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DCAA ISSUES THIRD REPORT TO CONGRESS

(*Editor's Note. DCAA has issued a third report to Congress that contains a variety of statistics on questioned costs and elapsed time to complete audits as well as proposals that indicate a "significantly greater intrusive focus" if they are adopted. The source of our information is based on an article in the September 2014 issue of Government Costs, Pricing and Accounting Report written by our colleague Bill Walter and Mark Burroughs of Dixon Hughes Goodman.*)

Background

Though DCAA has been around a long time this report is only the third annual report issued. It is based on the requirement in the 2012 DOD Authorization Act for DCAA to issue an annual report describing its activities for the previous fiscal year that must include (1) significant problems encountered during its audits of contractors (2) statistical tables showing total number of audit reports completed and pending, priority given to each type of audit, length of time taken for each audit, total dollar value of questioned costs (including dollar value of unsupported costs) and pending audits (3) summary of recommendations of actions and resources needed and (4) any other matters of significance.

Statistics

The report provides a variety of statistics for the last three years where the authors select reported statistics they believe show important trends that will most likely impact how contractors evaluate their pricing strategies and risk mitigation efforts.

Incurred Costs. In 2012 the first report addressed a large backlog of incurred cost audits that were not completed and that was growing. It told the GAO it would adopt a new risk assessment process to determine high and low risk submissions where all high risk ones and a small sample of low risk submittals would be audited where all other low risk submissions would be closed out administratively through the use of a memorandum and no audit would be conducted. In addition, its action plan to reduce the backlog included creating dedicated incurred cost audit teams, conducting multi-year audits, initiating low risk sampling and growing its workforce. Though it was not given additional staffing DCAA reported it had completed 8,616 audits in 2013 compared to 4,088 in 2012. It reported that in 2013 it had a backlog of 23,000 (15,000 "on hand" waiting to be audited and 8,000 "waiting" – received but returned to contractors for being inadequate) which was a reduction over 26,000 in 2012.

Net Savings, ROI and Questioned Costs. DCAA provided statistics showing that net savings to the government had increased from an average of $2.5 billion in the 2003-2009 period while it increased 50% in the last four years to $3.7 billion and another 75% over the earlier period in 2013 to $4.4 billion. Computing a *return on investment*, net savings sustained by contracting officers for each dollar spent, DCAA showed a $7.30 amount, the highest in a decade. DCAA also recommended $16 billion in recommended deductions from proposed or claimed costs which indicate a higher percentage of questioned costs as a percentage of dollars examined. The authors find this trend of increased questioned costs troubling in the current environment where contractors are working hard to find ways to decrease their costs to remain competitive while their costs related to compliance with government regulations are increasing.

Length of time to Complete Audits. Though it states it works closely with COs to establish due dates to meet government needs, DCAA, not COs, determines when an audit is to be completed. DCAA reports it has reduced the elapsed dates for a proposal or demand audit from four months to 3.25 while the time for incurred cost audits has increased from 2.6 years to three. Despite DCAA's insistence it should not be limited to a standard time to complete its audits where it must comply with generally accepted government auditing standards (GAGAS) the authors point out that over three months to complete a proposal audit when most solicitations establish 30 days for a contractor to complete its proposal is too long to effectively support the CO in most circumstances.

DCAA Challenges

In its desire to provide the highest value to its stakeholders the report lists a number of deficiencies in the acquisition process and has recommended changes.

Forward Pricing. Though the report states there have been significant improvements since its proposal adequacy checklist was issued in March 2013 it still cited inadequate contractor proposals as a significant barrier to performing high quality and timely audits of proposals. It is recommending that a forward pricing rate proposal checklist be approved.

Sufficiency of Commercial Pricing Documentation. For the last decade there are demands for cost analysis to demonstrate a proposed price is fair and reasonable. DCAA's report strongly reflects "heavily cost-justified approach to what is and is not adequate commercial – item pricing support" where now there are demands to include non-certified cost data called "data other than cost or pricing data." The report, whether it addresses prime or subcontract offerings, states contractors do not provide sufficient documentation necessary to support commercial item documentation which the authors disagree with.

Authority to Review and Subpoena "Data Other Than Cost or Pricing Data." In what the authors state is the greatest risk to industry, DCAA wants to substantially broaden its subpoena authority, which is currently limited to "certified cost or pricing data," to have subpoena authority to "data other than cost or pricing data." The report puts the contracting community on notice that a proposal for this subpoena power has been submitted.

Other Access Expectations

The report also indicates that DCAA is expanding its reach to areas contractors do not allow DCAA auditors to reach: (1) Access to Internal Audit Reports – despite court ruling that internal audit reports are judgments of the audit team and not cost or pricing data DCAA is continuing to press unlimited access to these reports where now such access is limited to internal control objectives (2) Access to Employees - DCAA is seeking legislation to provide its auditors with direct access to conduct interviews and observe contract employees which it asserts is a requirement of GAGAS where contractors want to ensure that DCAA talks only to those employees who have knowledge of the topic or issue being audited and (3) Read-Only Access to Online Data - DCAA continues to push for legislation to provide read-only access to contractors' online data where some contractors currently do so while many others do not.

TREATMENT OF DEDUCTIVE CHANGES

(Editor's Note. Reductions of work effort under current contracts are proliferating in the current budget constraint environment. You usually have choices in the way you characterize these reductions which will affect how much you may recover. Several changes have occurred since we last addressed this issue. Many parts of the following article are based on a recent article in the September 2014 issue of Contract Management by Mark Garrette who is a contracting officer at Wright Patterson AFB while those sections how to quantify changes and terminations are based on our consulting experience helping clients prepare, negotiate and resolve proposals related to deductive changes.)

Over the next several years the government contracting industries are expecting an explosion of contract reductions and partial or complete terminations to meet the across the board spending cuts being projected (e.g. $1.2 trillion from sequestration). When the government scales back requirements on existing contracts they must consider how they will treat the reductions where there are basically three types of treatments: (1) a "change" (covered by FAR 52.243-1 through 4)(b) or (2) "termination for the convenience (T of C) of the government" (FAR 52.242-2).

In all circumstances, the government will be looking to make a downward equitable adjustment in the contract price for these actions where the contractor is entitled to specific types of cost recovery since their business may be impacted from the reduction in contract price. The way a scope reduction is characterized directly affects the amount of the price adjustment. Though the decision ultimately lies with the contracting officer, contractors, in practice, usually have considerable input in how to characterize the reduction.

Why a Termination or a Change?

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 (discussed below). The difference in advantage stems from whether there is an advantage of calculating the costs on a prospective (change) or retrospective (termination) basis.

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 which is 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).

Recovery under a Termination Versus a Change

The termination for convenience clauses provide that the contractor may request an equitable adjustment in the price of the work that remains on the contract to compensate it for any additional costs incurred by performing the remaining work. 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*. The adjustment will not (1) include anticipated profits from the terminated work (2) increase the contractor's profit margin or (3) reverse a loss position. *(Editor's Note. For more information on maximizing recovery under a T of C, see prior articles using our word search at our website. We intend to address new developments related to T of Cs in future articles of the DIGEST,)*

The changes clauses provide a slightly more convoluted approach to cost recovery. A deductive change subtracts the amount that the deleted work "would have cost" including the profit reasonably attributed to the cost of that work. Stated differently, the 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. Unless the deleted work is clearly severable from the contract (discussed below) the contractor's actual bid price is irrelevant. For example, consider the scenario where there is a contract to provide new carpeting installed in a five story building for $50,000. If the government decides not to carpet three floors it must lower the contract value by the actual amount this work would cost to perform. If the three stories of carpet costs $8,000 for each story, the contractor would be paid $26,000 ($50,000 minus $24,000).

An important consideration in deciding which method to use is whether the contract is in a profitable or loss position. 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 is better. In the case of profitable work, the contractor may be entitled to retain a substantial part of its anticipated profit under a deductive change scenario since it must quantify the reduction by only its projected costs. Under a partial termination for the deducted work, the contractor would be entitled only to a "reasonable" profit on the work actually performed. However, when the work on a contract is unprofitable the effects are amplified. A contractor bears only a proportionate a share of its anticipated losses on the unterminated work under a partial termination while a deductive change would cause the contractor to lose the same aggregate amount of money as before work deletion. This can be clarified by an example. In the hypothetical example described above, consider the same facts in the $50,000 contract except the contractor bid too low and it will cost the contractor $12,000 to carpet each floor ($60,000 total). If the government decides to carpet three floors, that will reduce the contract value $36,000 leaving the contract with $14,000 to complete the two floors costing $24,000. So here, just as the contractor would have lost $10,000 had there been no deduction, it loses the same $10,000 after the deduction.

Other Considerations

1. *When are partial terminations versus changes to be used.* 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.

2. *Challenging a contracting officer's choice.* It is usually the CO's decision on whether deleted work is a deductive change or termination. In one case the Board held that as a general rule a decrease in the contract's required specification, cost or performance time is usually a deductive change while a partial termination is more appropriate for a reduction in the number of units or supplies, elimination of identifiable work, reduction of the quantity of work required under the contract or similar reductions in contract tasks (*Celesco Industries, Inc. ASBCA 22251*).

The Court of Federal Claims was more ambiguous saying if major portions of the work is deleted and no additional work is substituted then the partial termination is supposed to be used (*Niger Ele. Co v. US., 442*). A CO's determination that deleted work is a deductive change will not be overturned if the government and contractor has consistently treated the deletion as such while the change was being executed. In the case, the board considered the government action to be a termination but ruled it could be treated as a change because "it did not want to disturb the parties' treatment of the work as a deductive change" (*Goetz Demolition Coo., ASBCA No. 39129*).

3. *What cost data is best for changes.* A common problem in quantifying the value of deleted work is that a contractor my not have developed a baseline set of actual costs in establishing what the deleted work would have cost absent the deleted work. Unlike additive 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.

Several cases have addressed what evidence should be accepted over other when pricing the deductive change. These 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 noting such an approach ignores that certain fixed costs and other costs are expended early in performance making the performance 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.

4. *What overhead and profit rates should be used.* 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 force 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.

5. *When does contract price trump projected contract costs under changes scenarios.* 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 significant 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.

Case Study…

CHALLENGE TO QUESTIONED COSTS CLAIMED TO BE NON-ALLOCABLE "COMMERCIAL" COSTS

(Editor's Note. Though the government is required to pay a "fair" price for its products and services, there is considerable effort put into lowering prices paid. One of the most fruitful methods of lowering the price paid is to assert that a given cost allocation method adopted by a contractor should be altered to achieve a more "equitable" (translated – lower) price. We frequently encounter such positions in our consulting practice and when we think the government's position is wrong, we challenge them. In our ongoing interest to provide our readers with "real life" case studies, we thought we would present the results of a consulting engagement we had to challenge a Defense Contract Audit Agency draft report questioning significant costs on the grounds the expenses were "commercial" and hence not allocable to government contracts. The following presents a highly compressed list of challenges we presented where though every point put forth would likely not apply to your unique circumstances, some most definitely will.)

Background

The company (the contractor is real but we will not divulge the name) creates and sells software and provides IT services to a variety of government and commercial clients as both a prime contractor and subcontractor. The market for its software products and IT services varies. Products originally intended for the government market sometime become potential and actual sources of commercial business while, conversely, products developed for commercial use often become attractive to its government sector clients. For example, many of its products and IT services originally targeted for the commercial market are included in GSA schedules marketed to the government sector.

In 2005, the company purchased a company that sold software to a variety of commercial companies in the energy field. The company was attractive because its technology could enhance Contractor's existing line of products and it saw a large potential business in both the commercial and government markets. Though some of the technologies were adapted to Contractor's existing product line, the product line of the new company was discontinued in 2007 due to significant software problems that could not be fixed. Included in the labor overhead pool are costs associated with the new business line where Contractor chose to capture these costs in three separate accounts to ascertain what its investment was.

DCAA conducted an accounting system audit in early 2006 where it concluded Contractor's accounting system was "adequate" and provided "a logical and consistent method for allocation of indirect costs to intermediate and final cost objectives." During earlier incurred cost proposal audits in 2004 and 2005, the company actually proposed creating separate commercial and government rates where DCAA rejected that suggestion, recommending instead that the overhead pool be established on a company-wide basis. Contractor agreed not to attempt to segregate overhead between government agencies and commercial customers and subsequently submitted its 2005 Fiscal Year Overhead Submission on a basis which did not distinguish overhead rates based on the class of customer. This was accepted by DCAA.

DCAA's Position

In its audit of Contractor's 2006 incurred cost submittal, DCAA eliminated $650,000 of indirect costs from its overhead pool representing the three cost accounts discussed above, asserting these costs were related to "commercial activity." DCAA also eliminated $75,000 from the overhead labor base asserting these were direct costs associated with the "commercial" contracts of the acquired company. The result of these questioned costs were to reduce Contractor's overhead rate by over 30 percentage points.

The basis of DCAA's position was that allocation of about 50% of the firms overhead costs were associated with "commercial activities" of the new product line while the labor base associated with this activity represented only 10% of the total overhead base of direct labor. They asserted the commercial contracts provided little "proportionate benefit" to the government and resulted in an "inequitable" allocation of costs to government contracts. DCAA asserted these costs "represent(s) indirect expenses identified to Contractor's commercial product lines that are not allocable to government contracts and should be allocated to the commercial contracts through a commercial direct labor base." Rather, consistent with FAR 31.201-4(b) and 31.203(b) Contractor should create separate indirect rates for its commercial work.

Basis for Disagreeing with DCAA's Position

1. *Contractor's energy product lines and technologies are not a "commercial product line."* The energy product line is really a family of software products and technologies intended to meet a broad range of needs in both the government and commercial marketplaces. We provided several examples of (1) where the technologies of the new product lines were incorporated into many items of its existing work including several government prime contracts and subcontracts and (2) government contracts were not only envisioned but were being actively pursued with, for example, the Departments of Energy and Defense.

2. *The costs questioned are homogeneous with other costs in the overhead pool and do not call for separate overhead rates based on classes of customers.* The nature of Contractor's efforts and processes to develop, sell and produce the products are no different than any of its other products. These same types of costs in support of other product lines and technologies are included in the same overhead pool and allocated on the same direct labor base, thus undermining any rationale to create and maintain separate rates for the energy products by any other criteria including class of customers.

Further, the energy product line does not meet the conditions usually associated with establishing separate overhead rates for commercial and government business. Generally, such practices may be encountered at large firms that maintain separate facilities, have distinctly different production processes and produce unique products or services for each marketplace. None of these conditions apply here.

3. *The expense incurred on the energy products are related to expanding the sales and cost base of the company as a whole*. Even if the energy product line was exclusively commercial there is a long history of court and board decisions that provide a wide range of costs are allowable and allocable to government contracts when they are necessary for operation of the business and contribute to increasing the company's revenue (*Lockheed Aircraft Corp. vs. United States, 375F.2d 786* and *TRW Systems Group of TRW, Inc. ASBCA, 11499).* The Boards held the prospect of increasing non-government business benefits the contractor's government contracts by absorbing overhead and G&A in the new contracts. Even when commercial business did not develop, the Board ruled in *Data-Design Laboratories (ASBCA 27535)* the costs were allocable because the government would have benefited from a reduction in overhead cost had a commercial market developed.

4. *The costs questioned are "G&A and IR&D" type expenses*. After we presented the cases discussed above DCAA asserted they were irrelevant because the disputed costs were included in the overhead pool while the cases discussed only "G&A and IR&D type expenses." We disagree with DCAA's position for two reasons. First, as we have repeatedly asserted and DCAA has not challenged, the costs in question are primarily research and development (e.g. fixing software glitches, researching industry trends) and marketing-type costs (e.g. identifying end user needs) which certainly qualify as "G&A or IR&D type expenses." The fact Contractor chooses to assign these costs to their overhead rather than the G&A pool does not contradict the fact they are the type of costs addressed by the cases which mostly address IR&D and marketing and sales type costs. We do admit the costs in question could have, and perhaps even should have, been included in the G&A pool rather than the overhead pool.

Second, whether the indirect costs are included in the overhead or G&A pool for allocation purposes only makes a difference if a contractor uses the "total input cost" method to allocate G&A. Under these circumstances, the costs are allocated over a broader base. Contractor, however, uses the "value added" method to allocate G&A costs, which excludes subcontract costs and material costs from its base. Therefore, direct labor is the only driver. In other words, the indirect costs in question will be allocated in the same manner whether such costs are included in overhead or G&A.

5. *DCAA's proposed change would contradict its earlier pricing methodology*. The pricing of Contractor's negotiated government contracts and commercial services and products listed on the GSA Schedule were based on its long-standing, established and accepted cost accounting practices. Any retroactive adjustment establishing separate indirect costs pools would have a dramatic effect on the pricing of commercial work, which is the basis for establishing prices on the GSA Schedule. Contractor cannot reprice its existing contracts retroactively.

6. *There is a history of acquiescence by DCAA of Contractor's established accounting practice*. We showed that for its 2004 accounting system a review of an indirect rate structure is a basic audit step and should have been reviewed for an accounting system survey. The fact the accounting system was accepted in 2004 does not mean it is irrelevant for a 2006 incurred cost audit – DCAA is now, in 2006, attempting to change a system it previously (in 2004) accepted.

(*Editor's Note. In the past, we have successfully put forth the equitable estoppel argument. The principle, supported by many court and board decisions, will not permit a retroactive disallowance of costs when the contractor can show that it reasonably relied on the government's prior conduct especially when it can show a history of acquiescence or approval of a particular cost accounting practice by the government which is the case here. However, recent cases have established that the hurdle for asserting the equitable estopple argument is significantly higher where now the Contractor must show the existence of bad faith on the part of the government in addition to the other conditions.*)

7. *We disagree with DCAA's references to FAR 31.201-4 and FAR 31.203(b) as grounds for disallowing the costs.* FAR 31.201-4 provides that one of three conditions

be met in determining whether a cost is allocable to a government contract – as a direct cost or an indirect cost either as a cost that benefits more than one contract or is necessary for the overall operation of the business. The costs being questioned by DCAA certainly are necessary for the overall operation of the business. As for DCAA's observation that the direct costs of the energy product labor represents only 10 percent of Contractor's direct labor base, this is perfectly consistent with the nature of most R&D expenditures – the indirect labor is expended first in order to develop the product and then once the product is viable, revenue and direct costs are realized. DCAA has inappropriately taken the normal expenditure sequence of developing products to be indications of a misallocation of costs to government contracts.

Whereas FAR 31.203(b) provides general guidelines in grouping indirect costs (i.e. logical groupings such as manufacturing overhead and G&A, selecting an appropriate distribution base) there is no suggestion that overhead pools should be grouped by customer type. It is simply too great a stretch to reference this FAR section as providing support for distinguishing commercial versus government costs and then advocating that separate rates be established.

8. *Adopting DCAA's position would violate certain other government accounting requirements.* For example, FAR 31.203, which DCAA cites part (b) of that section in support of its position, fails to consider section (c) which prohibits fragmenting the base – "once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements." DCAA has fragmented the base and attempted to retroactively establish indirect cost pools based on the type of customer rather than considering the operational nature of the work.

Though Contractor is not CAS covered, the cost accounting standards are instructive. It should be noted that there would be a violation of CAS 401 (consistency of how costs are proposed , accumulated and reported) because DCAA's proposed retroactive establishment of separate rates would conflict with the manner in which it proposed prices on its prior contracts including its prices used on the GSA schedule.

Further, CAS 418 provides that indirect costs shall be accumulated in indirect cost pools, which are "homogeneous." The Standard provides in part: "An indirect cost is homogeneous if each significant activity whose costs are included therein has the same or a <u>similar</u> beneficial or causal relationship to the cost objectives as the other activities whose costs are included in the cost pool." (underscored for emphasis). Contractor's overhead pool is homogeneous. The elements included in its overhead pool, for the most part, have the same or similar beneficial or causal relationships. As stated above, Contractor is a labor-intensive business and the support costs are similar for both government agencies and commercial customers. Contractor's employees are not assigned by class of customers and they work on both government and commercial contracts.

9. *DCAA misinterprets the concept of "benefit".* DCAA's allusion to Contractor's practices not providing "benefit" to the government resulting in an "inequitable" allocation of costs indicates they are unaware of a seminal case – *Boeing North American, Inc. v. Roche, 282 F.3d.1320.* That case ruled "the word 'benefit' as used in FAR 31.201-4, refers to an accounting concept and does not impose a separate requirement that a cost benefit the government's interest for the cost to be allowable." The case held the concept of "benefit" used in FAR 31.201-4 refers only to an accounting concept which describes the "nexus" required between the cost and the contract to which it is allocated. The Court held "the requirement of a 'benefit' to a government contract is not designed to permit…an amorphous inquiry into whether a particular cost sufficiently benefits the government so that the cost should be allowable."

We are waiting to hear DCAA's response.

Knowing Your Cost Principles and Cost Accounting Standards

GIFTS AND HOSPITALITY RULES AFFECTING GOVERNMENT CONTRACTORS

(*Editor's Note. In this era of increasing GAO and IG investigations of government contractor actions all individuals* *and companies interacting with government officials must become aware of the strict ethics rules of doing business with government agencies. New rules and cases in this area has made it timely to address this issue. The following article is based on the June 2014 Briefing Papers by Jessica Tillipman, Assistant Dean at the George Washington University Law School.*)

FAR 31.101-1 articulates the overall policy of all government entities, whether federal, state and local or foreign – "Government business shall be conducted in a manner beyond reproach and except as authorized by statute or regulation, with complete impartiality, and with preferential treatment for none. Transactions relating to the expenditure of public funds require the highest degree of public trust and an impeccable standard of conduct." To ensure individuals involved in government procurement adhere to this standard, government entities in nearly all jurisdictions have established codes of conduct, ethical restrictions and anti-corruption laws where nearly all have established prohibitions on gifts and hospitality that may be accepted by government officials. While gifts and hospitality play an important role in conducting business in the private sector in the public sector these common practices and courtesies may be interpreted as attempts to influence public officials. Ethics and anti-corruption laws vary widely by jurisdictions resulting in considerable confusion over what rules apply. The following article attempts to provide an overview of these rules.

Government Ethics Restrictions on Gifts and Hospitality

Most of the laws target the relationship between the government and contractor to ensure the transactions are free of corruption or even the appearance of impropriety. Contractors that work in a variety of jurisdictions – federal, state-and local and foreign – are faced with a bewildering assortment of rules.

- **US Federal Restrictions**

The Office of Government Ethics (OGE) maintains a website that summarizes relevant laws as well as provides guidelines and training materials. In recent times, the complex rules have been complicated by the expanding use of government outsourced personnel where contractor-employees work side-by-side with government officials where common office traditions of birthdays, retirement and holiday parties create ethical issues. Though the policies are straight forward, the rules are fairly complicated where they are riddled with exceptions and nuances. As a general rule government employees are prohibited from directly or indirectly soliciting or accepting "gifts" from a "prohibited source." Companies that contract with or seek to contract with the federal government fall under the definition of "prohibitive source" while a gift is deemed to be given because of a federal government employee's official position if a gift would not have been offered or given if the employee was not working for the government. The definition of "gift" includes hospitality as well as any other item of monetary value. Excluded from this definition are items of little intrinsic value such as modest refreshments (that are not a meal), plaques, discounts available to the public and honorary degrees. However, included in the broad definition of "gifts" are many items that are business courtesies in the private sector such as meals, entertainment and transportation. If an item is not explicitly excluded as a 'gift" it is probably prohibited unless a limited exception applies. Unless a gift falls under one of the following exceptions, it is "the safest course" to assume the gift is prohibited.

1. *The 20/50 Rule.* A contractor may offer a noncash gift with an aggregate market value of $20 per occasion provided the cumulative value does not exceed $50 in a calendar year. The monetary value applies to an entire organization not to individuals. Contractors cannot offer or give gifts or hospitality that exceed the cap by allowing the government official to pay the difference between the fair market value of the item and the gift cap (e.g. cannot buy lunch valued at $40 even if the official pays the $20 difference).

2. *Gifts based on a personal relationship.* A gift can be provided if it is clear it is "motivated by a family relationship or personal friendship rather than the position of the employee." To qualify for this exception several factors are relevant such as who paid for the gift, the origin of the friendship and history of gift giving between the parties. The OGE has expressed suspicion if the friendship has developed on the job or gifts have been purchased with company funds.

3. *Gifts from the spouses' employer.* Similar to above, gifts or hospitality may be extended if it is based on a spousal relationship. For example, if a contractor employee is married to a government official the

contractor may provide meals, lodging, transportation and other benefits if offered because of the spousal relationship, not the government official's position. So if a contractor hosts a holiday party for all employees and their spouses then the government employee may attend as long as the invitation is made to all spouses.

4. *Gifts in connection with bona fide employment discussions*. If a contractor wants to engage in bona fide employment discussions with a government official it may provide meals, transportation and lodging in connection with the discussions as long as the government employee has complied with all the government requirements for such discussions.

5. *Widely attended gatherings*. Contractors may generally offer government officials free attendance at a widely attended conference as long as the event is legitimately widely attended and attendance is in the government's interests. "Free attendance" is defined as a waiver of all or part of the fees associated with the conference including "food, refreshments, entertainment, instruction and materials furnished to all attendees." It does not include expenses for transportation and lodging as well as entertainment that is "collateral to the event" or meals taken other than in a group setting. The exclusions should not be offered so frequently they represent "an improper purpose."

6. Other areas. For example, transportation costs (including local travel) offered to a government official can be tricky. Generally it depends on the purpose of the transportation where if it is offered by the contractor in connection with the official's duties (e.g. travel between two official work sites) it is deemed a gift to the agency and hence permissible while if it is for the "personal benefit" of the official (e.g. shuttle bus as part of his daily commute) it is an impermissible gift unless one of the exceptions above apply (e.g. if the shuttle ride was valued at less than $20). Another example is that gifts that are provided indirectly such as (1) those given to a family member with the official's knowledge or (2) a charity that evades funneling gifts directly. The rule of thumb here is if a gift may not be given directly to an official it may not be offered to or through another person or entity. Finally, contractors should be aware that they may face severe consequences if they violate gift restrictions to induce a government official including suspension or debarment actions or even worse consequences if they are given in an attempt to obtain a contract or favorable treatment to influence government officials.

- **State and Local Ethics Restriction**

Though federal rules can be difficult they can nonetheless be identified on user friendly websites while tracking down the vast work of state and local ethics rules can be a huge task. Though no single article can summarize the gift and hospitality rules of all 50 states and thousands of local agencies, the article does provide a few useful examples that appear to be common in most locales. Some states maintain "zero tolerance" ("no cup of coffee" states) such as New Jersey where "no state officer or employee…shall accept any gift, favor, service or other thing of value" except something of trivial value or offered to the general public under the same terms and conditions. At the other end of the spectrum are states that place no monetary restriction of giving gifts or hospitality to government officials where in South Dakota the only restriction is to prohibit giving to improperly influence an official action, making gift giving virtually limitless. Some states have had similar permissive gift giving where they are now tightening rules such as Virginia where there is a recent executive order to cap gifts at $100 though there is still no cap on cumulative value. Assuming a contractor can locate relevant state gift restrictions it must also consider more stringent rules applicable to specific agencies or localities.

Foreign Ethics Restrictions

Contractors doing business with governments outside the US may have the most difficult task locating gift and hospitality prohibitions where they often must hire local help to wade through the requirements. Many restrictions in other countries are notably less stringent than those in the US where because the foreign laws are comparatively newer, they are not well developed or well enforced. A few examples follow.

US Foreign Corrupt Practices Act

Generally, the FCPA prohibits the bribery of foreign government officials and requires covered persons and entities to maintain accurate books and records and an adequate system of internal accounting controls. The anti-bribery and accounting provisions are intended to work in tandem where companies are to be prevented from hiding bribes or other improper transactions in off-book accounts or slush funds but also the government may prosecute companies for violating accounting provisions even in the absence of a separate anti-bribery violation. Key provisions include:

1. FCPA is famous for its broad jurisdiction where much to the dismay of non-US companies they have found themselves ensnared by its provisions. The FCPA applies to companies and individuals based either in the country where the improper activity occurred (territorial jurisdiction) or the origins of the companies that committed the act (nationality jurisdiction). Territorial jurisdiction covers persons or companies committing an act within the US "in furtherance" of a corrupt payment or offer of payment using US mails or other means of interstate commerce. Since 1998, the "in furtherance" has been expanded to apply to foreign companies or persons covering any act taken within the US that furthers improper payments. Nationality jurisdiction is applicable to domestic concerns and US issuers which may be triggered by an act that takes place entirely outside the US, regardless of use of US mails.

2. The anti-bribery prohibitions of the FCPA cover "offering to pay, paying, promising to pay or authorizing the payment of money or anything of value to a foreign official in order to influence any act or decision of the foreign official in their capacity" to secure improper advantage. The term "anything of value" is interpreted very broadly which depends on the subjective value attached by the foreign recipient where there is no minimal dollar threshold. Equally important, the requirement of a thing of value must be provided with "corrupt intent" – requiring the gift be made to secure an improper advantage. There must also be a "business purpose" to the payment where bribing a government official to obtain a contract has been broadened to cover such "business purposes" as avoiding customs duties, licensing, zoning approvals, avoiding inspections or reducing tax liabilities.

3. The FCPA's knowledge standard is incredibly broad where it is designed to ensure companies do not hide behind agency or other third parties to avoid liability. Given this liability companies must be careful in their selection and oversight of agents or intermediaries hired to assist since the vast majority of FCPA cases have been a result of activities of third parties.

4. The FCPA does provide one limited exception to the anti-bribery prohibitions as well as an affirmative defense. The exception applies when the payment is for the purpose to "expedite or to secure performance of a routine governmental action" where the payments are used to expedite "non-discretionary, ministerial activities performed by mid-or low level foreign functionaries." However, this exception has become murky and is often not an exception when the foreign country does not exempt it. As for defenses, the FCPA does permit companies to pay a foreign official's "reasonable and bona fide" expenses as long as they are directly related to the promotion or demonstration of a product or to the performance of a government contract. Also, under the books and records provisions of the FCPA all gifts must be properly and accurately accounted for.

5. Over the years the Department of Justice and SEC have issued guidance. First, companies are "not to sweat the small stuff." For example, the guidance has made clear that modest meals and hospitality, reasonable cab fares and even company promotional items (usually with logos) are unlikely to improperly influence a foreign official and absent more items enforcement is unlikely.

6. Consequences of violating FCPA can be staggering resulting in hundreds of millions of dollars in fines and penalties as well as millions for internal investigations once violations are brought to light. In addition, suspensions and debarments, loss of licenses or clearances, inability to receive loans, loss of commercial business and severe reputational damages are also common consequences.

7. As a result of decades of long efforts by the US to convince other countries to enact anti-bribery prohibitions similar to the FCPA, contractors conducting business outside the US are likely to find themselves within jurisdictional reach of criminal anti-bribery laws of other countries.

Compliance

The problems of complicated and difficult to find laws and rules both domestically and internationally is exacerbated for contractors by a multitude of different rules in a particular jurisdiction. They are faced with the question of how do they ensure compliance with the law when the same activity of giving gifts

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and hospitality is subject to dozens (maybe even hundreds) of different laws and standards with varying interpretations. A vigorous compliance program is needed. Though too detailed to summarize here, a few words might be helpful.

- **Written Guidance**

Many jurisdictions have developed guidance. For example, the DOJ and SEC has "A Resource Guide to the US Foreign Corrupt Practices Act" that outlines the "Hallmarks of an Effective Compliance Program." Many other jurisdictions also have written guidelines.

- **Policies and Procedures**

Written policies and procedures are highly advised. The common format of Gift and Hospitality Policies and Procedures might include: (1) Defining the Purpose, Scope and Relevant Terminology (e.g. who is covered, limited to government officials versus all private parties) (2) General Policies and Procedures (e.g. a brief statement saying the company competes solely on the merits of its products and services) (3) Prohibited Gifts and Hospitality (e.g. cash, cash equivalents, per diem payments, loans, etc.) (4) monetary caps (e.g. determine if any dollar cap should be imposed, consistent with the 20/50 rule) (5) Government Officials vs Private Parties (e.g. separate policies may be desirable for each group (6) Spouses, Relatives and Friends (e.g. generally prohibited) (7) Personal Funds (e.g. can't use personal funds of covered individuals (8) Travel and Hospitality Expenditures of Government Officials (e.g. detailed provisions) (9) Acceptance of Gifts (e.g. compliance with Anti-kickback Act, monetary thresholds)

- **Internal Controls**

The level of controls will likely vary with the vulnerability of the company, size and desire of how dedicated corporate funds should be used to address the compliance functions. Examples of controls might include (1) Gift & Hospitality Request Form (e.g. as part of a detailed approval process) (2) Approval Authority (e.g. designating individuals or positions that must approve) (3) Procedures to Address Red Flags (4) Itemized Receipts Required and Information Needed) (5) Proper Recording in Books and Records (6) Gift and Hospitality Database (7) Routine Audits and (8) Training (e.g. annual anti-corruption and compliance training to covered individuals).

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