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NEW CASE LIMITS ALLOWABILITY OF COSTS RELATED TO SETTLING LAW SUITS

(Editor's Note. Government contractors, like most firms, are continuously faced with a variety of third party lawsuits whether they be allegations of mistreating employees, environmental contamination, professional liability or personal injury lawsuits. Most firms make business decisions on how much effort and expense they want to put into challenging these suits, choosing an array of options ranging from "fighting them to the Supreme Court" to settling the issue to avoid long drawn out, expensive fights. In recognition of these business expenses, the government has traditionally allowed legal and settlement costs associated with most of these cases as a necessary cost of doing business unless such legal actions were involved in one of the legal issues explicitly made unallowable by FAR 31.205-47 (e.g. mergers and acquisitions, patent infringements, pursuit of claims under the Contract Disputes Act (CDA), defense of fraud allegations, etc.) In recent times, there have been some conflicting cases that have narrowed the opportunities to recoup these costs which had the affect of making contractors think twice before settling these disputes. The following alludes to a few of these cases and creates significantly expanded grounds to disallow those costs that have traditionally been allowed as normal costs of doing business.)

Background

Tecom was awarded a negotiated cost reimbursement contract for military housing maintenance at Fort Hood, Texas. The contract incorporated by reference FAR 52.222-26, Equal Opportunity which prohibits contractors from discriminating against any employee because of race, color, religion, sex or national origin. There was no dispute by any of the parties that sex discrimination in violation of Title VII of the Civil Right Act of 1964 would constitute a breach of the Equality Opportunity clause of the contract.

During performance of the contract a former employee sued Tecom under Title VII, alleging sexual harassment and firing in retaliation for filing a sexual harassment charge. The alleged conduct occurred while the employee was working on the government contract where if the allegations were proved, there would be a violation of Title VII.

In defending the Title VII litigation Tecom incurred legal fees totaling $96,000 and ultimately decided to settle the matter for $50,000. In the terms of the agreement no "back pay" was provided for and Tecom did not admit any wrongdoing. Tecom requested payment for $146,000 for the defense and settlement costs in its incurred cost proposal.

Tecom claimed it did not violate the law and that the allegations were false but settled because trying the case would have exceeded $300,000. Tecom argued the defense and settlement costs were allowable under the contract and FAR and that the costs were reasonable because the settlement costs were far less than the costs of going to trial, even if Tecom prevailed. The government denied these expenses were allowable and converted the request for payment into a contracting officer's final decision and Tecom filed an appeal to the Appeals Board.

Board Decision

During cross motions, the government argued that the attorney's fees and damages associated with a judgment of liability under a Title VII claim were not allowable costs and that under *Boeing (298 F.3d at 1288-89)* the cost of settling such claims are unallowable unless the contractor proved the suit had very little likelihood of success on the merits. Tecom argued the costs of settling a Title VII suit is always allowable (except for an explicit backpay award which is unallowable per FAR 31.205-6(h)) and that the *Boeing* case was irrelevant because it involved fraud and similar misconduct which is not alleged here. The Appeals Board sided with the contractor noting that *Boeing* did not apply where there were no charges that Tecom had engaged in criminal conduct, fraud or violations of the Major Fraud Act of 1988. The Board said the contractor should be reimbursed a reasonable amount in accordance with the Allowable Cost and Payment Clause. The government appealed to the US Court of Appeals for the Federal Circuit.

Discussion

The issue is whether the costs of defending and settling a Title VII suit are allowable under this contract. The Court cited the five requirements for a cost to be allowable under FAR 31.201-2: (1) reasonableness (2) allocability (3) CAS, if applicable (4) terms of the contract and (5) limitations set forth in the cost principles of FAR Part 31. It noted that FAR 31.204 does not cover every element of cost so failure to include any item of cost in the contract or cost principles does not imply it is either allowable or unallowable. Where neither the contract nor cost principles explicitly address a particular cost, which is the case here, the cost principles must be looked at for treatment of "similar or related" selected items.

As described in *Boeing*, even though professional services and costs of settling litigation are generally allowable, this is not always the case. Where claimed costs are associated with a settlement agreement two steps of inquiry must be made: (1) if an adverse judgment is made (e.g. guilty) should damages, costs and attorney fees be allowable and (2) if not, should the settlement costs be allowable.

Should the Judgment costs be allowable?

The Court states right off that the attorney fees should not be allowed if there is a violation of Title VII. The Court's decision, which had issued the decision on *Boeing*, relied heavily on the case where first Boeing was convicted by the government for fraud. After this conviction and fines and penalties a shareholder brought a private lawsuit against 14 directors of the company where based largely on the criminal fraud convictions it was alleged the directors had failed to "establish internal controls sufficient to prevent fraud."

The Court stated that under Boeing, in order to determine whether the costs of defending against the shareholder suit was allowable, the court inquired into whether the suit was "similar or related" to the costs of the underlying convictions. They first said the costs of the shareholder suit are not *similar* to costs incurred in connection with criminal convictions or other disallowed costs identified in FAR 31.205-47. However it held that the shareholder suit was "related" to the convictions. That is judgment against the contractor in the suit would require a determination that the directors had failed to maintain adequate internal controls which the Court concluded had a "sufficiently direct relationship to the disallowed costs of the criminal convictions and hence the costs of defending against an adverse judgment in the suit should therefore be disallowed."

The Court said this aspect of *Boeing* was found in the *Southwest Marine case (Southwest Marine Inc. US 535 F.3d 1012 (9th Cir. 2008)*. There a court ruled Southwest was liable for civil penalties under the Clean Water Act in a citizen suit. Whereas the FAR makes costs unallowable in connection with any proceeding brought by a third party in the name of the U.S. under the False Claims Act, the Court held that citizen suits under the Clear Water Act that resulted in civil penalties were "similar" to costs disallowed in the FAR under the FCA.

In the current Teton case, the parties agree that neither the statute nor FAR explicitly discusses the allowability of costs associated with adjudicated Title VII violations. The Court says the costs would be unallowable because a contractor violation of Title VII would breach the contract and costs related to such a breach would be unallowable. The Court alludes to one of the criteria of allowability – cost complies with the terms of the contract. Here, the contract specifically requires the contractor to not discriminate on the basis of sex and sexual harassment claimed in the suit is a form of sex discrimination. If sexual harassment and subsequent retaliation were found at trial then the defense and judgment would certainly result from a breach of the contract. As an earlier case decided, *Dade Brothers Inc. US (325 F.2d 239, 240 (Ct.Cl. 1963)* concluded that costs resulting from a breach of contractual obligation are not allowable costs under the contract.

In this suit the alleged discrimination would clearly violate the contract and thus costs associated with an adverse judgment would not be allowable. This conclusion according to the court is underscored by the clear public policy of Title VII. In *NAACP v Federal Power Commission* the Supreme Court ruled that costs resulting from violations of Title VII were unreasonable and should rightly be excluded from utility rates passed onto consumers. The Court concluded just as it is not "just and reasonable" for a company to pass the costs of Title VII on to consumers, similarly it is unreasonable to pass such costs on to the government in a contract context.

Are Settlement agreement costs allowable if the adverse adjudication costs are unallowable?

Here, the Court stated its position on *Boeing* clearly addresses the issue. The decision should follow the rules of a private suit brought under the False Claims Act (FCA) where there the FAR states the costs may be allowable if the CO determines there was little likelihood the third parties would be successful on the merits. So here, there should be an inquiry whether the plaintiff was likely to prevail. Though the FAR "most clearly reflected" FCA related issues, the Court said it should not be limited to that situation. So under *Boeing* the court held that whenever the costs of a judgment would be unallowable, the cost of a settlement would also be unallowable unless the contractor could prove the private suit had little likelihood of success.

Tecom states that apart from fraud situations clearly spelled out in the FAR settlement costs should be allowable regardless of how clearly meritorious the claim and states Boeing got it wrong by applying a rule limited to fraud settlements. The Court, who ruled on the Boeing case, "clearly adopted a broader rule applicable to private settlements generally." The Court responded that this was the point of Boeing – to determine an applicable rule for similar or related cases not those covered by the regulation.

In response to Tecom's assertion that applying the likelihood of success test to private settlement would be unwise the Court said that if it sided with Tecom it would allow a contractor who engaged in conduct prohibited by the contract – where defense and judgment costs would be disallowed if it were tried to judgment – to nonetheless recover defense and settlement costs if it resolved the case before judgment. It cannot be the policy of FAR to permit this.

Dissent

One of the three judges dissented from the majority opinion. He first recounted the basis for the Boeing decision and stated the conditions were not similar. He said the *Boeing* court, in looking at a prior *Citron* lawsuit, presumed that meritorious suits should be treated differently from those that lacked merit and looked to the FAR for guidance as to whether the settlement costs of the *Citron* suit were allowable. In referring to treatment of settlement of private suits brought under the False Claims Act where the government does not intervene, the Boeing court said such costs may be allowable if the CO determines that there "was very little likelihood that the third party (plaintiffs) would have been successful on the merits" FAR 31.205-47(c)(2).

The dissenting judge states this very little likelihood of success standard may have been appropriate under the facts addressing *Citron* but should not apply here. The FAR quote applies to settlements brought by a third party under False Claims Act; it does not apply to "any and all" settlements of lawsuits brought by private parties involving "any and all types of allegations." The Citron suit that settled Boeing involved several instances of fraudulent behavior and the making of false statements. The dissenter agrees that the FAR reference does address private suits under the FCA and so does lend support to the Boeing court decision.

Here there is "no nexus" between the facts of the private suit in this case, a sexual harassment suit filed by a former employee, and a suit brought by a third party on behalf of the government alleging fraud or similar misconduct. To apply Boeing here would be extending the reach of that decision to any settlement of a lawsuit brought by a private party when the costs of an unsuccessful defense would be allowed. Such an extension is unwarranted and agrees the Board was correct in refusing to apply the Boeing standard.

In addition, the dissenting opinion stated that determining the likelihood of success is, in practice, not easily done. If it were, there would not be so many suits, appeals and reversals of decisions. It is one thing to have that standard be a criterion of allowability of costs in defending a suit when fraud against the government is alleged but it is quite another to have that standard apply when the criteria in a suit involving two private parties, even if the subject matter relates to a government contract. The standard should be higher for fraud allegations than for when two private parties are contending with each other. The dissenting judge "recoils from judicially extending that difficult-to-apply likelihood of success rule beyond its current borders," concluding the Court should not extend the application of a regulation to settlements beyond fraud cases.

NEW DEVELOPMENTS ON WHAT IS A SMALL BUSINESS – AFFILIATION RULES

(Editor's Note. Several of our clients and subscribers have been asking us about changes to their small business size status either before or after winning new awards. Others have been considering various ownership or affiliation arrangements so as not to loose their small business status while others are concerned that investment arrangements, either by outside venture capital and equity funds or family/employee groups will affect their

small business status. These concerns are particularly relevant to our readers in the light of recent proposed rules affecting small business size – e.g. effect of investments by venture capitalists on small business status, companies who have outgrown their "small" status may still be considered small for purposes of bidding on follow-on or similar procurements where they would still be small had they not been awarded the contract. So, we have been "boning up" on the SBA rules. During that process we came across a particularly pertinent article addressing many of these issues in the August 25 edition of Federal Contracts Report written by Keric Chin and Richard Vacura of the law firm of Morrison & Foerster LLP so we decided to reflect their insights in this article that are consistent with out own research. We believe these rules are relevant not only to small businesses but also large businesses working with small business concerns, considering various teaming arrangements or even investments or acquisitions of such firms.)

Basic Rules

The Small Business Act defines a small business as "one which is independently owned and operated and which is not dominate in its field of operation." In addition the SBA may specify detailed definitions or standards by which a business concern may be determined to be "small." SBA has established size standards which vary by industry and are matched to the North American Industry Classification System (NAICS) codes. The size standards are based on either number of employees or annual receipts, depending on the industry, which are designed to ensure the concern is not dominate.

When determining number of employees SBA counts all individuals employed on a full time basis, part-time or other basis averaged over 12 months. When determining annual receipts it is based on the average total receipts over the concern's most recently completed three years.

The contracting officer designates the NAICS code that applies to a particular procurement and thus the size standard that applies to it. A company that meets the size standard for the designated NAICS code may represent itself as "small." A company generally certifies its size status at the time it submits an offer or bid to the procuring agency and the agency may rely on the self-certification absent evidence to the contrary or a challenge by an interested party. Section 8(a) of the SBA provides for severe penalties for knowingly misrepresenting the size status of a concern in connection with a procurement. In addition there are separate certification processes for small business that wish to be certified an 8(a) Business Development Program, small disadvantaged or HUBZone small business.

A recent proposal to change the small business status of firms receiving funds from venture capital firms have raised the issues of what rules determine whether a company is small. When small businesses are pursuing federal government work infusions of capital by venture capital, private equity or other investment funds may change the business to other than "small," making the business ineligible for opportunities that the federal government has set aside for small businesses or making the business less attractive to prime contractors seeking to meet their small business subcontracting goals.

So what is the affect of an investment on the small business concern's size status? It depends on several factors including the relative size of the investment and types of management controls the investors typically seek to impose to protect their investment. If an investor is deemed to control the small business concern, either because of the size of its shareholding or other factors then the two entities are considered to be "affiliates" and the investor's revenue and employee number are aggregated with the small business concern's numbers for size determination calculations. Even minority shareholders can be, and often are, considered to be "affiliates" for size status. So the focus on the impact of investments to size status has raised the issue of small business size eligibility provisions and standards, particularly those related to affiliation.

Affiliation Rules

Making the determination of whether a company qualifies as a small business is often tough, especially when the SBA affiliation rules and the varied business models or investment arrangements may apply. In calculating the size of a business concern, the SBA aggregates the number of employees or annual receipts of the business concern with those of its affiliates. This, of course, depends how the concerns are affiliated. Affiliation is broadly defined as when "one controls or has the power to control the other or a third party or parties controls or has the power to control." It does not matter if actual control is exercised so long as the power to do so exists. The affiliation rules make clear that control may be either affirmative or negative – the latter is when a minority shareholder has the power to prevent a quorum or block ordinary actions by the Board or stockholders. (*The authors point to two cases in their footnotes that make the level of control less clear. In one case, the court distinguished between power to block ordinary and extraordinary actions of the board or shareholders while in another case, the Board* *found affiliation even though controls were characterized as limited to scenarios outside the normal course of business.*)

The SBA affiliation rules, in Title 13, Part 121 of the Code of Federal Regulations identify circumstances where affiliation will be presumed where in some cases the presumption is often rebuttable. These are:

1. Affiliation based on stock ownership – single large block. Affiliation exists when any individual, concern or other entity has the power to control 50 percent or more of voting stock or a block of voting stock that is large compared to other outstanding blocks.

2. Affiliation based on stock ownership – minority shareholder rule. When two are more individuals, concerns or other entities own or have the power to control 50 percent of a concerns voting stock *and* such minority holdings are equal or approximately equal in size *and* the aggregate of these holdings is large compared to other outstanding blocks. This presumption is rebuttable.

3. Affiliation arising under certain future arrangements. Affiliation may exist when ownership or control may exist based on ownership or control of stock options and convertible securities as well as agreements to merge.

4. Affiliation based on common management. Affiliation exists where one or more officers, directors, managing members or partners who control the board of directors and/or management of one concern also controls the board or management of the other concern.

5. Affiliation based on identify of interest. When two or more individuals or firms have identical or substantially identical business or economic interests such as family members, common investments or economically dependent relationships through contract or otherwise. This presumption is rebuttable.

6. Affiliation based on newly organized concern. An affiliation may arise when former officers, directors, principal stockholders, managing members or key employees of one concern organize a new concern in the same or related industry and serve as the new concern's officers, directors, principal stockholders, managing directors, principal employees and the preexisting concern furnishes or will furnish support to the new one. This broad based presumption is rebuttable.

7. Affiliation based on joint ventures. Affiliation exists where an association of individuals and/or concerns engage in and carry out more than three business ventures in a two year period. (*In one case the SBA found affiliation between two concerns because they have formed so many joint ventures that the independent identify of one or both concerns were blurred.*) With certain exceptions, this rule does not apply to: (1) a joint venture between two or more small businesses, each of which meets the designated size standard and (2) two firms approved by SBA to be a mentor and protégé and the protégé qualifies as small under the designated size standard.

8. Affiliation based on joint ventures – ostensible subcontractor rule. Certain prime contractors and their subcontractors are treated as joint venturers and affiliation exits where the subcontractor performs primary and vital requirements of the contract or the prime is unusually reliant on the subcontractor.

To complicate matters even more, the SBA will examine multiple levels of affiliation. For example, if Company A is affiliated through stock ownership and management control with Company B and Company B is affiliated with Company C then Company A would be affiliated with both B and C where employees or revenue of each affiliate would be aggregated for size determination. For many venture capital and other investment funds, the affiliation analysis is complicated by the number of individuals and business entities that are within the fund's portfolio. The SBA finds affiliation for such arrangements to be based on "the totality of the circumstances" where no single factor by itself is sufficient to determine affiliation.

There are also exceptions to the affiliation rules. For example businesses owned in whole or in part by investment companies licensed under the Small Business Investment Act are not considered affiliates. There are also exceptions pertaining to business concerns owned and controlled by Indian Tribes, Alaska Native Corporations, Native Hawaiian Organizations, Community Development Corporations and labor brokers and temporary employment agencies.

Consequences of Status Change

In assessing potential investment opportunities, both the small business and venture capital firm must consider the consequences of whether the small status will change and if so, what is the impact. A status change can affect business opportunities by making the former small business ineligible for contracts set aside for small businesses or they may become less attractive to prime contractors who are looking to subcontract out work to meet their small business subcontracting goals.

It may affect the status of its current contracts. Prior to June 2007, contractors did not have to notify their COs of a change in circumstances affecting their size status but that changed after that date where the FAR Part 19.301-2 now requires notification under certain circumstances: (a) execution of a novation agreement (b) following a merger or acquisition that does not require a novation agreement (e.g. stock purchase) (c) prior to the end of the fifth year of a long-term contract or (d) prior to exercise of any options thereafter. The FAR states the status change does not change the terms and conditions of the contract but the agency may no longer include the value of the option years against its small business prime contracting goals.

The meaning of this new notification requirement need not trigger the representation requirement if a venture capital or other investment firm invests with the company even if the investment impacts the size status of the concern until the five year option period is reached. However a CO may require the small business to recertify its size status at any time including in response to a solicitation for a multiple award (e.g. Multiple Award Schedule).

Mitigation Strategies

(*Though the authors address venture capital firms here, we would say it applies more broadly to other investment vehicles.*) To mitigate the potential impact of an investment by a venture capital firm the authors state the funds should limit their ownership and control of the concern's voting stock, including options and convertible securities. The greater the control over a business concern the more likely it will be considered an affiliate. This will, in turn, likely trigger an examination of the fund's other portfolio companies to determine whether they are also affiliates. In structuring the investment, the authors caution it is more than a numbers game where the totality of circumstances may be examined. Do the funds own or have power to controls blocks of voting stock that are individually or collectively large when compared to other blocks? Implications on shareholder voting agreements, corporate charters and bylaws, common management, and mutual business or economic interests among other things must be considered. There are no clear bright lines here so put simply, if an investor owns more than a relatively small percentage of a concern's voting stock it runs the risk of being considered an affiliate.

The authors put forth several factors to consider when structuring the investment relationship to avoid triggering "affiliation." The SBA Office of Hearings and Appeals (OHA) generally distinguishes between contracts that limit *ordinary* actions by the Board or stockholders (i.e. management decisions that affect daily operations of the business) and those that limit *extraordinary* actions pertaining to protection of ownership stakes. For example, OHA held that a supermajority voting requirements for amending corporate charter or bylaws, issuing additional common stock or entering any business substantially different from its normal operations are significantly different from the company's normal business and hence did not constitute negative control for purposes of triggering affiliation. The types of actions the OHA considers to be extraordinary are limited. The OHA has held the following types of actions to be important business operations and the investors' ability to block them would constitute negative control: (1) setting compensation (2) hiring and firing corporate officers (3) declaring or paying dividends (4) creating debt (5) alienating or encumbering assets (6) amending or terminating lease agreements and (7) purchasing equipment.

CASE STUDY – DIRECT VERSUS RESIDUAL POOL ALLOCATIONS OF HOME OFFICE EXPENSES

(Editor's Note: In an audit of one of our client's incurred cost proposals the auditors of the buying agency (not DCAA) are claiming that the method of allocating home office costs to the business segment working on a large cost type contract are not correct and the allocation practices may constitute fraud. Though we prepared several position papers and held numerous meeting with the auditors and agency contracting personnel on these and other issues, the following identifies the assertions being made by the auditors and a summary of our positions put forth in rebuttal. We will disguise important facts calling the contractor "Contractor", the agency "WA" and the business segment responsible for working on the WA contracts as "BU."

Background of Allocation of Home Office Costs to BU

Since the BU business segment did not have a full contingent of indirect personnel available to support WA contracts it used a small but growing group of corporate personnel to provide support as its large cost type contract work ramped up. Prior to 2006 timesheets were used to identify the fully burdened costs of these personnel that were allocated directly to BU. Due to concerns of accuracy of using timesheets (employees were inconsistent in how they distinguished work in support of BU versus corporate-related activities), the company substituted use of a sales metric approach (BU sales as a percentage of total sales) to directly allocate a portion of these personnel costs directly to BU and continued the prior practice of allocating the remaining costs to the home office residual pool. The Government is asserting that the allocation of these corporate personnel costs resulted in an over-allocation of costs to BU. Specifically, the over-allocation occurred because (1) the group of people should not be considered a separate pool of costs (2) use of a sales metric is inappropriate and (3) assigning the remaining costs not directly allocated to BU to the residual pool resulted in "double dipping" because a portion of these costs were also allocated to BU. Further, there is the assertion these allocations were made without informing the employees or changing source documents or accounting records.

Applicable Rules.

Both the Federal Acquisition Regulation and Cost Accounting Standards are the two main set of rules addressing the allocations of costs.

♦ Federal Acquisition Regulation

There is significant uncertainty when, if ever, Contractor's WA contract became fully CAS covered (there are several issues related to measuring the dollar value to see if the threshold for CAS coverage was triggered but these are too involved to recount here). However, there is no doubt about whether the contracts were subject to the FAR. The FAR Part 31 cost principles primarily address questions of allowability where specific categories or costs are made unallowable due primarily to public policy decisions. Sections of FAR 31.201 through 204 do provide general guidelines for cost allocation principles. After providing general guidelines of determining allocability and distinguishing between direct and indirect costs, section 31.203 addresses indirect costs. The most relevant sections are:

31.203(c). This part defines what a pool is. It states indirect costs will be grouped into "logical cost groupings" with consideration of the reasons for incurring such costs. The decision for grouping the costs will be based as to permit use of an allocation base that is common to the cost objectives to which the costs are allocated. The base selected will allocate these grouping of costs "on the basis of the benefits accruing to the final cost objectives." The next sentence provide even greater leeway in grouping costs - "When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation."

(e) The method of allocating indirect costs "may require revision" from time to time when conditions change. Examples of changes in conditions include nature of the business, the extent of subcontracting, fixed assets, volume of sales, etc.

♦ CAS 403

By far the most important regulation addressing the issues here, since it addresses allocation of costs incurred at the home office level is CAS 403, Allocation of home office expenses to business segments. Even if the relevant contracts are not CAS covered nonetheless, the prescriptions of CAS 403 are instructive because they provide the most specific guidelines on what constitutes adequate home office allocation guidelines. I will first provide a short summary of the standard.

There are three ways that corporate expenses are to be allocated to business segments in descending order of preference: First, direct identification of costs to a specific business segment. Second, nondirect allocation measurement where similar types of costs are grouped together and allocated to benefiting segments on allocation bases reflecting the relationships of the expenses. For example, Human Resources costs may be grouped and allocated to segments based on headcount. Third, residual expenses where remaining costs are to be allocated to all segments on a base representing total activity.

Use of a sales allocation base for measuring total activity has been a controversial element – many contractors, especially those not covered by CAS (which represents the vast majority of contractors) use sales as a basis to allocate some or even all of their home office expenses to business segments. Though the standard does not take issue with this practice, DCAA auditors sometimes do assert sales does not measure total cost activity because sales figure may include widely divergent profits as opposed to costs. However, many auditors will accept the practice, especially for non-CAS covered contractors.

♦ Memo Record Use for CAS 403

The allocation of home office costs or methods prescribed in the standard are almost never followed by commercial firms or even government contractors not required to provide estimates of costs to the government for pricing purposes. This is because most firms, who have no reason to fully allocate all costs to a contract, will not separately identify corporate and home office expenses. Even firms that do business with the government or are even CAS covered often do not follow the home office allocation methods discussed above for their financial, tax or GAAP reporting purposes. Accordingly, both the CAS Board and even DCAA long ago recognized that contractors may choose to report home office costs differently for contract costing purposes than those used to report such allocations for other reporting purposes. The term "memo records," that are widely accepted by the government and its auditors, refers to the reality that government contractors needed to create unique costing reports for contract costing purposes that are different from other records found in its books of accounts such as the general ledger. The memo records, commonly spreadsheets used to calculate home office allocations, are normally the basis to allocate these expenses.

Was Direct Allocation of Some Costs Appropriate

Contractor incurs significant costs at its corporate headquarters and allocates some of these costs to BU. Since BU did not have sufficient indirect resources they used corporate administrative resources to support the WA contract. My interviews with several of these people indicated the nature of activities of supporting the WA contract by corporate personnel differed significantly from their normal corporate activities. For example, HR personnel performed work related to recruiting and hiring new personnel for the contract compared to their corporate activities of administering health benefits and 401(k) plans and treasury personnel helped process and pay vendor invoices for WA work while its normal corporate activities consisted of cash management and financial analysis.

♦ Opinion

The corporate personnel performing a significant amount of effort on WA work was a small subset of total corporate personnel. In my opinion, it was correct to distinguish this group of corporate personnel from other corporate personnel and treat the time worked on WA work differently than the time worked on corporate matters. In fact to do otherwise would fail to accurately allocate costs to appropriate business segments. If material amounts of corporate costs can be identifiable with a specific segment CAS 403 says those costs should be distributed to the business segments rather than remain in either a nondirect or residual pool. If, for example, all corporate personnel were assigned to the residual pool and allocated to business segments on a proportionate base then those segments where personnel contributed a significant portion of time would likely have an under-allocation of costs while other segments would be over-allocated. So taking the relevant subset of corporate personnel into a separate grouping and proportionately allocating those costs in accordance with FAR cost principles was sound.

Replacement of Timesheets with Sales Metric

Prior to 2006, these employees, like all other indirect employees, used timesheets to track their activities. Those time sheets were used to identify the effort related to WA work where the time and burdened costs for WA work was charged to BU. (Since all other divisions had their own indirect costs staff, the amount of corporate support for other business segments was considered immaterial and not tracked.) Time not directly allocated to BU work was distributed to the residual cost pool on the grounds that all remaining costs were essentially corporate activities and hence allocable to the residual expense pool.

In 2006, it was anticipated that additional effort by corporate personnel for BU activity would increase substantially with the new large WA contract. There had always been some concern about the accuracy of using timesheets to identify effort related to BU where it was found different employees often had different ideas about what constituted BU versus corporate work, which subjected the allocation practices to assertions of inaccuracy. With the new contract it was determined that having even more employees working on both WA and other corporate work would create even more potential inaccuracies.

Consequently, alternatives to use of timesheets to assign corporate personnel labor costs to BU were sought. The first step Contractor took was to identify the employees who provided activities for the BU contract work and other corporate activities and analyze the percent of their time allocable directly to BU. The next step was to consider alternative allocation bases that would distribute the personnel costs about proportionately to the results generated by the analysis. A direct labor cost base was considered but rejected since direct labor did not sufficiently capture the full scope of activities performed by the personnel. These personnel provided support to all BU direct cost effort – direct labor, subcontract and other direct cost effort. It was decided an allocation base representing total activity of the business segment contracts was needed and sales was selected because it (1) was a good surrogate measurement of total activity (2) was easy to identify causing little administrative effort and (3) was not subject to assertions of inaccuracy.

♦ Opinion

Use of timesheets are commonly the default method of identifying effort to either business segments, segment indirect cost pools or final cost objectives. However, as it became more apparent that timesheet use was subject to error, it was rightfully feared that the allocation of costs to BU could be suspect which likely would have resulted in the government questioning all costs if timesheets were deemed to be inaccurate and possibly lead them to the conclusion that Contractor's timekeeping, labor charging and even accounting practices were inadequate for the WA contract. I have seen this unfortunate result many times.

So was the sales metric allocation base selected reasonable? I believe it was. The allocation base selected to allocate those corporate costs that were deemed to be allocable to BU meets the FAR requirement to select a base having a causal and beneficial relationship with the business segments. Since the effort of this group of corporate employees supports most direct activities related to the BU work, an allocation base representing total activities of the contracts would be most appropriate. So, for example, it was sensible to both consider a direct labor base and to reject it because the effort related to BU work supported all costs of the contracts including subcontract costs and ODCs rather than merely direct labor effort. In my opinion, there is more than one base that could have been selected that represented total activity e.g. total segment costs, cost of sales at each segment. Though sales do not necessary reflect total cost activity, in this case it represents a quite acceptable "surrogate" measurement of total activity which is an explicit requirement of CAS 403.

DCAA's Objection to a Sales Allocation Base. Though CAS 403 is silent on the issue, in many cases, DCAA has taken the understandable position that sales should not be used as a surrogate measurement of total cost activity because sales includes varying levels of profit as well as costs. So, a contract with a relatively low cost portion of sales but a high profit level would inequitably receive a disproportionately larger share of the allocation. However, in this case, the profit rate provided in BU contracts is relatively low compared to its contracts in some of its other segments. Profit rates on federal cost plus fixed fee contracts are notoriously low due to the relatively low risk of the contract type which was certainly the case with the WA contract. So the fact that a higher portion of sales represent actual costs compared to the sales in other segments indicates there is actually a lower allocation of the relevant corporate costs to BU compared to other business segments.

Was it appropriate to assign the remaining costs to the residual pool?

The allocation of remaining costs to the residual pool is the heart of the claim that Contractor "double dipped" or over-allocated corporate costs to BU. The auditors assert that if any contracts were covered by CAS there would be a non-compliance with CAS 403 and if not CAS covered the audit report asserted several FAR provisions were violated including the ones discussed above.

There is no question that the older timesheet system was in accordance with CAS 403 - in the parlance of the standard, it represented a combination of direct identification of some costs to business segments – those identified as BU – and the remaining costs to the residual pool.

However, when the sales metric approach was implemented, the auditors believe a different approach was taken - the adoption of the nondirect method in the CAS 403 terminology. This method requires the accumulation of costs into a logical pool and the allocation of those costs to benefiting segments. In this case, it could be viewed as accumulating the entire subset of corporate personnel into one homogeneous pool and allocating them on a sales base benefiting business segments including BU. Once this indirect allocation is made, there are no other costs left in the pool so distribution of these costs to the residual pool is not possible since no costs are left after allocating them to the business segments. To include these non-BU costs in a residual pool, where a portion is allocated to BU would appear to represent an over-allocation of costs to BU.

Contractor believed otherwise. They maintained that the basic allocation methodology – first directly allocating those corporate costs that directly benefit a business segment to that business segment and then, second, distributing the remaining costs to the residual pool - had not changed. The only thing that had changed was the method of identifying those costs that were to be directly allocated – shifting from a less reliable timesheet to a more accurate sales metric measurement.

♦ Opinion

I believe Contractor's position is not only reasonable but, in fact, has greater merit. I believe the allocation of costs using the sales metric can reasonably be viewed as providing an alternative to using timesheets to directly allocate relevant costs to business segments and the remaining costs would properly be considered residual. My reasons are:

1. Like the earlier method, all costs identifiable to business segments are allocated to those business segments (which happens to be only BU since no other business segments utilized corporate personnel in support of their contract work).

2. Neither the FAR nor CAS 403 prescribe the method used to assign the costs directly to the segments. For example, neither timesheets nor any other method is recommended or required. The presumption is to choose that method that most accurately does the job. In this case, as we discussed before, the sales metric is both an adequate surrogate measurement and provides more accurate results that are less subject to auditor objections and adverse opinions than using timesheets.

3. Does use of the sales metric constitute a nondirect allocation? The government position, in the parlance of CAS 403, is that by selecting the sales metric Contractor in effect changed its methodology from a combination of direct and residual allocation to a nondirect allocation exclusively. By making the change, all personnel costs in the "pool" had to be distributed to business segments using the sales metric, leaving no other costs available to be assigned to the residual pool. In fairness I do not think this position is unreasonable but I believe Contractor's position has greater merit. That is, there was no change of approach only the method of identifying the direct portion of the allocation had changed.

4. Is it appropriate to charge the remaining costs to the residual pool? I believe the answer to this question lies in a determination of what were the activities of the corporate personnel. If the activities by the personnel in question were substantially the same, then yes, the nondirect method would apply. The costs would clearly be a homogeneous grouping of like costs under like circumstances and allocable on a reasonable basis – the condition for nondirect allocation. However, if the activities related to supporting the segment activities, namely WA work, are substantially different than those activities for corporate purposes then separate treatment is justified. That is, the costs associated with WA effort should be assigned discretely to the benefitting segment and the remaining costs associated with corporate activities should be treated differently - in this case, included in the residual pool.

My interviews with several of the employees indicates clearly the latter condition is true here. That is, the activities of the corporate personnel engaged in supporting the BU contracts differ significantly from their normal corporate tasks. For example, Jane Doe worked on medical and 401(k) plans at corporate but recruiting and handling administrative efforts for new hires on WA work. John Doe worked on corporate bank reconciliation and dealing with banks at the corporate level and worked on payments to subcontractors, cash management forecasting and ensuring cash transfers were properly made for WA. Or, Jane Doe ll worked on Accounts Payable work at corporate but worked on several contract and subcontract issues as well as cash reports for the WA project.

Was it inappropriate to allocate the corporate costs without notifying employees or changing payroll records through undocumented journal entries

The assertion that costs of personnel allocated to BU were "reclassified" from the home office to BU without "permission" from employees and without any visibility of these changes in relevant company accounting records such as payroll or timesheets is being asserted as not only poor cost accounting but as possible fraudulent transactions.

♦ Opinion

Based on a thorough analysis, I did not see any inappropriate accounting. Rather, Contractor's accounting treatment of these cost allocations from corporate to BU are consistent with normal home office allocations practiced by most firms who allocate home office costs for government accounting reports.

Logistics of Cost Distribution. Home office expenses are usually first booked to relevant accounts at the home office. The basis of these charges are normally source documents such as timesheets, payroll records, vendor invoices or expense reports or allocations from other business units to the home office. The first step is to allocate home office expenses to the relevant business segments. Home office allocations are normally based on spreadsheet-based computations where all expenses are allocated to segments on one of the three methods of allocation – direct, nondirect and residual.

There are two common accounting treatments of these allocations. Most frequently, these reallocations are for government costing purposes made as memo records. No actual changes are made to the original books of account (e.g. the original home office accounts) but rather are distributed on a memo basis using a spreadsheet computation where the results are reflected in government contract reports and proposals. Other times, as is the case with Contractor, these home office allocations are actually made in the books of account where home office accounts are credited and the relevant receiving business segments and corresponding accounts within those segments are debited for the allocated amounts.

The same principle of distributing costs from one accounting entity to another is a common principle applicable not only to corporate allocations made for government costing purposes but applies for all purposes. For example, capital assets are commonly amortized on a straight line basis for financial reporting purposes. However, depreciation costs may be charged differently for tax purposes or government accounting purposes (e.g. using accelerated depreciation). Another example are computer costs where the costs reflected on a vendor invoice may be charged to one cost center but if the computer equipment is used by numerous divisions costs may be distributed to the benefiting divisions for monitoring costs at the division level. These costs may simply be distributed on a memo basis or through actual journal entries but the invoice itself is not altered to reflect the revised distribution of costs to multiple divisions for reporting purposes.

Changes to Accounting Documents. Whether or not home office costs are distributed only on a memo basis or actual journal entry transfers of expenses from the home office to business segments, I have never seen any contractor actually change the source documents. In other words, the original payroll records, timesheets, invoices, expense reports are not altered, changed or substituted by different ones. Rather the amounts are distributed for government costing purposes.

"Permission" of Employees. The assertion that "permission" from the employee whose costs are transferred is needed is based on a confusion of proper treatment of timesheets and cost allocations of indirect personnel costs after those costs have been assigned to a cost pool using either memo records or journal entries. It is true that an employee's timesheet is sacred and there are extensive controls over them (e.g. audit trails for change, initialing any changes). However, care over timesheet accuracy has nothing to do with the accounting treatment of employee costs with respect to allocation of those costs from one indirect pool to another. It is quite common, for example, to reassign indirect personnel costs from overhead to G&A, from one division or business segment to another or from a home office to a business segment or vice versa. No change to the actual timesheet is ever contemplated just as no change to an invoice for a capital asset is made if the depreciation method for amortizing it is altered.

RECENT DECISIONS ON TRAVEL

"Special Circumstances" Can Be Invoked if it Saves the Government Money

Rather than fly from his home in New Mexico to Los Angeles for his househunting trip in anticipation of his relocation, Damon found out that flying out of New Mexico was significantly more expensive than flying out of Colorado so he and his family drove the 500 miles and flew out of Colorado. When he submitted his claim that included miscellaneous and incidental expenses incurred in Colorado the government denied them saying he was entitled to temporary lodging and M&IE expenses at the old or new duty station and nowhere else. The Appeals Board supported Damon noting the travel regulations for his agency stated he was not entitled to be reimbursed for expenses outside of proximity of the old and new duty station "unless justified by special circumstances." The Board rules the fact he saved the government a significant amount of money was precisely the kind of special situation that "special circumstances" applied to (*CBCA 1314-RELO*).

Limits on Moving Person Vehicles

Lou Ann drove her car to her new duty station and shipped the second one by train. Her agency denied the cost asserting (1) she was entitled to reimbursement

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for only one personal owner vehicle (POV) and (2) the weight of the car should be included in the maximum weight of her household goods (HHG). The Board denied payment saying she was entitled to only one vehicle unless she had a dependent in which case she was entitled to one or two (she had no dependents). However the Board rejected the argument about inclusion of the car in the HHG quoting the JTR saying HHG does not include autos, trucks, vans or similar motor vehicles (*CBCA 1505-RELO*).

Selling Expenses Apply Only Occupied Home

Torralba received notification for a position at a different duty station where at the time he lived in a home he owned. After receiving the notice he completed a contract of purchasing a house he was having built at his old duty station. His agency rejected his claim for reimbursement of expenses related to selling the new house. The Board sided with his agency quoting the FTR 302-11.5 - to be reimbursed for expenses incurred in your residence transactions, you must occupy the residence at the time you are notified of your transfer (*CBCA 1524-RELO*).

"New Hires" Entitled to Limited Relocation Reimbursement

(*Editor's Note. Though the Federal Travel Regulations have limited applicability to private contractor employees, we have frequently seen auditors question costs like those found unallowable below on the grounds the FTRs do not allow it. The following case illustrates the need for contractors to explicitly identify costs that will be reimbursable in their company policies where if they are not, the FTR will often become the "default" regulation in the eyes of auditors.)*

Evester resigned from a government position in Aug 2006 and was hired by another Department in Oct 2006. His claim for relocation included temporary quarters, storage expenses, mileage expenses for his spouse, miscellaneous expenses and real estate transaction costs for his move to Washington DC. His agency denied the real estate transaction costs asserting he was a "new hire" which in accordance with 5 USC Section 5720 excluded such costs for new hires. The Board agreed he met the definition of a new hire – first appointed as well as appointed after a break in government service – and though he was entitled to most of his relocation costs those did not include real estate transactions expenses (*CBCA 1582-RELO*).

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