GCA DIGEST

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NEW DCAA GUIDANCE ON REVIEWING SENIOR EXECUTIVE COMPENSATION

(Editor's Note. Audit guidance on contractors' 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", how DCAA evaluates compensation levels of non-senior categories of labor (last issue) and senior executives in this article. We have used Chapter 6-414 in 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 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.)

The guidance on reviewing senior executive compensation for reasonableness should not be confused with applying senior executive compensation ceilings set by the government since 1995 and revised each year (*see our three part series on executive compensation ceilings in the GCA DIGEST Vol. 1, Nos. 2-4*). The new guidance emphasizes that though the compensation may not exceed the FAR and DFARS caps on senior managers, the compensation levels for certain "high risk" employees may still exceed what is considered reasonable for companies of similar size. These two quite distinct sets of criteria derive from the fact that the senior executive ceilings are derived from salaries of publicly traded companies with at least $50 million in sales and are intended to be the highest allowable rates for larger companies. The government has decided that reasonable compensation at smaller companies should be lower and auditors have adopted the guidance discussed below for these companies. There is no guidelines on which criteria should be applied to what size companies but we have seen a significant increase in review of "high risk" employees using the guidance discussed below.

What are High Risk Employees?

There is significant new guidance covering employees who have a "higher risk of unreasonable compensation." Following FAR 31.205-6(b)(2) that provides special consideration of compensation for certain employees, DCAA has prepared guidance that applies to these "higher risk" employees. In general, employees who can exercise influence over their level of compensation are considered high risk and include owners, partners or individuals having a substantial financial interest in the company and their family members as well as executives, officers and board members of companies who are not necessarily owners. Though there are no hard and fast rules determining what represents influence, the guidance alludes to the SEC threshold of 10 percent or more of voting stock representing the ability to exercise influence.

Review for Unreasonable Compensation

Recent guidance calls for compensation reviews of high risk individuals during incurred cost audits if no compensation system review audits are conducted. Under detailed compensation reviews internal controls are evaluated to assure compensation is reasonable. When these internal controls are deemed adequate (discussed in more detail in a future article) the scope of review of non-high risk employees are often reduced. Since high risk individuals are often not subject to contractors' normal internal controls recent guidance indicates such lessened scope should not apply to them.

Auditors are also told to review compensation of high risk employees who do not necessarily hold high level titles. A president's son may be an engineer or a partner may be one of several scientists working in research. Auditors are told not to accept their compensation as reasonable without checking to see whether the high risk individuals have equal duties and compensation as the other members of the same class for they may be overgraded considering the work they do or simply paid more than others doing the same work.

Unless the company is large, executive positions within a company are usually unique. Whereas larger companies may have a class of employees performing at, say, a vice president level, most executives in other companies are not part of a class of employees and hence their compensation must be evaluated on an individual basis. Auditors are told to evaluate these positions with comparable ranks, function and responsibility in other firms of similar sizes.

Auditors will also determine whether compensation is reasonable for the personal services rendered. A distribution of profits, as opposed to compensation, is considered unallowable and we have long cautioned our clients to avoid an appearance of the former. We were glad to see the DCAM add a note that payments made to owners where the accounting records indicate a distribution of profits are not automatically unallowable. The guidance notes that some smaller firms, including sole proprietorships and partnerships, regularly compensate owners through distribution of profits and these amounts are to be questioned only if the total compensation paid to the individuals exceeds an amount reasonable for the services performed.

New guidance addresses amounts of compensation considered deductible by the Internal Revenue Service which states just because the IRS does not challenge an executive or owner's compensation does not, in itself, indicate the amount claimed is reasonable for government contracting purposes. Different perspectives between IRS deductions and allowability for government costing purposes are that (1) the IRS rules, that covers compensation for like services by enterprises under like circumstances, consider those payments existing at the date of agreement while for government cost purposes expenses of services are considered those on the date when the amount is questioned and (2) excess compensation received by shareholders is considered by the IRS to be a constructive dividend based on distribution of earnings upon stock owned that could be deductible for tax purposes but not considered allowable for government costing purposes.

♦ Audit Steps

The new guidance adopts the results of a recent case – *The Techplan ASBCA 41470* – that cites the steps to take to evaluate the reasonableness of executive compensation. The Board set forth how compensation experts should market price executive compensation and should follow those procedures when practical. The process DCAA says the case puts forth is:

1. Determine the position to be evaluated.
2. Identify survey(s) of compensation for the position to be evaluated which match the company in terms of revenues, industry, geographic location and/or other relevant factors.
3. Update the surveys to a common data point for each year using escalation factors
4. Array the data from the surveys for relevant compensation elements at various levels of compensation such as the average (mean) or selected percentiles and develop a composite number for each. Use of other percentiles is necessary only if the contractor's performance is measurably above or below average.
5. Determine which of the numbers to use for comparative purposes. In most cases average or median data should be utilized as an initial position. DCAA uses a 50 percentile.
6. Apply a range of reasonableness such as 10 percent to the number or numbers selected. It is DCAA's policy to use a 10 percent range of reasonableness.
7. Adjust the actual total cash compensation for lower than normal fringe benefits (*see our last issue for an example of how to calculate offsets for fringe benefits*).
8. Compare the adjusted compensation to the range of reasonableness and question the difference.

♦ Adjusting Percentiles

The guidance states that some contractors will propose that their executives should receive more compensation than the 110 percent of average compensation paid by comparable firms. These above average proposals are often expressed as using different percentiles such as 75 percentile. The

guidance indicates such a proposal for an executive's salary may be justified when there is clearly superior performance documented by financial performance that significantly exceeds the particular industry average. The guidance incorporates another ASBCA case, *Information Systems & Networks Corp., ASBCA 47849*, which established the 75 percentile was justified by performance using certain financial metrics. Examples cited in the case included:

- Revenue Growth
- Net Income
- Return on Equity
- Return of Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share.

The superior performance measure by the chosen metric(s) should be a result of the executive's efforts being evaluated. Auditors are told to consider multiple metrics so, for example, revenue growth due to acquisition while operations were conducted at a loss should not be considered superior performance. Also, use of the metric should be applied consistently over a period of years so when the performance level decreases or increases the corresponding level of what is reasonable compensation will also change.

Auditors are told to be particularly sensitive to payments for termination and subsequent consulting agreements. A senior executive should not claim compensation for voluntarily terminating themselves. Severance payments apply only to involuntary terminations. When the executive receives payments for consulting services the auditor is told to examine the termination agreement and ensure the consulting payments are commensurate with services expected from the retiree and do not represent unallowable compensation payments.

The new guidance also incorporates recent DFARS 231.205-6(f)(1) changes covering bonuses or other payments in excess of the employee's normal salary that are part of restructuring costs associated with a business combination. The auditor is reminded this limitation does not apply to severance and early retirement incentive payments where the FAR provides these are allowable costs. *(Editor's Note. In future articles, we intend to discuss some of our experiences challenging government assertions of excess compensation.)*

CHANGING FROM A TOTAL COST TO VALUE-ADDED G&A BASE

(Editor's Note. From time to time contractors may want to change their method of allocating indirect costs. Reasons can vary widely but they often involve a conclusion of greater recovery of costs on certain contracts using the new method. In this article, we will address changing the method of allocating general and administrative (G&A) costs from a total cost input base to a value added base. Continuing our practice of illustrating a cost allowability or allocation issue using a real life situation, we will address the change from the perspective of challenging the Defense Contract Audit Agency's rejection of a proposed change that was prepared by Len Birnbaum of Leonard Birnbaum & Company, LLP in defense of his client. Len 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.)

Background

In early 1997 Len conducted a thorough review of his client's accounting policies and procedures and provided a position paper recommending Contractor (we will use "Contractor" in place of the actual firm) revise its G&A rate calculation using the value-added method rather than the total cost input (TCI) method. Contractor incorporated the new method in its 1997 forward pricing rates and continued to do so for the next four years. In its proposed forward pricing rates for 2000 the new method was continued.

In its draft audit report of their forward pricing proposal for 2000, DCAA rejected Contractor's change from a TCI to a value added base (total costs excluding material and subcontract expenses) to allocate general and administrative costs. DCAA's position was the "abrupt" change would (1) "adversely impact the allocation of G&A expense to existing cost reimbursable contracts" and (2) "would produce excessive hidden profits on existing commercial and government fixed price contracts." Acknowledging that FAR 31.203 (Contractor was not covered by the cost accounting standards) does not specifically require a total cost allocation base be used to allocate G&A expenses, DCAA cites FAR 31.203(c) in defense of its position stating "once an allocation base has been accepted it shall not be fragmented by removing individual elements."

Contractor asked Leonard Birnbaum & Co., LLP to prepare a response to DCAA that would be incorporated in the "Contractor's Reaction" section of the report.

Response

♦ Distortion of Allocating G&A Expense

In its response, Len summarized his early 1997 position paper, asserting the value-added cost base is appropriate when inclusion of material and subcontractor costs would significantly distort the allocation of the G&A expense pool in relation to benefits received. The breakdown of direct labor and direct materials/subcontractors was:

	R&D Contracts	%	Manufacturing	%	Total	%
Materials	$300,000	25	$17,000,000	74	$17,300,000	72
Direct Labor	900,000	75	6,000,000	26	6,900,000	28
	1,200,000	100	23,000,000	100	24,200,000	100

Based on the above, the use of the total cost input method for allocating G&A expense would result in a gross distortion of such expense. First, 72% of the G&A type expense, based on the combined value of direct material/subcontractors and direct labor would be allocated to material and subcontractor costs which would not produce realistic results. The unrealistic results stem from the nature of G&A expenses which is closely associated with managing personnel and manufacturing operations as well as research and development rather than materials and subcontractors. Second, if each dollar of material is considered equivalent to each dollar of labor this would also result in a gross distortion in the allocation of G&A type expenses between the R&D contracts and manufacturing operations.

♦ Fragmenting the Base

As to DCAA's assertion the change will "fragment the base" a change in the method of allocation is not the same as "fragmentation." As FAR 31.208(c) suggests, fragmentation refers to the elimination of a portion of the cost input base (e.g. unallowable costs that are normally part of the base should remain in the base). If DCAA's logic is accepted, then a contractor, not withstanding major changes in its operations, would never be allowed to make a change in the method of allocating indirect costs. In other words, once a contractor adopts an accounting method it would be required to use that method in perpetuity – an obviously incorrect result. FAR 31.203(d) provides that the method of allocating indirect costs may require reexamination (i.e. change) when: (1) substantial differences occur between the cost patterns of work under the contract and the contractor's other work and (2) significant changes occur in the nature of the business, the extent of subcontracting, fixed asset improvement programs, inventories, the volume of sales, production manufacturing processes, the contractor's products and other circumstances.

In Contractor's case, in the past 10 years it has changed from a pure engineering firm into both an R&D and manufacturing company and its sales volume has increased from $3 million to $70 million. It is true that Contractor's G&A expenses should be allocated on a base representing its total activity but considering its operations, total activity is best reflected by direct labor and manufacturing overhead. The inclusion of raw materials and subcontract costs in the base produces a gross distortion in activity because as we have seen above, each dollar of material under the TCI method is considered equivalent to each dollar of labor and overhead.

♦ CAS 410 and the *Ford* Case

Though Contractor is not CAS covered, the guidance included in CAS 410, Allocating G&A expenses, and associated cases are helpful for illuminating the meaning of total activity. The justification of the use of a value added method in lieu of a TCI method is best illustrated in *Ford Aerospace and Communications (Aerospace and Communications Corporation Inc. Aeronautic Division, ASBCA 23883*). In that case, it was noted the CAS Board in its prefatory comments to CAS 410 stated that "total activity" refers to the production of goods and services during the cost accounting period. It includes material, subcontracts, labor and overhead. In the *Ford* case, the government maintained that by omitting materials and subcontracts (i.e. using the value-added base) this would result in an inaccurate measure of total activity. The Board rejected this position. Though it noted material and subcontract costs can be "includible in total activity" it is fallacious to conclude "each dollar expended for materials and subcontracts necessarily bears the same relationship to incurrence of G&A expenses as each dollar of labor and overhead." To the contrary, the total cost of each element comprising total activity "may or may not best represent total activity depending on the circumstances of each business unit. *The crucial question is not what activity elements may comprise total activity, but what best represents total activity" (Italics added).*

CAS 410 does not establish a preference for the TCI method. Rather, CAS 410 expressly authorizes three cost input allocation methods (i.e. TCI, value added or a single element representing total activity) and leaves the selection to be based on individual circumstances of the company. In deciding that Ford was entitled to use the value-added method, the Board cited two primary reasons:

1. The material and subcontract content of Ford's contract is disproportionate and G&A expenses pertain more to Ford's in-house activity than to Ford's material and subcontract activity.

2. The G&A expenses provided substantially more benefits to Ford's labor-intensive development contracts than the material intensive production contracts.

This is equally true with respect to Contractor's operations.

As for the possibility of hidden profits there is no foundation for such an assertion. Most of Contractor's business is based on competitively awarded fixed price contracts, not on cost build up bids. As for its cost type contracts, Contractor has completed its contracts and never requested an increase in price due to an increase in its expense rates.

UNIQUE ISSUES TO CONSIDER WHEN BUYING A GOVERNMENT CONTRACTOR

(Editor's Note. When buying a company that is a government contractor, there are unique issues that if not accurately understood at the time of purchase, can significantly affect the value of what you thought you were buying. These potential time bombs are easy to elude buyers because government contracting matters may be put on the back burner of the multitude of concerns needing attention. We came across a recent article in the October 2001 issue of the Lyman Report written by Rand Allen of the law firm of Wiley Rein & Fielding LLP entitled "Due Diligence in Government Contractor Mergers and Acquisitions." The article addresses most of the government contracting-unique concerns that need to be faced during the due diligence process and we added some of our experiences as either employees or consultants for companies buying other firms with government contracts.)

General Background

"Due diligence" is one of those terms that is often bantered about during an acquisition. For the buyer, the process known as due diligence means finding out as much as possible about the target from a limited amount of available information in a limited amount of time. The buyer generally wants to obtain and analyze accurate information about the target company's assets, strengths and weaknesses as well as its potential for future operations. The purpose of the information is to (1) establish a purchase price the buyer is willing to pay (2) identify risks for purposes of protecting those risks through negotiating appropriate contract provisions (3) prepare for and execute an effective transition to, ultimately (4) realize the maximum value possible. For the seller, the process means anticipating the buyers' questions and organizing and presenting information about the company being sold in an honest and persuasive way to maximize the seller's return.

As a specialist in government contracts, you are likely to be called upon to provide insights into specific areas unique to your specialized knowledge. Though they represent only a part of the due diligence process, they are particularly important because it is not uncommon for the participants to have both broad and in depth knowledge of most issues without knowing much about unique government contracting and accounting considerations. These government contracting-unique issues include:

Novation Agreements

Though long lived statutes prohibit transferring contracts to another company, the government recognizes the need to provide the means to transfer a contract when ownership changes and assets are transferred. FAR 42.12 sets forth the basic and procedural requirements for recognizing a successor in interest to a government contract when that contractor's assets are transferred. FAR 42.1204 sets forth the conditions in which the government's contracting personnel should believe they are entitled to consent to a transfer of contracts. Generally, the government will want a Novation Agreement for most transaction that are not pure stock purchases. Even when there is such a stock purchase arrangement the FAR states there may be issues related to the change in ownership where a formal agreement is appropriate.

The language of the FAR suggests the government has unbridled discretion to approve or disapprove novation requirements. However, nowhere does the FAR or its various agency supplements identify what factors or conditions a contracting officer should or should not consider when approving or disapproving

a novation. Consequently, contractors are at the mercy of the good faith and sound business judgement of COs who are often inexperienced in novation agreements.

A Novation Agreement is the vehicle for the government to consent to assignment of a contract. It is a three way agreement (i.e. tripartite) between the seller, buyer and the government. In the typical Novation Agreement, the government recognizes the buyer as the successor-in-interest to the seller. The seller waives "all rights under the contract" against the government and guarantees the buyer's performance (or in lieu of a guarantee, offers a suitable performance bond). The buyer, in turn, assumes the seller's obligations under the contract. FAR 42.1204(e) sets forth a model Novation Agreement. The FAR states this model agreement may be adapted to fit specific cases. It is not uncommon for the government to set forth additional clauses that may not be in the FAR.

One peculiarity of going though the novation process has to do with timing. FAR 42.1204 contemplates that a request for a Novation Agreement will normally be submitted after the transaction has been consummated. For example, the FAR requires "authenticated" copies of the transaction documents, balance sheets certified as of the date immediately following the transaction, and legal counsel's opinion on the legal validity of the transfer. As a practical matter the buyer and seller should enter into a separate agreement in which the seller delegates to the buyer authority to perform government contracts in the seller's name for a period of time after the closing until all Novation Agreements are executed.

Valuation of Backlog

The variations of government contracts make assertions about contract backlog problematic. Recent increased use of Indefinite Delivery-Indefinite Quantity (IDIQ), Multiple Award Schedule (MAS) and Blanket Purchase Agreement (BPA) contracts does not obligate the government to purchase significant items or services. Though these contracts may be awarded with great fanfare and large dollar amounts announced, they often only provide the contractor with the right to compete for future orders and those orders may never be funded. What really counts when assessing a seller's backlog is the receipt of funded orders. Hence the buyer needs to carefully examine orders actually received under IDIQ, MAS and BPA vehicles when conducting due diligence of seller's backlog with particular focus on the amount of funding, terms and scope of the orders.

Audits/Investigations

The government's extensive audit rights, particularly under negotiated contracts, provides it numerous remedies that can result in retroactive price adjustments to the contract price under the Truth and Negotiations Act (TINA). Although TINA was amended in 1994 and 1996 to limit its application to only certain type of contracts with exclusion of its requirements on "commercial item" contracts, a careful due diligence needs to identify the seller's universe of TINA covered contracts, its history with TINA and any expected price adjustments. In our initial requests for data, we ask the seller to identify the universe of TINA covered contracts to both gauge potential liability and evaluate their understanding of their own contracts when pursuing other information. In addition, fraud liability under the False Claims Act must also be examined.

Claims & Terminations

The government has the unique rights to change the scope and other terms of performance of a contract as well as terminate all or part of it in exchange for "making the contractor whole." The buyer needs to assess all existing claims, potential claims and termination settlements and estimate the likelihood of recovery. In our due diligence, we have found many circumstances of exaggerated assertions of potential recovery. We have also encountered the opposite circumstances where though the seller did not identify any potential claim and termination benefits, our close examination of the likelihood of certain recoveries provided a significant source of unexpected value to our buyer client that was later realized.

Cost Allowability/Indirect Rate Submissions

A unique aspect of government contracting is the set of rules that specify the types of costs that can be reimbursed as either allowable or allocable to a given contract. For cost reimbursement contracts and other types where downward adjustments to billings can be imposed, the rules will dictate how much a contractor gets paid. In addition, the prices set for certain firm fixed price contracts will also depend on what these rules will allow the contractor to receive. In both cases, the contractor will agree to interim billing rates or forward pricing rates and these rates will be subject to retroactive adjustments based on

audits of the contractor's actual incurred costs experience for a given year.

The amounts of these readjustments are not often clear at the time of a buyer's due diligence efforts resulting in potential time bombs in the future. Incurred cost proposals for relevant years may not have been prepared. If prepared, they may not have been audited. If audited, the rates for a given year may not have been settled, where the contractor, government auditors and contracting representatives may be in the middle of resolving numerous questioned costs issues. If settled, the seller may have (inadvertently or not) not disclosed the results and the impact on relevant contracts and subcontracts.

The due diligence efforts need to identify the potential liability of these potential time bombs. An estimate of liability needs to be taken. For example, at the very least, the buyer may want to ascertain the seller's historical experiences (e.g. ratio of billed to settled costs), adequacy of financial reserves, etc.

Intellectual Property

A contractor doing business with the government needs to exercise considerable care to assure it does not grant an "unlimited rights" license to the government for its technology or other assets. Such a license could entitle the government to give the design - either in the form of technical data or computer software code - to other companies and to authorize those companies to copy and sell the product illustrated in the data or code to any customer, anywhere. On the other hand, a contractor that developed its intellectual property at private expense or, to some degree, not at government or public expense can protect it (*see GCA DIGEST Vol. 2 No. 1 on Primer on Intellectual Property*). The company's policies related to protecting its intellectual property and the status of its intellectual property, especially if the seller's proprietary technology accounts for a significant share of its value, needs to be examined during a due diligence.

Knowing Your Cost Principles… INSURANCE COSTS

(Editor's Note. In our consulting practice, we frequently encounter disputes on whether certain insurance costs are allowable, whether they are allocable to a specific contract and how they should be charged indirect. We have relied on a "White Paper" prepared for a client by a consultant colleague of ours named Keith Davis, one of our favorite texts "Accounting for Government Contracts" by Lane Anderson and our own experience.)

Regulation Coverage

Insurance costs can arise either through purchased policies or self-insurance programs. Coverage by insurance includes that required by a contract or what is necessary for the general conduct of the business. FAR 31.205-19 covers general allowability of both purchased and self-insurance, CAS 416, Accounting for Insurance Costs focuses on self- insurance and FAR Part 28 covers the type of insurance coverage contractors need to obtain. In addition, certain types of insurance (e.g. fringe benefits such as health, death, post-retirement) are more relevant to FAR 31.205-6, Personal compensation and CAS 415, deferred compensation.

Allowability Criteria

The Lane Anderson text addresses six areas:

1. *Contractually required*. Costs of coverage required by the terms of the contract are allowable.

2. *General Business Insurance*. Costs of insurance related to the general conduct of business are generally allowable with certain exceptions. The type and extent of coverage must follow sound business practice and be "reasonable." Exceptions include: (a) the cost of insurance covering an asset in excess of its acquisition value is unallowable unless the contractor has a written policy providing that in the event of an involuntary conversion, the new asset will be valued at the book value of the replaced asset plus or minus adjustments for the difference between insurance proceeds and the actual replacement cost (b) costs of insurance for the risk associated with government property is allowable only to the extent a contractor is liable for damages other than that caused by willful misconduct or lack of good faith (c) business interruption insurance premiums are allowable except for any portion that provides coverage for loss of profits and (d) life insurance on company officials are unallowable when the beneficiary is the company or partners while when the beneficiary is named by the company official (e.g. family member, estate) it is considered additional compensation covered by FAR 31.205-6, personal compensation.

Also insurance coverage exists for a particular occurrence so a contractor must seek recovery on the insurance rather than from the government in the form of indemnification. The rationale for this is since the government helped pay the insurance premiums the loss must be borne by the insurance carrier not the government. We also frequently encounter assertions by government representatives that certain types of insurance (e.g. product liability, professional liability) are either unallowable or if allowable, not allocable to government contracts because the government does not receive benefit (e.g. damages paid on military products are less than commercial, no third party law suits result from government funded projects). Such questioned costs generally should be challenged on the grounds they are a necessary cost of doing business (*see the GCA DIGEST Vol. 3, No.4 for a case study of a successful challenge to such questioned costs*).

3. *Actual losses*. Actual losses are unallowable unless they are (a) expressly provided for in the contract (b) for nominal deductibles required by purchase insurance policies and (c) minor losses that occur in the ordinary course of business and are not usually covered by insurance (e.g. spoilage and breakage). Also, in accordance with CAS 416, actual losses may be used to determine the self-insurance charge provided the actual losses do not differ significantly from the projected average losses for the accounting period.

4. *Contractor defects*. Insurance expenses to protect against the costs of having to correct the contractor's own defects are unallowable except for casualty losses like fires and floods. The government's rationale is it does not want to have to pay to insure against the contractor's own poor performance because it is paying for a quality product (however, warranty costs are generally allowable).

5. *Professional Liability Insurance*. General practice coverage is usually considered an allowable indirect cost allocable to all work. If the policy contains special coverage on designated products, services or projects a direct allocation is generally required. You can expect auditors to compare commercial and government work to ensure the relative risks in the two areas are comparable.

6. *Self-Insurance*. FAR 31.205-19 limits the recoverable amount for self-insurance programs to purchased insurance, if available, plus administrative expenses. Insurance provided by captive insurers is considered self insurance unless the captive can demonstrate it sells insurance in substantial quantities to the general public and that the premiums it charges based on market forces. Premiums for "fronting" are arrangements with companies who reinsure with a captive are allowable but cannot exceed the amount (plus reasonable fronting company service charges) that would have been charged directly by the captive.

"Allowability" Requirements of CAS 416

Though most cost accounting standards apply to allocation as opposed to allowability questions, CAS 416 provides prescriptions for how self insurance costs should be computed which comes mighty close to allowability. Any contractor that establishes a program of self-insurance must comply with the requirements of CAS 416. If it is anticipated that 50% or more of the self insurance costs to be incurred at a business segment is allocable to negotiated government contracts and those self-insurance costs will exceed $200,000 the contractor must submit written information regarding the proposed self insurance program to the ACO and obtain approval of the plan.

CAS 416 provides detailed criteria for measuring insurance costs and assigning them to periods and cost objectives (contracts or indirect cost pools). For purchased insurance, premiums must be assigned to cost accounting periods on a pro rata basis. Any refund, dividend or additional assessment must be an adjustment to the pro rata premium cost for the earliest period in which the refund or dividend is actually received or in which the added assessment is payable. Where insurance is purchased for a specific cost objective and the costs are directly allocable to it, the premium need not be pro rated between accounting periods.

For self insurance, CAS 416 provides the contractor will make a self insurance charge for each period for each type of self insured risk. The charge is to represent the projected average loss for the period. If insurance could be purchased against self-insured risk the cost of such insurance may be used as an estimate of the projected loss; if this method is used, the self-insurance charge plus insurance administration expenses cannot exceed the cost of comparable purchased insurance. If insurance cannot be purchased, the amount of the self-insurance charge for each period is to be based on the contractor's actual experience, relevant industry experience and

anticipated conditions in accordance with accepted actuarial principles.

Other Considerations

In addition to the FAR and CAS, individual agencies may have their own regulations and clauses affecting insurance companies. The Department of Energy and Environmental Protection Agency, for example, have unique specifications (e.g. Management and Operating contracts). In addition, there may be negotiated "advance agreements" where, for example, certain indirect rates may be capped making such costs as increased insurance costs unallowable if they are included in the capped indirect cost pools. Also, under indefinite delivery indefinite quantity contracts, price is determined at the task or delivery level so insurance costs need to be budgeted there – for fixed price task orders insurance costs needs to be included in the price and for cost type orders insurance needs to be considered up front rather than later after issuance of the task order putting a constraint on recovery by the Limitation of Cost and Funds clauses.

Direct vs. Indirect

Certain costs are clearly direct or indirect. For example, a special policy required by a contract would be direct while general liability and director and officers liability insurance is clearly indirect. Most other insurance costs – workers compensation, property insurance, professional liability, environmental, etc. – can plausibly be considered direct or indirect. Both the FAR and CAS provide wide latitude in how to treat these costs, generally requiring that established policies be set and like costs under like circumstances be treated consistently.

If the insurance costs are material and a change in treatment would yield considerable cost savings for the government, you may expect your practices of allocating otherwise allowable insurance costs to be challenged at some time. No matter what general FAR or CAS provisions are cited, the general allocation issues are in the gray area and should be challenged. If challenged, you will need to demonstrate your methods are consistent with both prior practice and/or written policies; if you change your method, you should be prepared to demonstrate it is a different cost or incurred under different circumstances and benefits the company as a whole (if charged to G&A), multiple contracts (if charged to overhead) or a particular final cost objective (if charged direct).

DEDUCTIVE CHANGES

(Editor's Note. When the government reduces the scope of work on a contract it usually seeks a price reduction in the contract price. Whereas many contractors have mastered the essentials of a change that adds work and earns an increase in the contract price, fewer understand deductive changes in spite of the fact they are likely to face one. We often see this unfamiliarity with the rules result in the contractor paying or crediting the government more than they need to so we have also focused on how to quantify the deduction. We have relied on a July 2001 Briefing Papers article by John Person of the law firm of Person & Craver LLP.)

Characterizing the Work Scope Reduction

The way a scope reduction is characterized directly affects the amount of the price adjustment. Contractors usually have considerable flexibility in how to characterize the reduction. A reduction in contract scope can be a (a) "change" (covered by FAR 52.243-1 through 4)(b) "termination for the convenience (T of C) of the government" (FAR 52.242-2) or (c) "variation in estimated quantity" – "VEQ" – (FAR 52.211-18). The choice depends on how the scope reduction is characterized and the right choice will affect how well you come out.

♦ Change vs. Termination

No matter what "changes" clause applies to the contract, all authorize the contracting officer to make an equitable adjustment in the contract price for a deductive change. In calculating the price adjustment, the general rule is the government is entitled to a credit representing the difference between the reasonable cost to the contractor of performing the work without the change (e.g. the deletion) and the reasonable cost of performing with the change. Most of the time, the relevant costs are those expected to be incurred, that is, *prospective* costs. Under a termination for convenience (T of C), a price adjustment may be requested on the continued portion of the contract. When calculating costs under a T of C circumstance, the costs are usually those already incurred, that is *retrospective* (*for more on T of Cs, see our two part series in the GCA DIGEST Vol. 1 and 2, Nos. 4 and 1, respectively*)

Generally reductions that are "major" are considered a partial termination while "minor" reductions are considered changes. Hence deductions that are neither clearly major or minor can go either way.

When determining whether deleted work is major or minor, Courts and Appeals Boards have stated there are no "hard or fast rules" and have given a high level of deference to the CO or agreements between the parties. When major portions of work are deleted without substitution of other work a partial termination applies (*J.W. Bateson Co.*). In one case, a deletion of 20% of contract work was ruled a partial termination (*Ideker, Inc.*) while in another, 12% was considered a deductive change (*American Constr. & Energy*). When a specification change results in a reduction of units or supplies to be delivered, elimination of identifiable items of work or in the quantity of work to be supplied a deductive change is sometimes considered to have occurred even with a major deduction. Generally, deletions in excess of 20% are considered terminations while deletions of 10% or less are considered changes. However, when reductions exceeding 20% result from specification changes or substituted work does occur, numerous decisions have allowed for deductive changes.

Why Chose One over the Other? There are several reasons why a termination or a change would be preferable over the other:

1. *Difference in Recovery*. The advantage of using the changes versus the termination method of calculating a price adjustment shifts under varying circumstances. As a general rule, if the contract is profitable, deletion of work through a deductive change is better for the contractor while on a loss contract, a partial termination for convenience is better. The difference in advantage stems from whether there is an advantage of calculating the costs on a prospective (change) or retrospective (termination) basis. Under a deductive change, the contractor is entitled to the full contract price unless the government can prove it is entitled to a price reduction for deleted work. Under the change scenario, unusually large profit on non-deducted work is preserved and not subject to scrutiny by the government. In other words, if the projected costs are greater than originally anticipated, the price adjustment under the change will be greater than under a termination analysis (i.e. you will owe the government more). Under a partial termination, the contractor is entitled to a reasonable profit on work not deleted, even if that rate of profit is less than what was bid or actually earned on the project. In this case, if the deleted work will cost less than originally anticipated, the government will recover a greater amount under the termination rather than changes scenario.

2. *Time Limits*. Under the T of C clause, a contractor must submit its termination settlement proposal within one year of the effective termination date while no such limit applies under the changes clause. In one case, the CO denied a contractor's proposal submitted after one year on the grounds the deleted work was a partial termination while the Court ruled for the contractor because the deletion should be considered a change not subject to the one year limit. Of course the opposite result could occur if a Board or Court ruled the proposal in dispute should be considered a T of C. When in doubt, submit the proposal within one year.

3. *Burden of Proof*. Under a change, the government has the burden to prove its entitlement while under a T of C, the burden falls to the contractor. This consideration may be critical when proof of cost is scant or cost records are shoddy.

4. *Applicability of FAR Cost Principles*. Whereas FAR Part 31 cost principles fully apply to changes, their application to terminations are less strict. This is because the "fair compensation" principle overrides strict FAR cost principles under the T of C analysis.

5. *Allowability of Consultant and Legal Services*. Whereas these costs are routinely allowed under a T of C proposal, they might not be under the changes clause if they are considered to be costs related to a "claims presentation" (unallowable) rather than "contract administration" effort (allowable).

♦ Deductive Change Versus a VEQ

When work scope reduction is a quantity reduction in a unit-priced contract the VEQ clause may apply. The VEQ clause provides that if actual quantity of a unit-priced contract varies more than 15% from the estimated quantity, either party may seek an equitable price adjustment. The government may seek a price adjustment if its orders are more than 115% of the estimated quantity on the grounds that economies of scale reduce unit prices; conversely, contractors can seek a price adjustment for higher unit prices if quantities are less than 85% of estimated quantities because of absence of economies of scale. The Courts have limited recoveries to the government and contractors to only those increased or decreased costs caused solely by the quantity variation itself.

When does the Changes clauses or VEC clause apply? Where neither party causes a quantity variation, Courts have held there should be a no-cost window surrounding the estimate. However, even if the VEC

variation thresholds are not met the Courts have held that a price adjustment should be based on the Changes clause. Also, recent cases have ruled the Christian Doctrine does not hold for the VEC clause – if the VEC clause is physically absent from a contract, it does not apply like other important clauses that are in effect whether or not they are physically included or explicitly referenced in the contract.

Quantifying the Deductive Change

To obtain a price reduction the government must meet two conditions:

1. *The deleted work was required under the extant contract.* After a new specification was agreed to, departure from an earlier, more costly spec was not considered a deduction. On the other hand, relaxation of a technical spec is considered a deduction and a price reduction is in order

2. *The contractor must enjoy cost savings.* If the government cannot demonstrate or the contractor can show there is no cost savings, then the government is not entitled to a price reduction from the original contract price. Once the government has put forth a reasonable case for cost savings, the burden shifts to the contractor to rebut this contention.

♦ Impact on the Contractor

Like an added change, the amount of price adjustment is measured from the perspective of the contractor, not the government. If the government, for example, deletes a first article testing from a contract, the amount of price reduction is the cost savings to the contractor, not the added costs to the government. Similarly, a reduction in support personnel from consolidated operations must be measured by the impact on the contractor, not value to the government.

A common problem in quantifying the value of deleted work is that a contractor may not have developed a baseline set of actual costs in establishing what the deleted work would have cost absent the deleted work. Unlike additives changes where the contractor can generally develop some critical cost data to help price an adjustment, the absence of cost data puts the parties in an awkward position of trying to establish the value of work not performed. Fortunately, the courts and appeals boards have established fairly predictable rules for pricing deductions.

♦ Current Estimate or "Would Have" Cost

In general, pricing deductive changes should be based on the contractor's current estimate ("would have" cost) for performing the deleted work. Stated differently, the equitable price adjustment the government is entitled to is the difference between the estimated reasonable cost of contract performance without the deletion and the estimated reasonable cost of performance with the deduction. With limited exceptions discussed below, the "would have" cost technique is not the bid amount, the initial estimate or contract line items. If the difference between these original items and estimated costs yield either losses or high profits, the results are intended to keep the contractor in the same position.

♦ Hierarchy of "Would Have" Costs

Cases addressing what evidence should be accepted over other when pricing the deductive change include: (1) actual costs of identical work was considered more relevant than government use of estimating manuals (*ASC Constr. Co.*) (2) invoice between a contractor and vendor for an identical item was better than a contractor's proposal (*Atlantic Elec. Co.*) and (3) postaward quotes from vendors were superior than a contractor's prebid estimate (*Glover Const. Co.*). In another case addressing a common error made by the government, the Board rejected the government's attempt to price partially completed work by applying a straight proration of the line item amount to the percent completed. It notes such an approach ignores that certain fixed costs and other costs are expended early in performance making the rate of expenditure non-linear with the pace of performance (*Tom Shaw, Inc.*).

When the government is unable to validate estimates based on the contractor's cost records, the Courts have shown a willingness to consider other means for pricing deductions such as (1) when deleted work is a commodity market prices have been used (2) estimating manuals can be used to develop a price in absence of cost data though such evidence must give way to actual contractor costs (3) absence of consideration of learning curve estimates when they should apply has resulted in downward adjustments and (4) contractors' certified cost and pricing data has been used (this makes artificially high cost estimates not only subject to defective pricing allegations but costly if they are used for estimating deductive changes). Lastly, specific provisions in a contract for pricing deductive changes have been ruled to prevail over general rules.

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♦ Overhead and Profit

In determining the amount of the price reduction, reasonable overhead, G&A and profit must be applied to the contractor's direct costs. As with other costs, the focus is not on what rates were originally included in the bid. To maintain consistency, the courts have stated the same rates used for additive changes should be used for deductive changes. The focus, especially for manufacturing firms, should not be on actual rates after the deletion but on actual rates had the deletion not occurred. This will allow the contractor to use the lower overhead rates. When a deductive change is made to a contract on which the contractor is experiencing a loss, the courts have ruled no profit should be added to the costs based on the rationale that a price adjustment under a loss contract should not add to the loss the contractor would have experienced if there had been no change.

♦ Separate and Severable Work

In general, when the solicitation advertises that line items or phases are severable (i.e. can be separately contracted and priced), then the proper measure for a deletion of that line item or phase is the quoted price. This "separate and severable" exception to the general rule of pricing deductive changes by cost, not price, is to by applied only in the presence of two conditions: (1) the deleted item was priced separately and (2) the term of the award allowed for a piecemeal or severable award (e.g. something other than award on an all-or-nothing basis). Merely including separate line items – a common practice in all-or-none contracts – is insufficient to trigger this exception. When a contract provision or regulation provides for a different approach, even though the conditions for an exception are met, those provisions trump the exception.

The exception has been extended by the courts to punish contractors who use unbalanced bidding or when a windfall would occur. For example, the government deleted certain encapsulation work from an environmental remediation contract where the contract price was $52,000 but the contractor proposed $1,200 based on a subcontractor's bid price for the work. In spite of the fact the encapsulation work was not severable in the contract the court ordered the price adjustment to be $52,000 because to provide $1,200 would result in an unfair windfall.

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