GCA REPORT

(A publication of Government Contract Associates)

July - August 2007 Vol 13, No. 4

NEW DEVELOPMENTS

CAS Board Addresses Several Issues

The newly convened Cost Accounting Standards Board has finalized a couple of rules, proposed another one and issued a staff discussion paper on a hot new issue.

1. *Contracts For Commercial Items*. Effective July 3, a new rule exempts time and material and labor-hour contracts for commercial items from coverage under CAS. The final rule, which adopts a proposed rule issued Jan. 4, 2006 will apply to "firm fixed price, fixed-price with economic price adjustments (provided the price adjustment is not based on actual cost incurred), time and material and labor hour contracts and subcontracts for the acquisition of commercial items." The Board pointed out that effective Feb. 12 the FAR was amended to add T&M/LH contracts as an acceptable contract type for federal agencies acquiring commercial items when the contract is awarded competitively and includes a ceiling price that the contractor exceeds at its own risk (*Fed. Reg. 36367*).

2. *CAS Applicability Threshold*. Effective June 14 the CAS Board increased the CAS applicability threshold to $650,000 which makes it consistent with the threshold required for compliance with the Truth in Negotiations Act (TINA) that addresses defective pricing. On Dec 15, 2005 the CAS Board proposed a rule that made a variety of inflation adjustments according to the Defense Authorization Act of 2005 (e.g. thresholds for applicability to a business unit from $7.5 million to $8.5 million, full coverage from $50 million to $56.5 million, separate segment disclosure statement from $10 million to $11.5 million) but upon further review, the Board concluded the CAS thresholds were not covered by the Act because they are not "acquisition related." Accordingly, the final rule was limited to the sole adjustment to TINA because such consistency is required by statute (*Fed. Reg. 35397*).

3. *CAS Clause for Foreign Concerns*. The CAS Board has proposed use of a new clause for inclusion in CAS-covered contracts and subcontracts awarded to foreign concerns. Such firms are covered only by CAS 401 and 402, which the new clause will reflect. The clause will be identical to the one applicable to modified CAS covered contracts except rather than the four standards that apply to them (401, 402, 405 and 406), the new clause will refer only to CAS 401 and 402 (*Fed. Reg. 32829*).

4. *Harmonization of the Pension Protection Act and CAS 412 and 413*. The CAS Board July 3 published its long awaited Staff Discussion Paper on harmonizing CAS 412 and 413 with the Pension Protection Act of 2006. The paper, considered to be the first of many steps needed to change a standard, results from the PPA amending the minimum funding requirements and tax-deductibility of pension plans under the Employee Retirement Income Security Act of 1974. The drafters of the PPA recognized that the changes to ERISA, which were made to better protect the security of benefits, would likely result in increasing the funding employers needed to contribute to their pension plans and the increase would likely entail more funding than the methods prescribed by CAS 412 and 413. To eliminate this disconnect, the PPA required the CAS Board to "harmonize" CAS 412 and 413 with the amended ERISA minimum funding requirements not later than Jan. 1, 2010. Though the PPA requires this harmonization only for "eligible contractors" (i.e. those whose CAS and FAR-covered contracts total at least $5 billion) the Board determined the scope of its paper should include all CAS-covered contracts. The Staff Discussion paper posits a series of questions intended to probe whether and if so how CAS should be revised to address the PPA minimum required contributions. (*Editor's Note. The proposal is already generating considerable comments from all contracting circles.*)

Final Rule Issued on Recertifying Small Business Status

The FAR Council issued a final rule July 5 in the form of FAC 2005-18 that makes permanent an interim rule issued by the Small Business Administration requiring small businesses holding long term federal contracts to re-certify their size before the beginning of the sixth contract year and before any options are exercised extending the contract beyond that period as well as following a merger or acquisition or a contract novation. The rule was thought to be necessary because up to now federal agencies have been counting all contracts originally awarded to small businesses as small business contracts for up to 20 years even if they grew to be large or were acquired by large businesses. Under the new rule if a company is no longer small the contract continues but the government can no longer count it as a small business contract and hence will not be counted as such to meet the requirement that at least 23 percent of federal contracts go to small businesses.

A new clause FAR 52.219-28 will be inserted in all new contracts awarded after June 30 and added to older contracts that are longer than five years in duration. The new clause will require that a contractor "rerepresent" its size status within 30 days after execution of a novation agreement, merger or acquisition. For long-term contracts the contractor must rerepresent its size within 60-120 days prior to the end of the fifth year of the contract and within 60-120 days prior to the exercise date specified in the contract for any option thereafter. The clause also requires the size standard be that corresponding to the North American Industry Classification System Code in effect at the time of rerepresentation and that contractors validate or update their small business status in the Online Representations and Certification Applications as well as in the Central Contractor Registration and they notify their COs they have done so (*Fed. Reg. 36852*).

Growing Opposition to 3 Percent Withhold

A coalition of industry groups are trying to kill a legislative requirement that federal, state and local government withhold 3 percent from all payments for goods and services by 2011. The issue is gaining notoriety among certain members of Congress where house and senate bills calling for repeal of the requirement have recently been introduced. Opponents of the mandate are arguing (1) it is complex to implement and will increase costs to both business and the government (2) the tax represents "substantial" costs to businesses where they often reap less than 3 percent profit on the contracts (3) the withhold represents an "interest free loan" to the government and (4) the withhold will impede particularly small business cash flow and significantly reduce funds that could be used for reinvestment in the business.

Industry Group Takes Issue with Certain Tax Certification Proposals

The Council of Defense and Space Industries Association is urging changes to a proposed rule to expand certifications by federal contractors as to their compliance with tax laws that includes an exemption be made on purchases of commercial item. In addition to the current requirement to certify they have not been convicted of, had a civil judgment rendered against them or been indicted criminally or civilly charged with commission of tax evasion in the last three years, the new proposed rule would further require certification whether an offeror has, within the last three years, (1) been convicted or had a civil judgment against it for violating any tax laws or failing to pay any tax (2) been notified of any delinquent taxes for which liability remains to be satisfied or (3) received a notice of a tax lien against it for which either liability remains unsatisfied or the lien has not been released. The rule writers say the additional certifications are needed for the government to make an informed responsibility determination.

In seeking an exemption for purchases of commercial items, CODSIA argues the FAR Council has no authority to impose the certification requirement on commercial item purchases since the Office of Federal Procurement Policy Act prohibits imposing any certification for a commercial item that is not required by a statute or executive order, which applies here. CODSIA also recommends the proposed rule should be limited to federal income and payroll taxes and there should be a $25,000 minimum threshold to trigger the reporting requirements. The group also states the proposed rule is "too broad" where it is quite common for tax delinquencies to be mistakenly asserted or tax liens are frequently imposed and contested.

DCAA Issues Guidance on New T&M/LH Rules; Conducting Incurred Cost Audits of Nonmajors

DCAA July 31 issued guidance to its auditors on treatment of subcontract and intercompany labor effort on time and material and labor hour contracts. The guidance is based on new rules that address when subcontract or intercompany costs can reflect billing rates contained in the prime contract and when they must be treated as pass through other direct costs (*see the last issue of the GCA DIGEST for a detailed report on the new rules*). The guidance provides instructions on how to review the costs during incurred costs, contract billing and forward pricing reviews. During the first two types of reviews, auditors are told to examine contract briefs to ascertain applicable contract clauses and develop appropriate audit procedures to ensure claimed costs are in compliance with contract terms. Audit procedures should include verifying claimed/ billed labor rates to the contract rates by labor category and to audit claimed/billed material costs for allowability, allocability and reasonableness. Audit of labor hours should include selectively verifying billed/ claimed prime, subcontract and intercompany labor hours to applicable timekeeping records and invoices and identifying the hours worked by labor category. Auditors are told to also ensure the claimed/billed direct labor efforts meets the labor category qualifications specified in the contract. For non-DOD competitively awarded contracts, the guidance reminds auditors the contract may include blended rates and in these cases, the auditor needs to reconcile claimed hours to supporting contractor documentation and the labor records should include evidence of prime, subcontractor and or inter-company hours worked by labor category.

Under forward pricing audits, auditors are to selectively verify the subcontract and inter-company direct labor is proposed and supported using separate hourly labor rates and are not included as part of the prime contractor's labor rates. The subcontract labor rates that are separately proposed by the prime contract should include the prime's subcontract costs and applied indirect costs and profit. In addition, auditors are told to make sure inter-company labor rates do not include profit of the transferring organization (an exception applies to certain commercial items per FAR 16.601) but may include profit for prime contractors (*07-PPD-023(R*).

Effective July 18, DCAA has eliminated the two incurred cost audit programs applicable to contractors with less than $15 million of auditable dollar value (ADV) and between $15 and $90 million of ADV. In its place it has issued one Nonmajor Incurred Cost Audit Program intended to provide audit guidance on incurred cost proposals for all nonmajor contractors with ADV less than $90 M. (*See feature article below on the new audit program.)*

DOD Issues Guidance on Data Needed to Ensure Reasonable Prices

As part of its continuing effort to ensure contracting officers have sufficient information to support a determination that contract prices are fair and reasonable, the Defense Department issued a June 8 memo to the military services and defense agencies that revises its internal guidance to the Procedures, Guidance and Instruction (PGI) manual. The Director of Defense Procurement and Acquisition Policy Shay Assad explained the revised PGI coverage (1) emphasizes the requirement for COs to obtain cost or pricing data when a procurement is covered by the Truth in Negotiations Act (TINA) – currently $650,000 and none of the exemptions apply (2) stresses COs must obtain "whatever information or data is necessary to determine a fair and reasonable price that may include cost data normally considered cost or pricing data" (3) includes procedures and guidance pertaining to TINA waivers and (4) includes procedures and guidance for determining when to perform price, cost and technical analysis. The revised PGI addresses pricing policy, obtaining cost or pricing data and techniques for proposal analysis to ensure price reasonableness. (*Editor's Note. Considering the importance of these revisions, we plan to explore them in greater depth in the upcoming GCA DIGEST.*)

Industry Groups Ask for Rewrite of Pass-Through Rule

A variety of industry groups are asking for a substantial rewrite of an interim rule recently issued by the Defense Department intending to protect the government against paying excessive pass through charges on subcontract work. The rule follows allegations of profiteering from Hurricane Katrina and assertions that pass through charges under DOD time and material contracts are too high. The 2007 defense authorization bill directed DOD to issue regulations ensuring pass through charges (defined as overhead, profit or other costs added to the direct subcontract costs) were not excessive in relation to the cost of work performed by relevant contractors and subcontractors. The DOD rule includes a solicitation provision and a contract clause that prohibits "excess" pass through charges on fixed-price negotiated contracts (does not apply to fixed price contracts awarded on the basis of price competition or for commercial items) and requires offerors and contractors to identify the percentage of work that will be subcontracted. A 70 percent figure triggers the requirement for submission of further information such as indirect costs, profit and the value they add to the subcontracted work.

Though they emphasized different elements of the rule, all groups were unanimous in saying the 70 percent figure was not required from the Act and no rationale has been provided for its use. They also unanimously asserted that whether the pass through charges are excessive should be a one-time determination made by the contracting officer at the time of contract award, opposing any after-the-fact "look back determinations" by the CO. Such look back provisions, most groups argued, would allow for continued post award audits with potential disallowances throughout the life of a contract and would unfairly give one party – the government – a unilateral chance to change a mutually agreed to price. Rather the rule should be written "solely as a direction" to COs to deal with issues related to fairness and reasonableness and whether contractors and or subcontractors "add value" and should not focus on such items as contractor overhead rates, allocation of costs and accounting practices.

DOE Withdraws Its Controversial Policy Limiting Pension and Health Benefit Costs

Following extensive challenges from industry and certain congressional representatives, the Department of Energy has decided June 22 it will not reissue its controversial policy affecting employee pension and medical benefit costs for its maintenance and operations contractors. The abandoned policy change, announced April 2006 and suspended in June 2006, would have continued reimbursing M&O contractor employees' costs for pension and medical plans under their contract provisions but would have required market-based pension plans (i.e. 401K plans only) and medical benefits for new employees. The April 2006 announcement generated significant opposition and was suspended in June to enable stakeholders to put forth more comments and more discussions. In announcing its decision to not reissue the policy, DOE said it will continue to discuss "benefit challenges with its stakeholders."

FAR Final Rule Providing Website for DOL Wage Determinations

The FAR Council agreed to adopt an earlier interim rule as final that would amend FAR Part 22 to allow the Department of Labor Web site at www.wdol.gov as the source for federal agencies to obtain DOL wage determinations for service contracts subject to the Service Contract Act and construction contracts subject to the Davis Bacon Act.

The final rule eliminates the requirement of contracting officers to submit a copy of collective bargaining agreements to DOL to obtain a wage determination unless directed by DOL to do so. The new rule also incorporates new geographical jurisdictions for DOL's Wage and Hour Regional Offices and eliminates references to the Government Printing Office publication of general wage determinations (*Fed. Reg. 13585*).

CASES/DECISIONS

Anticipatory Repudiation Requires Absolute Refusal to Perform

(*Editor's Note. The following illustrates how far a contractor can go without the government being able to assert it is refusing to perform.*)

During performance of their roofing contract, numerous issues arose related to scope of work, structural issues, payment for past work and negotiations of reasonable extension whereupon the government suspended the contract. After work was suspended, the government asked Randall if it intended to meet their outstanding contract obligations where Randall responded to the CO in an email saying it is our "intention, upon satisfactory resolution of a number of outstanding issues, to complete performance of this suspended project" where it listed the issues it believed required resolution. On the same day, the CO terminated the contract for default claiming "anticipatory repudiation", characterizing Randall as indicating it would not complete performance unless certain conditions were satisfied "in advance of initiation of such performance." The Board disagreed citing prior cases that held anticipatory repudiation of a contract requires an absolute refusal to perform which was not present here. The Board concluded Randal was not issuing ultimatums but rather was attempting to work with the government to resolve problems (*David/Randall Assocs., vs.` Dept. of Interior, CBCA, No. 162*).

Legal Costs Not Allocable to Government Work; Mixed Bag on Penalty Assessments

FMI defended itself against a criminal indictment for violating export control laws by exporting certain goods to the Indian government without required license fees. Regardless of whether FMI was found guilty the government questioned these costs on the grounds they are not allocable to its government work because they were identified specifically with its commercial contracts. The government also disallowed costs related to leasing an aircraft, amortization of certain patent costs and certain sales commissions and recreation costs and assessed penalties on the unallowable costs. FMI asserted the legal expenses were allocable to its government contracts under *Boeing North American Inc.* because they were necessary to the overall operation of the business. They also asserted the other unallowable costs were not subject to penalty assessments because they were not "expressly unallowable." With respect to the legal costs, the Board sided with the government stating the contractor did not establish the necessity of the costs being incurred for the overall operation of the business because "there is no nexus between the costs it incurred in the proceeding and …any federal government contract." It sided with the contractor on the aircraft and amortization costs stating though they were properly disallowed they were not expressly unallowable since had they been *properly* supported they would have been allowed while it agreed that the sales commissions and recreation costs were expressly unallowable in accordance with specific FAR Part 31 cost principles (*Fiber Material Inc., ASBCA No. 53616*).

Underbid of CPAF Contract is not an FCA Violation

(*Editor's Note. The following should address common concerns about whether underbidding can constitute potential fraud claims.*)

In 1993 Lockheed bid was awarded a NASA cost plus award fee research and development contract. Mayfield, a Lockheed specialist responsible for preparing monthly and quarterly R&D contract cost estimates on 533 forms, was concerned the projections on the 533s underestimated the actual costs (overruns were 13 and 18% in the first two evaluation periods) and though Lockheed and NASA took action to remedy the projections, he continued to complain about the 533s after which he was fired. After his failed unlawful discharge action he then filed a qui tam suit action against Lockheed alleging violation of the False Claims Act asserting Lockheed intentionally underbid the contract and submitted false 533s.

The Court found no evidence suggesting Lockheed's proposal was fraudulent and found the cost overruns were largely attributable to NASA who made alterations in the R&D contract. Under prior case law, Mayfield would have had to prove Lockheed did not intend to perform according to the terms of its proposal and that it obtained contract payments to which it was not entitled to which Mayfield was unable to prove. The Court pointed out that Mayfield's inference that Lockheed underbid the contract while intending to charge its real costs from the beginning "ignores the realities" of CPAF-type contracts where its central purpose is to afford the government the flexibility to purchase labor in an unpredictable environment. The Court concluded a contract underbid is not a false claim. The Court also dismissed Mayfield's assertion the 533 forms that underestimated actual costs were fraudulent explaining they were "immaterial" because they were only cost projections that did not independently entitle Lockheed to award payments nor did they either actually or potentially affect NASA's decision to pay fees (*US ex rel. Laird v Lockheed Martin, 2007 WL 1930743*).

Warranty Obligations Survive Termination

IDP won an 8(a) contract to provide computers to the Air Force and when it was purchased by a non-8(a) firm the government had to terminate the 8(a) contract. The termination letter stated the termination would not "affect the rights and liabilities of the parties…concerning defects, guarantees or warranties related to any article furnished…under the contract." With the Air Force purchasing $35 million worth of equipment from IDP it continued to demand warranty and upgrade services with IDP attempting to negotiate an additional contract to cover its costs. A lower court ruled against IDP's claim for termination costs but ruled the termination ended IDP's obligation to provide warranty and upgrade services because the company was required to cease performance. A higher court reversed the lower court's decision about IDP's continuing obligation while upholding the decision refusing termination costs. The Court stated the termination letter "closely tracks" FAR 49.603-1(b)(7) that provides similar obligations to honor the liabilities related to warranties after a termination. The Court agreed with the Air Force that by terms of the contract, the agency already paid for the costs of the contested services since they were incorporated into the price of the equipment and hence was not entitled to additional termination costs (*Int'l Data Prods. Corp. v US 2007 WL 1827842*).

Air Force Not Obliged to Hold Clarifications with Both Offerors

(*Editor's Note. The following sheds light on the continuing efforts to distinguish between clarifications and discussions.*)

Incumbent DI and MI were the only bidders to respond to an aircraft maintenance services solicitation where the negotiated award would be based on a best value determination. The Air Force stated it intended to make the award without discussions though it reserved the right to hold them if needed. During the evaluation phase the Air Force sent six evaluation notices (ENs) to MI marked "clarifications" that related to its capabilities (e.g. cost savings related to engine parts) and to its price proposal (e.g. provide most recent available financial statements). After MI was awarded the contract DI protested asserting the ENs between MI and the Air Force were discussions, not clarifications, that must be held with all offerors in the competitive range. The Court disagreed, stating the ENs were clarifications. The Court cited *Info. Tech. & Applications Corp* that held clarifications (FAR 15.306(a)) were deemed to be "limited exchanges" that may occur when discussions are not contemplated to give offerors the opportunity to "clarify certain aspects of proposals" while discussions (FAR 15.306(b)) were exchanges undertaken with the intent to allow the offeror to revise its proposal. In rejecting DI's argument that providing additional information constituted discussions rather than clarifications the Court held any meaningful clarification requires providing information. The decision stated the Court must give deference to the agency's view that an EN was a clarification as long as the view is permissible and reasonable which is the case here. In all of its ENs the court found no evidence that the requested information allowed MI to revise its proposal (*Dyncorp Intl. LCC v. US, Fed. Cl. No. 07-84*).

SMALL/NEW CONTRACTORS

New DCAA Guidance on Auditing Nonmajors' Incurred Costs Proposals

(*Editor's Note. We thought the new change to the audit program we reported above would provide a timely opportunity to review the audit steps nonmajor contractors can expect from audits of their incurred cost proposals. The guidance should provide useful information for newer contractors as well as a good review and checklist for all contractors to anticipate areas of audit scrutiny. In reviewing the guidance, even we learned of new audit steps e.g. profit margins on T&M contracts, a bit less focus on internal controls, looking for income and credit items that should be reflected in the proposal.*)

The Defense Contract Audit Agency issued a new audit program, effective July 18, to be used in audits of incurred costs proposals of nonmajor contractors.
The major preliminary steps to be taken are:

1. Verify the contractor's calculation of flexibly priced contract percentages against schedule of direct costs by contract.
2. Identify non-DOD contracts subject to audit and make sure there is approval from the non-DOD customer to bill for the audit. If there is no approval, the audit scope and auditable dollars should be reduced.
3. If there is significant subcontract effort, determine if a subcontract audit is needed.
4. Review the files for prior audits to identify adequacy of the accounting system, potential audit leads or key audit findings. Also consider the impact of floorchecks and other observations made.
5. Determine if the submission includes significant corporate allocations, shared services, auditable subcontracts or intracompany orders that may require an assist audit.
6. For ADV less than $15 million, document the understanding of the contractor's internal control structure and assessment of control risk. For ADV greater than $15 but less than $90 million, document understanding of the contractor's internal controls by completing the Internal Control Questionnaire (ICQ). Consider risk factors identified in the ICQ e.g. recent business combinations, defined benefit pension plans. (*Editor's Note. This area of documenting adequacy of internal controls represents one of the greatest differences between auditing nonmajors and major.*)
7. Document the audit work to be performed that will support reliance on computer-based data. For ADV less than $15 million, tracing computerized transaction amounts to source documents is sufficient. If sufficient work is not to be performed, the audit report should be qualified.
8. Review the contractor's prepared brief or brief significant contract terms that affect allowability of costs.
9. Compare the submitted expense pool accounts and bases with prior year's amount to identify significant changes from year to year. Also identify sensitive accounts (e.g. lobbying, consulting).
10. For ADV greater than $15 million, perform a profit margin test on T&M/Labor Hour contracts by comparing total contract billed amounts to total actual contract costs reported.
11. Consider fraud risk indicators that may be relevant (*its not a bad idea to become familiar with this section of the DCAA Contract Audit Manual, Figure 4-7-3*).
12. Conduct an entrance conference.

Types of reconciliations and analysis of costs to be expected are:

1. Reconcile the costs claimed by major cost element to the contractor's job cost ledger and other accounting system records. Follow up on major differences.
2. Trace the amounts of base and pool costs to the general ledger.
3. Test the contractor's reconciliation of booked to billed costs.

4. Evaluate adjusting and closing journal entries to identify unusual or sensitive entries that may affect direct or indirect costs.

5. Identify and analyze the universe of general ledger and trial balance income and credit adjustments to find income or credits to which the government may be entitled to.

Major cost elements to be reviewed are: (*Though direct costs were usually not audited in the past, we are seeing more and more auditors reviewing these costs.*)

- **Labor**

1. Verify total labor costs have been incurred and paid by testing the contractor's reconciliation of IRS Form 941 payroll totals with totals in related labor cost distribution records.

2. Select a sample of labor transactions. If a floorcheck has not been conducted during the year(s) under audit, conduct at least an abbreviated one.

3. Select a sample of T&M or Labor Hour contracts, if they are significant, and test if claimed hours, rates and employee qualifications comply with contract provisions.

- **Direct Material**

1. Select a sample of material transactions for testing if material costs are significant. If a material observation has not been performed in last year(s) conduct a test (e.g. tracing material costs through the accounting system to source documents).

- **Subcontracts and Intracompany Costs**

Audit effort will depend on whether there were assist audits and the significance of the costs.

1. If assist audits were received compare allowable costs in the reports to amounts claimed and review significant differences.

2. Select a sample of remaining costs for testing.

- **Other Direct Costs**

Based on risk assessment, select a sample of ODCs for transaction testing.

- **Indirect Expenses and Cost of Money**

1. Verify executive compensation in excess of applicable ceiling amounts have been excluded. (*Editor's Note. Since this is the first item in the audit program, it is not surprising that survey results show executive compensation to be the number one topic of audit scrutiny.*)

2. Review contractor's IRS Form 941 for year(s) under audit to obtain employee taxes withheld and employer matching payroll taxes to determine total payroll taxes owed were paid.

3. Select a sample of indirect cost transactions based upon risk assessment.

4. Evaluate voluntary deletions and questioned costs for directly associated costs that need to be excluded.

5. Evaluate the contractor's indirect cost allocation base(s) and verify the base properly reflect the appropriate cost accounting period and that the indirect costs allocated to final cost objectives are commensurate with "benefits received." The program alludes to DCAM 6-606 as a reference for this last item.

6. Cost of money. For ADV greater than $15 million, verify the amounts on the CASB-CFM form reconciles with balance sheet and other source documents.

Concluding Steps are:

1. Conduct an exit conference and provide audit results to the contractor. The contractor's reaction should be obtained for inclusion in the final audit report. (*Editor's Note. We cannot stress enough the importance of both a revealing exit conference that identifies all questioned costs and any perceived weaknesses in accounting practices and an examination of the draft audit report. You may need to explicitly request the draft report but it is critical to review because it is very common to have "surprises" surfaced in the report that were not discussed earlier. If you want to challenge the audit finding, it is important to have well reasoned written comments at this stage – if well presented we have frequently seen questioned costs and adverse opinions withdrawn at this stage in the process, eliminating the need to either go up the DCAA chain or confer with the ACO not to mention appeals later.*)

2. If the contractor agrees with the audit results, prepare a rate agreement letter and prepare (or have the contractor prepare) the cumulative allowable cost worksheet.

3. If the contractor does not agree with the audit results and the rates are audit determined, prepare a Form 1 in accordance with DCAM 6-900. (*Editor's Note. Since its highly desirable to avoid issuance of a Form 1, you can either eliminate or at least delay it by either appealing up the DCAA chain or arranging discussion(s) with the ACO. At that level, it is quite common to arrive at mutually agreeable compromises that can prevent its issuance. We recommend using our free "Ask the Experts" service to our subscribers to discuss the validity of DCAA's position and what alternatives are available to avert issuance of the Form 1.*)

GCA REPORT
P.O. Box 1235
Alamo, CA 94507

FIRST CLASS
U.S. Postage
PAID
CONCORD, CA
PERMIT NO 249

QUESTIONS AND ANSWERS

Q. We use a fringe benefit and an indirect labor rate but we are being told by our auditor that we must have three rates – fringe benefit, overhead and G&A. Since we have used this rate structure for a long time we would like not to have to change. What do you think?

A. Though I would like to know why he/she is saying you must have three rates, in general I would strongly disagree with the auditor's position. It is the responsibility of the contractor, not the auditor or government, to decide what rates it will use and how to apply those rates and as long as the structure is reasonable and does not result in significantly "inequitable" results you have every right to use them even if the auditor may have a preference for some other structure. In fact, a variety of structures and number of rates are common and generally considered acceptable – one indirect rate (common with smaller firms), your method of fringe and indirect rates, one overhead and G&A rate (where fringe costs are assigned to either overhead and G&A pools) and the three rates the auditor is insisting on.

Q. We recently won a commercial contract and are faced with a puzzle involving how we bill our travel. In the past our practice of billing all contracts for an employee's travel based on the percentage of labor hours they worked during the travel has been accepted by DCAA and our customers. Our new commercial customer is asking us to bill them a Per Diem for international travel (but not for domestic travel). We have heard that many companies simply charge all travel expenses to the customer who "caused" the travel to happen and are wondering whether to switch. Two questions: Would the switch from our current approach of travel apportionment to the method of billing only one contract be challenged? Would the change from charging actual costs to per diem amounts be considered a "materially significant" change to our accounting practice?

A. An employee takes a trip and visits two customers or works on two projects - now the employee assigns travel costs on the basis of time spent and you would change this to a charge to only one customer. In the light of your previous, accepted practices, I think the odds of being challenged are pretty good. It seems to me the government would question allocation of total travel costs to one contract (say, a government cost type contract) where some travel costs could but are not allocated to say a commercial contract.

As for being reimbursed on a per diem basis versus actual costs, that should not affect how you charge the actual cost. You will charge the cost for accounting purposes the same – the actual incurred cost of the travel. If you make money (per diem is higher than cost) or lose money, the amount of the cost (not the amount of revenue received) is the determining factor. The only exception is if any of the travel cost you charge the customer for is originally charged indirect - then you need to credit the pool when you receive revenue associated with the cost charged indirect.