GCA Report

(A publication of Government Contract Associates)

March - April 2008 Vol 14, No. 2

NEW DEVELOPMENTS

OMB Increases Executive Compensation Ceiling

The Office of Management and Budget has set the maximum "benchmark" compensation allowable for contractor executives in Fiscal Year 2008 at $612,196 for all applicable contracts no matter when awarded. The benchmark will apply to contract costs incurred after January 1, 2008 and should be used on all applicable contracts and subcontracts for FY 2003 and beyond until revised by OMB.

The new cap represents a 2 percent increase over the FY 2007 amount of $597,912. Contractors can, of course, pay their executives more than $612,196 but the additional compensation will not be allowable under their federal contracts. The cap covered compensation includes the total amounts of salary, bonuses, deferred compensation and employer contributions to defined contribution pension plans. The cap covered compensation does not apply to fringe benefits like health benefits and employer contributions to defined benefit plans where if they are reasonable they are allowed irrespective of the cap. The cap covers the five senior managers of a company as well as subsidiary business segments directly reporting to the corporate headquarters. The benchmark compensation amount reflects the median amount of compensation for senior executives of all surveyed corporations for the most recent year data is available. Since the benchmarked companies represent large publicly traded companies with revenue exceeding $50 million, lower caps are likely to apply to smaller companies.

DCAA Says Executive Comp Cap to Be Applied After Deducting Unallowables

The Defense Contract Audit Agency has issued guidance stating the Federal Acquisition Regulation cap on unallowable compensation on federal contracts should be applied only after the executive's compensation has been adjusted to account for unallowable cost elements. Executives subject to the compensation cap at FAR 31.205-6(p) – contractor's five most highly compensated executives (or those five executives at each business unit) – may sometime perform activities or be compensated amounts which are unallowable. For example, unallowable activities for which related compensation needs to be adjusted might be for significant lobbying, advertising, reorganization or merger activities which must be deducted as well as unallowable compensation amounts such as stock appreciation rights or changes in the price of corporate securities.

In determining whether the senior level executives' compensation are below the cap – currently $612,196 as discussed above – auditors are told to make sure that all unallowable cost elements are first deducted from the salary being benchmarked. The guidance reminds auditors that not all compensation cost elements are subject to the compensation cap but that under FAR 31.205-6(p)(2)(i) only wages, salary, bonuses, deferred compensation and employer contributions to defined contribution pension plans are. Other compensation elements should be evaluated using applicable FAR principles (08-PAC-010(R). (*Editor's Note. Though the audit guidance explicitly addresses OMB caps established for larger companies, informal inquiries we made to DCAA indicate the provisions of the guidance will apply equally to reviews of smaller companies where lower caps will apply.*)

Grant Thorton Survey Issued

Grant Thorton has issued its new 2006 survey of federal contractors. Though we intend to discuss the finding of this important survey in depth in the next issue of the GCA DIGEST some of the findings include:

1. Over 50 percent of surveyed companies said their revenue increased in 2006 and 72 percent said they expect growth in the future.
2. 40 percent of respondents' revenue came from cost reimbursable contracts.
3. Dispelling notions of high gross profits, 42 percent of responding companies reported profit rates of 0 to 5 percent while 76 percent reported profit rates of 0 to 10 percent. Only 12 percent reported profit rates over 10 percent.
4. Executive compensation continues to be the most frequently challenged cost by DCAA.

5. 66 percent reported their procedures for identifying out of scope work are either not effective or only modestly so.

6. Respondents reported a 33 percent win rate from proposals for non-sole source business and the rate jumped to 58 percent when the company established a special business unit or joint venture.

7. 49 percent of respondents own intellectual property where 92 percent reported it was developed either entirely at private expense or a mix of private-government funding. 33 percent of IP owners charge their customers license fees for use of their property.

8. Respondents reported a significant reduction in management and support as a percentage of headcount with the ratio falling to 9.9 percent.

9. 32 percent of the respondents say they do not account for all hours worked.

Army Bars Profit on Some Subcontract Labor

In what appears to be a first time application of a recent rule intending to stop "excessive pass-through charges" on subcontract work, the Army Communications and Electronics Command (CECOM) has invoked a 2007 DOD interim rule as a basis for disallowing prime contractor profit on subcontractor-loaded labor rates under a new program – Rapid Response-Third Generation (R2-3G Program). The solicitation for the program indicated that time-and-materials rates for subcontractor labor will be treated as "material" to be paid as actual costs where prime contractor profit will not be allowed. An influential contractor group, the National Defense Industrial Association, has objected asserting the solicitation is inconsistent with the contract clause covering T&M/Labor Hour contracts (52-232-7, Payments Under T&M/LH Contracts) that provides a clear definition of material and allows prime contractors to include profit on subcontractor labor. CECOM Director Edward Elgard replied that the language of the clause does not mandate that primes receive profit on subcontractor labor and interprets the clause as saying "the hourly rate is the rate prescribed in the contract, which should include subcontractors' hourly labor rates consisting of wages, indirect costs, G&A expenses and profit." Elgard states it will be the practice of the program not to allow prime contractors to include their separate profit rates on top of subcontractor rates which already contain subcontractor profit. Prime contractors will be allowed to bill for their costs of administration and oversight and will be allowed to add profit on those costs.

Following concerns expressed by certain congressional representatives that the government had on T&M contracts paid prime contractors excess profit on subcontracts being managed where the prime provided "no or negligible value," revisions to DFARS 252.215-7003 and 7004 were issued in April 2007. The revisions provided that if an offeror intends to or later decides to subcontract more than 70 percent of its total costs, the government may have audit rights and the government can be permitted to recover excess pass-through charges. The rule excludes fixed price contracts awarded on the basis of adequate price competition. Several industry groups have issued disagreements with the rule stating the 70 percent test is arbitrary and is not based on statute, the government has not provided an adequate rationale for its use and what constitutes excessive pass-through charges ought to be made by the government prior to contract award. DCAA has also issued guidance. Most recently the GAO issued a January 25 report stating contracting officers should take into account "contract risk" (e.g. type of contract, existence of unique circumstances such as urgency) when assessing pass through costs and to document in contract files their assessment of value added by the prime contractor or upper-tier subcontractors with their lower-tier subcontracts.

DCAA Issues Guidance on Reporting Internal Control Deficiencies

(*Editor's Note. The following could have significant impact on auditors' assessments of a contractors' accounting system. Contractors need to be become aware of their potential internal control weaknesses identified below and provide fixes quickly to avoid opinions their accounting system is "inadequate" or even "inadequate in part."*)

The Comptroller General issued in July 2007 Revision of Government Auditing Standards (the so-called "Yellow Book") which was not, surprisingly, influenced by this era of corporate scandals and Sarbanes-Oxley requirements. New audit guidance to DCAA auditors was issued to incorporate new GAGAS definitions and clarify guidelines on reporting internal control deficiencies. When engaged in its audits, auditors are told to report, based on their work performed, "significant deficiencies in internal controls." For government contracts, a significant deficiency is an "internal control deficiency that (1) adversely affects the contractor's ability to initiate, authorize, record, process or report government contract costs in accordance with applicable government contract laws and regulations (2) results in at least a reasonable possibility that unallowable costs will be charged to the government and (3) the potential unallowable costs are not clearly immaterial." Though the first item above would seem to include any problems that might be associated with accurate contract costing, the rest of the guidance goes on to address only deficiencies associated with screening unallowable costs.

All internal control deficiencies that "result in or could result in unallowable costs being charged to the government" are to be reported as "significant deficiencies" and are to be considered as "material weaknesses" unless the dollar value of the potential unallowable cost is clearly immaterial. For those conditions that would not materially impact contract costs but the systems could be enhanced then they should be reported as "Suggestions to Improve the System" and in the audit report they should be referred to as "matters or conditions" not deficiencies. The guidance provides an example of a "Suggestion to Improve the System" where the majority of forward pricing proposals are not submitted electronically so the contractor would be encouraged to submit electronic proposals.

Auditors are reminded that if significant deficiencies or material weaknesses are identified then the opinion of their contractor's accounting system should be either "inadequate in part" or "inadequate." What opinion to issue is considered to be "a matter of auditor judgment." If deficiencies affect "only certain control objectives or parts of the system" the audit opinion should be inadequate in part and the portions of the system that are inadequate should be identified. If the deficiencies affect the entire system the audit report should be "the system is inadequate" even if the deficiencies relate to only certain controls objectives or parts of the system. Two examples given are: if the controls related to labor authorization and approvals are so deficient they result in "or could result in" labor costs being charged to the wrong final cost objectives then the labor system would be inadequate. If there are inadequate controls over work authorizations then the entire system would be impacted even though the deficiencies relate only to one "control objective" (*08-PAS-011(*R).

CAS Board Seeks Input on Thresholds Related to Allocating Home Office Expenses; Continues Exemption For Contracts Outside U.S.

The Cost Accounting Standards Board is considering possible revisions to CAS 403, Allocation of Home Office Expenses to Segments to update operating revenue thresholds that have not changed since they were promulgated in 1972. Over the past two years it has received two proposals to revise the thresholds used in determining whether a contractor must use a three-factor formula to allocate residual home office expenses. One proposal recommended the thresholds be raised 400 percent to reflect the consumer price index (CPI) from 1973 while another proposal suggested that the board obtain actual statistics of various companies and conduct a staff study before updating the thresholds. The CAS Board initiated a case study to determine whether the thresholds need revision. The CAS Board's staff paper commented on the proposals saying basing changes on the CPI would have the advantage of a simple, quick fix and provide a clear objective measure of economic inflation but it might not be good in the light of trends increasing the number of intermediate home offices occurring in many companies. As for the staff study proposal it would have the advantage of understanding the impact of various revisions but would require significant time and effort and still not yield useful data.

The staff discussion paper asked for public input on whether thresholds should be increased and whether the two proposals are sound or other alternatives should be considered. Key questions asked in the paper are: (1) should the operating revenue thresholds be increased and if so why (2) what should be the basis for the revision (e.g. CPI, staff study, other) (3) what type of data is available for the staff study and (4) what extent does the proliferation of intermediate home offices impact any potential change (*Fed. Reg. 8260*).

In a separate move, the CAS Board has decided to discontinue its review of the current CAS exemption for contracts that are executed and performed outside the US. The announcement is based on a Sept 2005 staff discussion paper asking for public comments on whether the exemption should still apply. Three sets of commentators argued the exemptions should remain because (1) Congress did not express an intent for extra-territorial application of the CAS (2) the dynamic nature of international relations and bilateral agreements would make it difficult for the CAS Board to ensure consistency with its rules and other international rules and (3) it would be impractical to expect contractors and subcontractors to follow both CAS and accounting conventions required where the contract is being performed.

Industry Group Challenges New FAR Proposal on Travel Costs

The Council of Defense and Space Industry Associations has challenged a recent proposed change to FAR travel regulations as "unnecessary" and apt to "create confusion" where the current cost principle at FAR 31.205-46(b) is "more than sufficient to provide guidance on the allowability of contractor airfare costs."

The current cost principle limits contractor airfare costs to the "lowest customary standard, coach or equivalent airfare offered during normal business hours." CODSIA says it is commonly understood that unless one of the exceptions for premium airfare apply that "only the cost of coach airfare is allowable."

The proposed rule, published in the Federal Register last Dec. 20, states the current rule causes confusion because it is being interpreted as either the lowest coach fare available to the contractor or lowest coach fare available to the general public so the proposal is to clarify the lowest fare to the contractor should govern. The rule writers stated to allow lowest fare to the general public would require continuous monitoring of fluctuating air fare prices during a day. The proposal would provide that airfare costs in excess of the lowest price coach class airfare available to the contractor would be unallowable. The proposal would also drop the term "standard" from description of classes of allowable airfare since the term does not describe an actual class of airline service.

CODSIA says the FAR writers should leave well enough alone asking what has changed to make the regulatory language in place for so long no longer adequate? The proposed change adds no additional clarification and instead adds potential confusion by a perceived requirement to compare the cost of a purchased coach class airfare with various other coach class fares. The cost principle has never been interpreted to mean the absolutely lowest cost available because, for example, some companies are able to negotiate special deals. CODSIA also objects to dropping the term "standard" since that term is meaningful in another section of the cost principle where cost of contractor-owned, leased or chartered aircraft is compared with "standard airfare."

DOD IG Reports on Deficiencies in Reporting Past Performance Information

The Defense Department's Inspector General Office issued a report citing failure to register all active systems contracts worth more than $5 million in the Contractor Performance Assessment Reporting System (CPARS) and for those registered, failures to include sufficient detailed narratives establishing the credibility of the ratings. The IG report said deficiencies found mean the acquisition officials do no have the necessary past performance information they need to make informed contract awards. The primary purpose of the CPARS is to ensure data on contractor performance is current, available and electronically transferred to the Past Performance Information Retrieval System, the government-wide data warehouse on information of contractors' past performance. In spite of a requirement to register all new contracts meeting dollar thresholds into CPARS within 30 days from contract award and annually issue past performance assessment reports annually within 120 days after the end of an evaluation period, the study found 48 percent were registered more than 365 after contract award and that 85 percent more than 30 days after award. Also, 68 percent of assessment reports were overdue and that 82 percent of the reports were deficient. The IG urges greater efforts to catch up on all late registrations and begin preparing required assessment reports within the 30 day time frame.

The report mentioned that in addition to the systems contracts having a $5 million threshold, registration in the CPARS is required for contracts for: (1) operations support valued at $5 Million (2) fuels valued at $100,000 (3) health care valued at $100,000 (4) services valued at $1 million (5) IT technology at $1 million (6) construction at $550,000 (7) Architect-engineering at $30,000 and (8) science and technology "as required."

FAR Proposal to Clarify Priorities Among Small Business Programs

The FAR Council is proposing a rule intended to clarify which small business programs have priorities when it comes to deciding whether to satisfy an award to a HUBZone, service-disabled, veteran-owned, or 8(a) firm. The proposed rule, which would amend FAR 19.2, seeks to address confusion over whether there is an order of precedence that applies when making an award decision. The proposed rule states:

1. There is no precedence among the different types of companies except there is a requirement that if the Small Business Administration accepts an 8(a) requirement it must remain an 8(a) unless a waiver is made.

2. For acquisitions over $100,000 the CO must consider making an award under the HUBZone, service-disabled, veteran-owned small business (SDVOSB) or 8(a) program before the CO proceeds with a small business set aside. If the CO has considered a small business set aside it cannot do so if the criteria for setting it aside for HUBZone companies are met.

3. An acquisition between $3,000 and $100,000 must be exclusively reserved for a small business unless the CO determines there is not a reasonable expectation of obtaining offers from two or more small businesses. The proposed rule clarifies that these small business set-asides do not preclude awards to one of the other small businesses because the SBA regulations give the

CO discretionary authority to use these programs at these dollar levels (*Fed. Reg. 12,699*).

New FAR Rule Updates CAS Administration Provisions

Effective March 31, the FAR updated Part 30 for rules issued three years ago to streamline the administration of the cost accounting standards. The new provisions (1) will require the cognizant federal agency official (CFAO) to request and consider the advice, when appropriate, of the auditor when administering CAS (2) specify the CFAO must evaluate the detailed cost impact (DCI) proposals for cost accounting changes or non-compliances when a contractor is required to submit a DCI (3) indicate the changes clauses of the contract are to be used to negotiate equitable adjustments to contract price related to required or desirable changes and (4) provide that the cost impact of a noncompliance affecting both cost estimating and cost accumulation must be determined by combining separate cost impacts of both the estimating and accumulation non-compliances.

DOD Continues Suspension of SDB Price Evaluation Adjustment, Extends Commercial Item Test Program

The Defense Department's use of price evaluation adjustments for small disadvantaged businesses (SDBs) is to remain suspended for another one year period. The suspension is consistent with prior defense authorization acts requiring DOD to suspend authority to enter into a contract for a price exceeding fair market cost if the secretary determines at the beginning of the fiscal year that DOD achieved the 5 percent goal of awarding SDB contracts.

In a separate move, DOD issued a class deviation intended to extend the current FAR Subpart 13.5 test program for certain commercial items. The FAR section authorizes use of a test program to use simplified acquisition procedures for acquisition of supplies and services in amounts greater than the simplified acquisition threshold (now $100,000) to not exceed $5.5 Million, including options if the CO reasonably expects that offers will include only commercial items.

CASE/DECISIONS

Downgrading of Bid Is Proper After Proposing Use of Non-Employee Expert

(*Editor's Note. Many contractors are shifting from traditional categories of full time employees to other forms (e.g. temp, subcontractor, "variable employee", etc.) but care must be used when using non-traditional employees on proposals.*)

Despite offering the lowest price, PMC's unsuccessful bid was downgraded because one of its proposed experts was a contract employee rather than an in-house employee. In its protest, PMC argued it was unreasonable for the agency to downgrade its proposal since there was no requirement in the RFP that proposed personnel be in-house employees. The GAO disagreed stating the agency adequately explained that the PMC's expert was a concern in view of the requirement that the project be underway promptly after award. Acknowledging the RFP did not expressly require proposed experts be employed directly by the contractor nor did the evaluation factors specifically address employment status, the GAO ruled that an agency may take into account "specific, albeit not expressly identified matters that are logically encompassed by or related to the stated evaluation criteria" and that here it was implicit that an evaluation of employees "logically encompasses the employees' availability to perform under the contract" (*PMC Solutions Inc., GAO, B-310732).*

Subcontractor Claim Dismissed Finding No Evidence of a Teaming Arrangement

(*Editor's Note. One advantage of being part of a joint venture as opposed to being in a prime-subcontractor relationship is that sometimes the members of the joint arrangement can both be considered to be prime and hence be in direct relationship ("privity") with the government. The following demonstrates the need to clarify this relationship at the beginning.*)

Naniq and RFID entered into a Memorandum of Understanding where each party would work together to obtain federal contracts and stated each project between the two companies would be a joint venture, prime-subcontractor or teaming agreement. The Defense Logistics Agency awarded Naniq a prime contract where the contract incorporated RFID's cost proposal. Into the contract RFID submitted a $129,000 claim to the government following Naniq's attempt to modify the contract without RFID's approval. The CO refused to recognize the claim stating the government was not in privity with the subcontractor and hence could not consider the claim while RFID's asserted its agreement with Naniq contemplated a joint venture working relationship. The Board sided with the government asserting the only party to the contract was Naniq, the proposal referenced a prime-subcontractor relationship and the prime contract neither included language authorizing a direct appeal by a subcontractor nor did it refer to FAR 9.6 which allows two parties to a teaming arrangement to act as a potential prime contractor. The

Board ruled none of these conditions existed and the contemplated relationship between the two parties were irrelevant so the normal situation applies where a subcontractor lacks privity with the government and the only way to prosecute a claim is with the consent and cooperation of the prime contractor (*Ronchetti and RFIDcomplete LLC, ASBCA No. 56201*).

Participation in Trade Association May Result in an Organizational Conflict of Interest

(*Editor's Note. The following shows that potential conflict of interest can apply not only to contractual relationships but even participation in organizations whose intent is to foster goals deemed to be in conflict with contract performance.)*

SAIC was a member of an industry group called Association of Radioactive Metal Recyclers whose aim was to advocate in favor of recycling and reusing radioactive materials. A complaint was filed against SAIC asserting it had violated the False Claims Act by not disclosing organizational conflicts of interest as required in its contracts with the Nuclear Regulatory Commission. The government alleged that its relationship with the association created an appearance of bias in its contractual duties to provide technical assistance and support services to the NRC. SAIC stated its contracts required it only to disclose those consultant or other contractual relationships that could result in an OCI. The Court disagreed holding that under the definition of an OCI, SAIC was required to disclose not only its consulting and other contractual relationships but "any relationship which may have compromised its neutrality under the contracts." The Court concluded the government sufficiently alleged its membership in the association impaired SAIC's ability to provide impartial assistance (*U.S. v Science Applications Int'l Corp., 502 F. Supp. 2d 75*).

Divulging Line-Item Prices are Trade Secrets Under FOIA Exemption

The Court had to decide whether disclosure of CCC's option-year prices under its Air Force J85 engine maintenance contract to an unsuccessful bidder would have to be disclosed under the Freedom of Information Act (FOIA) or would not have to be disclosed because of potential harm to CCC. The government argued that the line item prices were not trade secrets and were required to be disclosed under the FAR provisions incorporating FOIA. Consistent with earlier decisions, the US Court of Appeals sided with CCC ruling the government cannot divulge a contractor's line-item prices under FOIA because Exemption 4 of the act protects "matters that are… trade secrets and commercial or financial information obtained from a person" that is privileged or confidential. Alluding to a prior case (*Nat'l Parks & conservation Assn V Morton, 498 F.2d*) that held Exemption 4 applies if the disclosure would "impair the government's ability to obtain necessary information in the future" or "cause substantial harm to the competitive position of the person" from whom information was obtained, the Court ruled the line-item prices are trade secrets that fall within the Exemption 4 (*Canadian Commerce Corp. v Dept of the Air Force, D.C. Cir., No. 06-5310*)

GAO Lacks Jurisdiction on Protest Over Modification of a Task Order

The Coast Guard modified a task order for QSS to provide information technology services under its ID/IQ government-wide contract award. GCE, which previously provided such services to the Coast Guard, protested the IT services award claiming they were materially different from services requested under the original task order and hence should have been separated and competitively procured as a separate contract. The GAO said it lacked jurisdiction over the protest stating that is was generally precluded under the Federal Acquisition Streamlining Act of 1996 to consider challenges to the issuance of task or delivery orders under ID/IQ contracts unless the protest asserts the order increases the scope, period or maximum value of the contract under which it is issued. Since CGE is asserting only the modification at issue is outside the scope of the original *task order*, GAO concluded the protest did not fit within the FASA exception (*Global Computer Enterprises Inc., GAO, B310823).*

QUESTIONS & ANSWERS

Editor's Note. We received an unusually high volume of questions the last couple of months that we believe would be of interest to most subscribers so we decided to substitute more Q&A for our normal feature article. We will continue with the feature article next issue.

Q. We're a small government contractor. For simplicity's sake, we have a single overhead rate. Our G&A expenses are embedded in our single overhead rate. From time to time the DCAA indicates that they would like us to establish a G&A rate. Is there any advantage for us to adopt a G&A rate? Should we postpone it as long as possible?

A. Though it is not uncommon to have one rate for small companies, it becomes more and more unusual to have it on companies with revenue exceeding $1 million so it is understandable that DCAA might express a preference for a G&A rate because that is what they are more used to seeing. However, one rate may be justified and we can discuss it.

Nonetheless, there are often advantages in having a G&A rate. For example, if your single rate applies to all direct costs then adoption of a G&A rate may allow you to have a higher overhead rate to apply only to direct labor or the government may believe your single rate is too high for ODCs so having two rates allow you to apply a higher overhead rate on direct labor and a lower rate on ODCs. On the other hand, you may want to resist establishing a G&A rate as long as possible if you have lots of non-labor direct costs and get away with applying a higher indirect rate to those costs.

Q. We are bidding on an ID/IQ contract whose estimated value is $80 Million where certified cost data was presented to establish billing rates for employees as task orders are issued. Will award of this contract make us CAS covered?

A. Technically, contractors are not really CAS covered, only specific contracts. For determining the dollar amount for purposes of determining CAS coverage, where no value is identified the dollar value would reside at the individual task order level while, for example, a fixed contract funded with a stated value, the contract level would determine the threshold. For situations between these two extremes like what you describe, we put the question to one of our colleagues, Len Birnbaum, a noted contracts attorney and consultant, who said it is not clear cut. It is quite common to have an ID/IQ contract that never comes close to the original estimated amount. He indicated there are different schools of thought on the matter. For example, Lane Anderson in his Accounting for Government Contracts, Cost Accounting Standards, recommends obtaining an estimate from the contracting officer of the most likely dollar value of the entire contract and using that figure as the dollar amount of the contract for purposes of deciding whether the dollar threshold of CAS coverage is met (e.g. $50 Million for one contract, total of $50 Million for more than one with a $7.5 million trigger contract). Len's inclination is to have each PO for each task order under the contract stand alone since the ID/IQ vehicle is not really a contract until task orders are issued and the amount of the contract vehicle is highly uncertain.

Q. We charge a 25% G&A rate on supplies and travel costs. Our commercial clients tell us it is too high and want us to lower the charge. If we do so, can the Government force us to lower our G&A rate charges on government contracts?

A. No. As long as the G&A rate reflects your expected costs and the contract does not cap a lower rate, charges on commercial contracts have no bearing on rates charged on government contracts.

Q. What is the proper way for indirect employees who are shared between two or more separate segments to keep track of their time?

A. There is no better way than having those individuals keep timecards where hours can be assigned to specific segments or a residual pool. If that is not practical, you need to come up with a reasonable methodology that is easy to verify to allocate people's time to the separate segments (e.g. period of time at each location). You may also want to include those individuals' time in either the residual cost pool or create a separate central service cost pool where their costs would be allocated to some but not all segments on an appropriate cost base.

(*Editor's Note. How to charge G&A on subcontract costs and whether or not to establish a separate subcontract handling rate has become a "hot" issue lately. In the last couple of months we have received numerous questions related to it so here are a few.*)

Q. We are a small R&D company working primarily on Federal contracts and grants (often through the SBIR or STTR programs). Program rules (particularly for the STTR program) require us to award a relatively high amount of subcontracts to universities or other "research institutions" on many of our projects, so after applying the full 25% G&A markup on subcontract costs (we cannot add profit) we find there are very limited funds remaining for our direct labor efforts on these projects. Any suggestions?

A. It sounds like you may want to establish a subcontract handling fee. The 25% markup on flow-through subcontract costs would be substantially less by applying a handling fee but the additional markup you would receive on the direct labor costs (e.g. fringe benefits, overhead, G&A and profit) make those elements more profitable in the sense you will receive more dollars to cover your indirect rates and profit.

Q. In recent years, we have tended to have an increasing number of subcontractors and we find that, in our view, application of our full G&A rate to subcontract costs results in an inequitable allocation of G&A costs to certain contracts. We recently proposed a method to DCAA in which we would charge G&A against only the first $20,000 of subcontract cost on a particular contract. This makes sense since the

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

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

administrative costs associated with a small or large subcontract is about the same. DCAA did not accept this proposal.

A. Your proposal of applying G&A only to the first $20,000, though somewhat unusual, is not uncommon. I have a couple of clients (one large company who is CAS covered) who treat subcontract costs like you are proposing and the methodology was at first rejected but then accepted once it was carefully explained. The auditor is understandably reluctant because both the FAR and CAS clearly make the point that like costs incurred under similar circumstances must be treated consistently so, they conclude, subcontract costs must be treated consistently. However, you will want to argue in a well thought out position paper that the subcontract costs are either not "like" or are not incurred under "similar" circumstances (e.g. administrative costs do not vary by dollar value) and that under current practices there is a cost allocation distortion. Your point about there being the same costs to administer subcontracts no matter their value is a strong argument for asserting there is not a "causal beneficial" relationship between the costs and final cost objectives. There are also probably some court cases and CAS guidance that would support your position.

Q. We are a mid-sized professional services firm and are considering creating a handling fee to apply to subcontracts but I am not very tempted to have a fee related to materials since we incur very little direct material costs and tracking indirect costs associated with materials seems unduly burdensome. I am thinking about just creating a subcontract handling but always see such a fee referred to as "material and subcontract handling." Can we cut out the material part?

A. There should be no problem creating a subcontract handling rate just as there should be no problem creating a material handling rate in a manufacturing setting. Both are quite common. If you were CAS covered there might be a little more resistance since CAS 410 states G&A bases can be one of three things - total cost, value added (where material and subcontract costs are eliminated) or one representative cost element (e.g. labor). However, since you are not CAS covered, there should be more flexibility though the auditor may try to apply the more strict restrictions of CAS.

Q. If we create a subcontract handling pool, clearly the indirect costs that would now be identified as subcontract handling costs would be removed from the G&A pool. Would the G&A base continue to be total cost input (which now includes the subcontract handling cost)? Our DCAA auditor said:

"A separate pool could be established by the costs being charged would have to be carefully tracked to the pool. You would have to establish separate indirect charge codes and then demonstrate that the costs were actually for the subcontract effort, not some other indirect cost. In addition, the total would still wrap into the G&A base for allocation so I'm not sure that it would benefit you."

A. Though the auditor offers some good advice on tracking the pool costs I would disagree with the auditor's assertion that the subcontract handling pool costs must be included in the G&A base. Though that is one possible treatment, separating the handling pool and base from the G&A pool and base is also acceptable (and even more common) where now the G&A base becomes a value added rather than total cost input base. If the auditor still insists I would raise the issue with the branch manager.