402, FAR 15.404-3 and DFARS PGI 215.404-1 that address prime contractors' responsibilities to document their subcontractors' CIDs and for the contracting officer to assess the prime contractor's assessment. Failure for the prime contractor to properly document the CID can result in the entire subcontract amount being questioned as unsupported. The presenters state that auditors and other government representatives will scrutinize CIDs more closely the farther they are from catalog pricing or COTS justification. That is, the more CIDs rely on "of a type", offered for sale as opposed to actual sales in some quantifies or that in-

volve modifications the more scrutiny of the CIDs can be expected.

One of the strongest indications of current resistance to commercial item pricing is a recent DOD proposal to change the commercial item definition to (i) remove the "of a type" designation and (ii) add the requirement that goods and service be actually sold in "like quantities" to those being acquired. This proposal was rejected but there are several groups that are opposed to "of a type" so we can expect the issue to be raised again.

9. Documentation from the seller's perspective. In this era of pushback for CIDs, contractors should be aware that the farther a claim for a CI is from a pure catalog or COTS, the more persuasive its documentation should be. The presenters suggest and we concur that contractors should do some market research themselves to show their items qualify for a CID. Though not discussed in the seminar, we find that inclusion on GSA schedules are also strong evidence of commerciality so contractors anticipating significant use of CIs should seek to be included on GSA schedules. Contractors are well advised to put together a package to help the buyer feel more comfortable in the CID. In addition, commercial items offers must show (a) a technical description of the items being offered in sufficient detail to evaluate compliance with the requirements of the solicitation (b) terms of any express warranty (c) price and any discount terms (d) a copy of the representations and certifications found at FAR 52.212-3 and (5) past performance information when it is included as an evaluation factor.

10. Implications of misclassified CI claims. Being attorneys the presenters would be expected to identify potential "bad news." Contractors are particularly vulnerable to the False Claims Act where a suit can be brought by the government or a "qui tam relator." The FCA imposes liability on knowingly false invoices where treble damages can be imposed plus civil penalties. The relevant elements of a cause of action is (a) a claim (e.g. invoice) (b) falsity (said the item was a CI and it is not) (c) knowledge the claim was false – here intent is not required but "reckless disregard" or "deliberate ignorance" is enough and (d) materiality. The presenters state the best defense for FCA assertions is to document well the CID.

11. Summary of FAR Part 12. This section of the FAR prescribes the policies and procedures that are unique to the acquisition of CIs as defined in FAR 2.101. FAR Part 12 seeks to implement the federal government's preference for acquiring CIs that are contained in Title VIII of the Federal Acquisition Streamlining Act of 1994. It requires agencies to (a) conduct market research to determine whether CIs are available to meet agency needs (b) acquire commercial items when they are available and (c) requires contractors to incorporate, to the maximum extent practicable, CIs as components of items. As is common with rules that have been in place for a while, the requirements for CIDs expanded from 17 in the 1990's to 50 now. In addition there were approval requirements added in March 2012 (Fed. Reg. 14480) that requires higher level approval for CIs for purchases >$1 million one level above the CO and when CID is based on "of a type" or "offered for sale." This approval is not required for acquisitions to facilitate defense of recovery from nuclear, biological, chemical or radiological attack.

BASICS OF STATISTICAL SAMPLING

(*Editor's Note. DCAA's use of statistical sampling has moved from a little noticed aspect of their audits to the forefront. Whether it be recent cases on executive compensation challenging DCAA's use of statistical sampling, increased use of the technique in place of "judgmental sampling" to better conform to auditing standards and significant increases in questioned costs either using the technique or projecting from a sample to the universe of costs contractors need to understand DCAA's use of the method and have a basis to challenge their inevitable imperfect application of the technique. DCAA's recent expanded use of statistical sampling has resulted in significant changes to guidelines it expects its auditors to follow as well as extensive changes to the DCAA Contract Audit Manual (DCAM). We thought it would be a sound idea to present a good practical article with minimal technical jargon on DCAA's revised use of this powerful tool. Our source is primarily a recent article in Government Contract Pricing & Accounting Reports written by Nicole Owren-Wiest of Wiley Rein and Bill Walter and Mark Burroughs of Dixon Hughes Goodman as well as our experience as former DCAA auditors who have gone through DCAA training seminars.)*

Statistical sampling is a powerful tool to collect and evaluate information about a large population – a universe – when it is impractical to collect data and information for it. When conducted properly it allows reasonable, objective inferences to be made about the uni-

verse from information gathered about the sample. DCAA will typically select "high risk" accounts, ask for data showing all transactions in each account, select a sample of transactions to audit and based on the results of that sample project the findings to all transactions in that account. DCAA will also attempt to ascertain whether a contractor has adequate practices in place by selecting a universe of transactions, say timecards, to determine if its labor charging practices are acceptable, and then will select a sample of timecards to examine, determine whether they were completed adequately and project the results of that sample audit to the entire universe of timecards to ascertain whether its time keeping or labor charging practices are adequate.

JF Taylor Case

In this case, which we have reported on extensively, the Appeals Board rejected the government's disallowance of certain claimed executive compensation costs that relied on DCAA's statistical sampling methodology and ruled it was "fatally flawed statistically and therefore unreasonable." DCAA's methodology relies on use of compensation surveys which are statistical samples, to obtain information about the amount of compensation paid by comparable firms and compares the result with that of the contractor's executive officials to determine if its compensation is reasonable. Though the government admits the surveys are "variable and thus imprecise" the board found DCAA does not perform any statistical analysis of the sample data it uses. The statistical flaws the board cited was DCAA ignores the actual dispersion of data among the surveys which is supposed to be a measure of how close the data is to each other and therefore how precise the prediction of reasonable compensation is as a result of using the sample data. Instead, DCAA uses an arbitrary 10-percent "range of reasonableness" factor in each and every case to account for the variability inherent in the survey data as opposed to the actual dispersion of data which can and does often far exceed the 10 percent amount. JF Taylor was able to show that its compensation was reasonable using the same surveys DCAA used but adjusting for the statistical errors and other flaws in its approach. (Despite the case findings, DCAA continues to use its same approach and in fact has expanded its use to all executives and now even categories of direct labor.)

DCAA's Use of Sampling Techniques in Other Areas

The authors note that DCAA's use of surveys are not limited to compensation evaluations. For example surveys are used to evaluate reasonableness of air fare where the "average" is used to determine reasonable air fare where there is likely a guarantee that half of the flight costs – anything above average – will be questioned as excessive without taking into account the data dispersion. Given the large disparity in airfare price depending on many factors such as when the ticket is purchased there will be grounds for challenging many questioned costs in this area. We are also increasingly seeing similar approaches and surveys being used to evaluate various fringe benefits payments where we anticipate similar problems in the future.

As a result of critical DODIG findings DCAA issued revised audit guidance for statistical sampling and non-statistical sampling which are reflected in DCAM Chapter 4 and appendix B which made extensive revisions to DCAA policies on variable and attribute sampling including changes related to sample size, evaluating sample results and reporting them in audit reports.

Variable Sampling

Variable sampling is used by DCAA and most other auditors which is a method to estimate total value for an entire population. The revised DCAM states variable sampling can be widely applied in auditing proposals, incurred costs, progress payments, forward pricing rates and defective prices where examples of universes evaluated might be accounts, vouchers or bills of material from which a sample is drawn. When using variable sampling to estimate total questioned costs the sample evaluation results are usually expressed as a "point estimate" of unallowable costs in the sample universe. DCAA then uses the point estimate to project any findings from the sample to the broader universe. DCAA stresses that the only time that monetary projections are to be made is when statistical sampling is used. The point estimate is used because DCAA considers it to be the right balance between overstating and understanding the true amount. When describing the statistical reliability of a sample finding DCAA guidance states the amount estimated by a sample will fall within a specified range (or confidence interval) which is usually defined as the point estimate plus or minus the precision amount. Precision is a term that refers to the accuracy of the point estimate by show-

ing for a specified confidence level, how much the point estimate may vary from the true universe amount. The confidence level represents how confident one is that the result will capture the true population amount. For example, a 90 percent confidence level indicates that with repeated sampling under the same sampling plan, 90 times out of 100 the actual universe amount is expected to be within the interval computed from the results. Each number within the confidence interval is statistically as valid as any other including the number at the low end. Whereas DCAA used to instruct its auditors to use the low number when projecting questioned costs it now states auditors should use the higher number. (*DCAA maintains a proprietary software, available to the public through its website, where it inputs certain variables like size of universe, confidence and precision levels and puts out such information as number of transactions to select, random number generator to choose which transactions to review and projection of results from the sample to the universe.*)

The basic assumption is that any dollar in the sample is representative of all the dollars in the universe. In lay terms, if $20 in a sample are questioned then the auditor will assume a similar proportion of unallowable dollars are found in the universe. So the auditor will extrapolate that $20 to the universe which can result in thousands of dollars of questioned costs in the universe plus interest and penalties. As a result it is important for contractors to understand when statistical sampling is being used and how the sample will be used. Care should be taken to provide adequate documentation on the sampled transactions selected to minimize the questioned costs.

Attribute Sampling

The other form of sampling used by DCAA is attribute sampling where the sampling units are measured or evaluated on whether they have the attribute being measured where some statistics are computed to then project the results onto the universe. There are two approaches under attribute sampling – acceptance or estimating sampling. With acceptance sampling the goal is to either accept or reject the universe while for estimating the goal is to estimate the actual error rate of the universe. DCAA typically uses attribute sampling when evaluating a contractor's internal controls and explains that it is performed when there are only two possible outcomes – the item either is or is not in compliance with the "control" such as law, regulation or procedure being tested. It is based on the assumption that perfection is seldom achieved so some level of noncompliance can be tolerated - attribute sampling is designed to determine whether compliance is within tolerable levels. The tolerable levels of compliance – the so-called error rate – is required to be specified in advance.

Care should be taken to determine what documentation would best match what the auditor is looking for and ways the auditor may misinterpret what is given to him. The authors provide an example of where it was attempting to ascertain whether a contractor had adequate internal controls over business ethics and compliance program by selecting a sample of training records. It found that certain employees selected in the sample did not have any training records resulting in attribute "failures" that exceeded the tolerable levels and hence a significant deficiency existed. Further investigation showed the failed employees were either on short term family leave or temporary leave where they took the training when they returned but based on the attribute sample the compliance program was deemed unacceptable. Another example showed that though a contractor thought it was being audited for incurred costs and focused on providing financial documents such as invoices it found out later the auditor was conducting an attribute sample of whether purchases had adequate authorizations which would have been demonstrated if it provided non-financial documents.

Audit Sampling Plan and Report Requirements

In addition to DCAM Chapter 4 and appendix B the agency has put out additional audit guidance on planning, performing and evaluating audit samples. Auditors are told to have an understanding of the controls or account being testing. DCAM advices that some non-statistical analysis may be needed to understand the transactions or process flow, controls applied and types of supporting documentation that is available. With this information in hand they are then told to develop a written sampling plan which must include:

1. Audit and sampling objectives.

2. Describe the audit universe, sampling universe and sampling unit.

3. Describe the sample frame. This is the physical or electronic representation of the sampling units from which the sample is selected such as the electronic file of the contractor's general ledger that contains all the transactions for the account.

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4. State the sampling technique to be used.

5. For attribute sampling, establish the desired sampling parameters. The plan should state the minimum acceptable level at which the auditor is willing to express an opinion. For estimating sampling, the sampling reliability parameters will be the desired precision and confidence range while for acceptance sampling, the parameters include the critical error rate, government risk, false-alarm error and false-alarm risk.

6. Determine sample size consistent with audit objective and audit risk. The DCAM provides a sample-size table based on a 90-percent confidence level that is required to be used to select sample size.

7. Describe the sample selection method. The plan must document how the sample items were selected e.g. random selection. If stratification is used, it must be described.

8. Describe how the sample result will be evaluated. This describes, by name, the specific software to be used such as DCAA E-Z Quant application.

As for the workpapers and audit report the auditor must "thoroughly document" justification for determining whether the sample result is acceptable to project to the sampling universe. The audit report must state whether nonstatistical or statistical sampling were the basis of the auditor's conclusions where it must state details of the sample universe, the sampling method and the sampling unit. Contractors should be on the alert to auditors who may not have sufficient statistical experience and should not be hesitant to elevate concerns within DCAA.

How to Mitigate Auditing Sampling Risks

The authors suggest obtaining a meeting of the minds in certain critical areas:

1. Accounts to be tested. The guidance states the sampling universe should consist of costs that are essentially alike ("homogeneous").

2. Risk assessment. It is a good idea to discuss with the auditor their risk assessment associated with the audit or a specific account to be tested. An auditor may assess risk as high which generates a larger sample size where discussion with the contractor could provide information showing the risk should be low (e.g. previous audit results).

3. Appropriate audit support. Hold auditors to recent "Rules of Engagement" requiring greater communication throughout the audit.

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