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# GCA REPORT

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## **NEW DEVELOPMENTS**

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### **Defense Department Seeks Input to Streamline FAR Part 31**

DOD's Director of Procurement Deidre Lee is sponsoring a series of public meetings intended to discuss opportunities to streamline FAR Part 31 provisions on measuring, assigning and allocating contract costs. DOD's Office of Cost, Pricing and Finance has proposed an outline – they call it a “strawman” - highlighting issues to be considered. The strawman poses a number of specific questions regarding:

FAR 31.201-4, Determining Allocability. Is there a viable alternative that will provide “adequate criteria” without significant administrative burdens?

FAR 31.201-6, Accounting for Unallowable Costs. Can this be revised to permit sampling of unallowable costs when, for example, the CO and contractor can agree to a sampling plan where the results will be projected to determine unallowable costs for the year?

FAR 31.203(e), Accounting Period. Should an accounting period longer than one year be allowed when a transitional period is required?

FAR 31.205-6(j), Pension Costs. Should the “payable for life” distinction reflected in CAS 412, 413, and 415 be revised or eliminated in favor of the IRS's definition of a pension plan? Can Generally Accepted Accounting Principles (GAAP) rather than CAS 412/413 be followed? (*Editor's Note. CAS 412, 413, and 415 apply to non-CAS covered contractors when they claim pension and deferred compensation costs.*)

FAR 31.205-6(k), Deferred Compensation. Should GAAP be applied in lieu of CAS 415 or should CAS 415 be applied with some exceptions?

FAR 31.205-6(o), Postretirement Benefits Other Than Pensions. Should funding be required to be considered for government costing purposes or some other alternative recognizing a valid liability be used?

At the first meeting in April, some industry representatives recommended going further than measurement, assignment and allocation considerations to address cost allowability. Lee indicated she would be open for a concrete proposal but said she was more interested in accomplishing things “now” even though they may be more limited in scope. David Capitano, of the Office of Cost, Pricing and Finance suggested four criteria will be used for making potential streamlining: (1) Does GAAP adequately cover the issue (GAAP covers measurement and assignment but not cost allocability)? (2) Is the current provision a barrier to attracting new entrants to the federal marketplace? (3) Does the provision get in the way of doing business? and (4) What does the FAR add?

### **DCAA Issues Guidance on Auditing Low Risk Contractors' Incurred Cost Proposals**

April 27 DCAA issued guidance to its auditors that eliminated certain electronic guidance issued earlier and provided a reminder of the guidelines to use when auditing low risk contractors' incurred cost proposals. Referencing the DCAA Contract Audit Manual (DCAM) Chapter 6-104 a summary of the guidance is as follows:

“Low risk” contractors are considered those with auditable dollar volume (ADV) of \$10 million or less. ADV does not include fixed price contracts or other contracts where the product or service are commercial items but does include flexibly priced contracts and subcontracts (e.g. cost type, fixed price with cost redeterminations or incentive profit schemes) and time and material or labor dollar contracts and subcontracts. For these contractors, each incurred cost proposal, after they are determined to be “adequate”, is either classified as high risk to be audited or low risk to be desk reviewed (discussed below).

New guidance addresses contractors whose ADV for a given fiscal year is less than \$500,000. If there are no audit leads with a high probability of significant questioned costs (e.g. the impact of questioned costs is more than \$10,000 on flexibly priced contracts) and there has been an audit of one of the contractor's last two fiscal years' incurred cost proposals then the

contractor's proposal is automatically considered low risk. The only exception is if there was no prior audit experience such as a preaward accounting survey, proposal audit or review establishing billing rates. For these new contractors with no prior audit experience, their incurred cost proposal is to be classified as high risk.

If a contractor's ADV for a given fiscal year is between \$500,000 and \$10 million for any fiscal year their proposal is low risk if (1) there are no significant questioned costs in the prior audit (e.g. the same \$10,000 impact discussed above) (2) No "audit leads" that indicate a high probability of significant questioned costs (3) there is incurred cost audit experience and (4) either of the last two years' incurred cost proposals were audited. In addition, if a proposal does meet DCAA's criteria for low risk but the ACO still considers it high risk then DCAA will usually consider the proposal to be "high risk"

The guidance establishes procedures to ensure both all high-risk proposals and one-third of the low risk proposals are audited. Each branch office is to establish a random selection process for selecting one third of the proposals from the "low risk" pile. If a branch office has two or more proposals that are considered high risk, then each will be audited. If it has two or more proposals from a low risk contractor and based on the audit/desk review cycle one must be audited, then auditors will select the proposal with the "highest risk" (usually highest dollar ADV). If the proposal selected for audit is found to contain significant unallowable costs then the other proposals will also be audited.

For those low-risk proposals not randomly selected for audit, a desk review is to be performed. The new guidance provides appropriate work papers to document a desk review has been conducted. The desk review will include (1) assurance a "Certificate of Indirect Costs" has been executed (2) scanning a proposals for unusual items, obvious potential significant costs (*e.g. large entertainment expenses*), compliance with special contract terms (*e.g. exclusion of contract specific unallowable costs, special allocation*) and audit leads needing follow up (3) scanning the proposals to determine any significant changes from prior years (4) verification of mathematical accuracy (*e.g. totals of different schedules reconcile*) and (5) audits of home office costs were conducted if home office allocations are significant. New guidance stresses the need to execute a rate agreement letter (proforma letter included) reflecting the desk review-determined rates and to request the contractor incorporate them in provisional billing rates (MRD 01-PPD-031).

## OMB Sets Targets to Increase Outsourcing

In action intended to specify more concrete goals of President Bush's management reforms outlined in his budget to increase outsourcing and performance based contracting, OMB Deputy Director Sean O'Keefe issued March 9 more detailed marching orders to government agencies. The O'Keefe directive states government agencies must either compete with private firms or directly convert under OMB Circular A-76 at least 5 percent of the commercial jobs identified in their Federal Activities Inventory Reform Act lists in FY 2002. The FAIR Act requires agencies to annually compile and publish an inventory of potential commercial activities being performed by government employees but does not require the positions be competed. It is expected the 5 percent goals will result in competing about 42,500 full time equivalent positions out of a total of 850,000 identified in FAIR Act lists. In addition, the O'Keefe memorandum establishes a goal of not less than 20 percent of total dollars awarded on service contracts over \$25,000 use performance-based techniques for payments (i.e. payments based on pre-established milestones).

To help ensure the FAIR Act lists identify all the potential compete positions, Mr. O'Keefe issued an April 3 memo requiring agencies separately list all inherently governmental positions – those not subject to contracting out. Unlike the FAIR list, the new list will not be released to the public but will be scrutinized by OMB. In addition, in response to criticism that the Circular A-76 guidance on public-private competitions requires excess amount of time (up to two years), OMB Director Mitch Daniels announced April 18 it will initiate "touch-up" work to shorten the process.

## HUBZone Application for Certification Now Online; CCR Changes to On-line Registering

Hoping to expand participation of its Historically Underutilized Small Business Zone Contracting Program and expedite applications, the Small Business Administration is providing electronic applications for certifications at <http://www.sba.gov/hubzone>. The site provides links to online guidance and regulations implementing the program while allowing applicants to monitor the status of their applications.

All companies hoping to do business with the Defense Department must register with the Central Contractor Registration system. A new addition, under the "Goods and Services" tab, is the North American Industry

Classification System (NAICS), an economic classification system adopted to replace the Standard Industrial Classification (SIC) code. Recognizing that not all contractors and government agencies have made the transition to NAICS, the CCR will continue to collect information using SIC codes. The CCR has also added the HUBZone as a business type that vendors can select under the "Corporate Information" tab. The CCR website is at <http://www.ccr2000.com>.

### **NASA to Avoid Appearance of Personal Service Contracts**

The National Aeronautics and Space Administration issued internal guidance on the use of contract support and the need to avoid the appearance of entering into personal services contracts. The guidance follows many critical reports issued by the NASA Inspector General office in the last year that the lines are often blurred between legitimate contractor support and prohibited personal services contracts that make the contractor personnel appear to be, in effect, government employees. Citing FAR that requires agencies make sure that inherently governmental functions not be assigned to a contractor, the guidance says the best way to reduce the risk of establishing a personal service contract is to physically separate contract employees from the federal workforce. Recognizing this is not always possible, NASA direct its COs and technical representatives to (1) ensure the contract clearly specifies expected tasks and work products (2) limit work assignments to those in the contract (3) provide all other work requests on a work order issued by the contracting officer and (4) ensure the supervisor of the contractor employees makes regular contact with the employees and is responsible for all performance, discipline, training and work assignments not specifically addressed in the contract.

### **BRIEFLY...**

#### **New Executive Compensation Cap Set at \$374,228**

The Office of Federal Procurement Policy May 3 announced \$374,228 as the maximum "benchmark" executive compensation that will be allowable under government contracts during contractor's fiscal year 2001. The new cap represents a 6 percent increase over the FY 2000 amount of \$353,010. Contractors can, of course, pay their executives more than \$374,228 but the additional compensation will not be allowable under their federal contracts. The compensation amount is the amount reflected in a company's W-2s and 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 benchmark corporations for the most recent year data is available. The new cap applies to contractor fiscal year 2001 as well as subsequent years until it is revised by OFPP.

#### **DOD to Post all Contracting Opportunities over \$25,000 on FedBizOpps by July 30**

Beginning July 30, all Defense Department contracting opportunities over \$25,000 must provide notices and synopses on the FedBizOpps Website. FedBizOpps is the electronic government-wide entry point for information on government contracts over \$25,000. Though there is a FAR proposal to require all agencies to post their notices by October 1 the earlier directive is to test the system to ensure the October 1 deadline can be met. The current use of Commerce Business Daily and the CBDNet Web sites will continue to be used though December 31.

#### **OMB Circular A-76 Escalation Rates Amended**

The Office of Management and Budget issued a March 7 memo amending the A-76 Circular to update escalation factors to use in computing the government's in-house personnel and non-pay costs like supplies and equipment. When an agency thinks it may outsource an item and contemplates a "public-private" competition it must develop cost comparison estimates for its efforts in accordance with A-76 Circular guidelines. The guidelines include pay raise assumptions and inflation factors to use for calculating out years in-house personnel and non-pay costs. The federal pay raise assumption rate for the year effective January 2000 was 4.8 percent; for January 2001, 3.7 percent; for January 2002, 3.6 percent and; for the year 2003 through 2006, 3.9 percent. The non-pay category for FY 2000 is 1.9 percent and FYs 2001-2006, 2.1 percent.

#### **Bush Administration Resists Involuntary Use of Union Dues for Political Contributions**

The Bush Administration issued Executive Order 13201 that reinstates the rights of contractor employees to object to the use of their union dues for purposes unrelated to collective bargaining, contract administration or grievance adjustment. Under the EO, specified in Department of Labor guidance issued April

18, government contractors must post notices throughout their workplaces advising employees of their rights to protest the amount of union dues withheld from their paychecks. The interim procedural notice published by the DOL's Employment Standards Administration includes model language fulfilling contractors' responsibilities until a final rule is adopted. EO 13201 also requires contractors and subcontractors to flow down the posting requirement to lower tier subs. The FAR will promulgate appropriate clauses and related provisions for this purpose. Violations of the order may result in contract cancellation or termination as well as administrative debarment or suspension.

### **Senate Proposes to Make Mentor-Protégé Program Government-wide**

A Senate panel is proposing to extend to all federal agencies the Defense Department's mentor protégé program. The program, established in 1991, is designed to strengthen the ability of small and small disadvantaged firms to participate in government contracting. Mentor firms – generally large, experienced DOD contractors – help small business “proteges” develop the technical infrastructure and expertise needed to win bigger and more complex subcontracts and in return, they are reimbursed for their assistance and their efforts often help earn higher evaluation points for their proposals.

### **FAR and DOD Suspend the Contractor Responsibility Certification Requirement**

The FAR Council issued an interim rule April 3 suspending the Clinton Administration's controversial contractor responsibility criteria. The next day DOD Director of Procurement Deidre Lee notified its contracting officers to delete the contractor certification developed by the Clinton Administration and replace it with the April 3 suspension so a contractor need no longer certify it is in compliance with tax, labor and employment, environmental, antitrust or consumer protection laws.

## **CASES/DECISIONS**

### **Amount of Tax Refund Credited to the Government is Based on Contract Mix When Tax Was Imposed Not Received**

Hercules received a \$10.5 million state income tax refund and determined the amount of credit allocable to government contracts based on the percentage of

such contracts in the year the refund was *received* while the government claimed the percentage of refund allocable to government contracts should be based on the mix of contracts in the year the state income tax was originally *imposed*. Hercules defended its position by stating it had followed a consistent practice of including state refunds as a credit to its overhead pool in the year the refund was received and that such practice was consistent with both CAS 406, Accounting periods and 410, G&A costs. Hercules further stated that even if the allocation method was incorrect, the *Litton Systems Inc* decision ruled that for purposes of “fairness, reasonableness and equity” the government could not force a contractor to make a retroactive change of an incorrect cost allocation if (a) the contractor had a “long and consistent use” of the method and (b) the contractor was “unduly prejudiced” by the government failing to provide adequate notice it would no longer approve the method.

The Court ruled against Hercules stating the federal government's share of the state tax refund must be determined based on Hercules's mix of federal contracts when the tax was imposed. The Court said that Hercules erroneously assumes the tax refund is an indirect cost when it is a credit for a previously recognized and allocated indirect tax cost. The Court acknowledged that CAS 406 requires contractors to follow consistent practices in selecting a period to accumulate and allocate adjustments and that CAS 410 requires a G&A expense to be allocated to the cost of period in which it was entered but neither cost accounting standard specifically address how credits to G&A pools will be handled or what period they must be allocated to. Rather, if the tax refund is treated as a separate cost allocable on a base during the year it was received, there would be “no nexus between the cost and the credit relating to the cost.” Addressing the *Litton* case, the criteria of “fairness, reasonableness and equity” favor the government because in this case, Hercules would receive a windfall by applying the mix in the year it received the refund but if the mix pointed in the other direction, Hercules could be short-changed (*Hercules Inc. v. United States*, Fed. Cl., No 98-127C).

### **Change in Inspection Methods Is Grounds for Equitable Adjustment**

During Rohr's performance of its subcontract to provide airplane parts for the F-14 production contracts, the Defense Contract Administration Services changed its inspection procedures from “production orientation” (i.e. hardware inspection) to “production processes” (i.e. manufacturing processes and paperwork). Rohr

presented a claim for \$34 million, sponsored by the prime contractor (Grumman), to recoup the additional costs incurred when the average “deficiencies” per lot jumped from 16 to over 600. The amount claimed was based on a modified total cost method (comparing actual costs versus “should have” costs based on proposed price for four lots) and included profit and preparation costs. The government rejected the assertion the new inspection procedures represented a change to the contract and also disputed Rohr’s method of calculating the cost impact.

The Appeals Board ruled that Rohr had reasonably relied on the quality assurance practices and specification interpretations in effect for over 18 years of its contract and the Government’s departure from these practices both disrupted performance and increased its cost resulting in a compensable change to the contract. As for the total cost method, the Board ruled against the Government’s assertion Rohr’s accounting system was adequate to identify “cost per change” - instead, the total cost method was reasonable since providing actual costs was impractical and the original bid price was a reasonable basis to establish the amount the subcontract should have cost without the inappropriate increased costs. As for the government’s assertion that profit was unjustified because the four lots would have lost money regardless of inspection methods used, the Board disagreed stating Rohr was entitled to a reasonable profit as part of its equitable adjustment despite the expected loss. The Board did reject the \$2.9 million costs of preparing the request for equitable adjustment ruling they were incurred to prosecute claims against the government rather than to administer a contract (*we intend to address this distinction in a future article in the GCA DIGEST*) (Grumman Aerospace Corp., ASBCA 50090).

### **Receipt of Email After Hours Considered to Occur Next Business Day**

The Contracting Officer emailed IRG notifying it was excluded from the competitive range around midnight Sept. 1, a Friday before Labor Day weekend. The email entered IRG’s system Sept. 2 and was not opened until Tuesday, Sept. 4. Following the requirement to request a debriefing within three days of notification, IRG requested a debriefing Sept 7. Since more than three days had elapsed since the Sept 1 email, the CO asserted the debriefing request was untimely. The GAO agreed with IRG’s protest ruling that notification after business hours is not considered to have occurred until the next business day (i.e. Sept. 4) (International Resources Corp., GAO, B-286663).

### **Bid and Proposal Costs Must be Charged Direct To Partnership Contract**

*(Editor’s Note. The following indicates it will be tough to recover bid and proposal costs when contractors enter into teaming arrangements).*

In order to finance and commercialize a satellite communication system it developed, TRW entered into a Memorandum of Agreement (MOA) with Teleglobe, forming a limited partnership. In accordance with the MOA, TRW prepared a firm fixed price proposal to build and sell the hardware to the limited partnership. TRW never received compensation for its proposal work and included the bid and proposal costs in its indirect G&A pool. The Court ruled the B&P costs TRW incurred under the partnership agreement was “required under a contract” (i.e. the MOA) and hence in accordance with FAR 31.205-18, IR&D/B&P costs, should be charged to the agreement and not recorded as an indirect B&P cost. In its arguments, TRW claimed (1) the 1997 amendment to FAR 31.205-18 provides costs prepared in “potential cooperation agreements” are allowable and (2) since B&P costs are to be treated like independent research and development costs, a 1991 DOD memo made R&D costs incurred pursuant to a cooperative agreement allowable IR&D costs as long as they would be allowable had there been no cooperative agreement. The Court rejected both points stating (1) the 1997 revised definition provided for “potential” arrangements whereas the partnership was “actual” and (2) IR&D and B&P costs are not the same because unlike IR&D costs the definitions of B&P costs does not include “efforts sponsored by a cooperative agreement.

### **Contractor Reimbursed Proposal Costs When Improperly Awarded Contract Could Not be Cancelled**

The court agreed with Dynacs that FAR Part 15 was violated when the government unfairly gave the awardee several opportunities to correct deficiencies during numerous rounds of discussions whereas it was not. The court, however, declined to order the contract be given to Dynacs stating it would significantly disrupt performance. The Court did award Dynacs its proposal costs indicating the award would help ensure the government complied with procurement regulations (Dynamics Engineering Co., Inc. v. United States, Fed. Cl., No. 00-166C).

### **Recent Decisions Affecting Travel Costs**

*(Editor’s Note. Though the FAR provides that contractors need follow only certain provisions in the Federal Travel Regulations*

– maximum per diem rates, definitions of lodging, meals and incidentals and special circumstances justifying deviations from maximum per diem amounts - many contractors, not to mention government auditors and COs, look to them as the basis for allowable and unallowable travel and relocation costs. Consequently, we intend to report on recent changes and decisions to the FTR we believe our readers would be interested in from time to time.)

Its OK to mix personal and business travel as long as you don't try to circumvent the rule against indirect routing of business travel. Mr. Van Deusen's first assignment was to fly from Washington DC to Dallas between May 10 and May 12 and the second assignment was to Greensboro, NC between May 15 and May 16. During the intervening three days he went to Orlando, FL to visit his family. His total airfare was \$1,009 and he sought reimbursement for \$969 (round trips from Washington DC to Dallas and Washington DC to Greensboro). The government asserted he was entitled to \$738 (one way from Washington DC to Dallas and round trip from Washington DC to Greensboro). The GSA Appeals Board sided with Mr. Van Duesen ruling employees are permitted to mix personal with official travel as long as the extra costs of deviating from official destinations are borne by employees and they do not try to cause indirect routing for official travel (In the Matter of Peter J. Van Duesen, March 20, 2001).

You cannot be reimbursed any costs incurred in an unsuccessful attempt to purchase a home at a new duty station. Mr. Sharp was transferred from California to Washington DC and found a new house in his new location where he paid inspection and appraisal fees. The builder refused to offer a warranty and make many agreed-to repairs so Mr. Sharp cancelled the contract and bought a different house. The government refused to pay the fees on the home not bought and the Appeals Board sided with the government citing a GAO case that ruled agencies cannot reimburse employees for fees and costs associated with UNCOMSUMMATED purchase transactions unless the government precluded the employee from completing the transaction (In the Matter of Richard Sharp, March 23, 2001).

You cannot be reimbursed for temporary quarters for an apartment you intend to purchase and stay permanently. After staying with relatives and a hotel, Mr. Jones found an apartment and decided to rent it starting Feb. 1 on a month-to-month basis and then purchase the entire apartment building. Both the rental agreement and purchase agreement were signed the same day – January 1 – and Mr. Jones moved in Feb 1 and settled on the building Feb 29. When he sought reimbursement for the rent, his agency refused saying since the contracts were signed

the same day, Mr. Jones forfeited entitlement since his intention was to remain permanently. Mr. Jones argued (1) the apartment was temporary until the building closed, (2) he did not intend to permanently rent the apartment and (3) he did not have complete access to the building until March 1. The Board rejected his appeal noting it is not the original intentions of employees that determine whether temporary lodging is to be paid but rather their intention beginning the day they occupy the facilities. The Board cited cases that when transferred employees located quarters they wished to reside in and arranged to rent them they must be considered permanent from the moment the employee occupied them (in the Matter of Shane Jones, April 9, 2001).

You cannot be reimbursed for stolen travel advances. Mr. O'Callaghan requested and received a cash advance of \$3,000 for meals, lodging and incidental expenses. He was advised by his local office not to leave cash at the hotel for fear of theft so he carried it with him out to dinner when he was attacked and robbed. The Agency for International Development rejected his claim because the loss did not occur during official working hours or on official premises and the General Services Appeals Board sided with the agency (GSBCA, 13872, In the Matter of William O'Callaghan).

## SMALL/NEW CONTRACTORS

### Some Cost and Pricing Issues of Inter-Organization Transfers

We've been receiving a lot of questions and hearing of increased audit challenges related to inter-organizational transfers so we thought we would discuss the basics as well as some frequent areas of contention.

FAR 31.205-26(e) covers inter-organization transfers. It is defined as a transfer or sale of materials, supplies or services between divisions, subsidiaries or affiliates that are under common control. For contract costing purposes, the price paid by the receiving entity used to generally be the transferring entity's cost. FAR 31.205-26 has been repeatedly amended to provide greater opportunities to price the transfers at other than cost. Now, price other than cost can occur when the CO determines that (1) the price paid was based upon adequate competition (2) prices agreed to are based on law or regulation (3) when a commercial item is being acquired (4) when a waiver has been granted (5) or when

a contract or subcontract is modified to be for acquisition of a commercial item. More opportunities for non-cost pricing stem from a 1995 amendment eliminating the requirement the contractor provide most favored treatment customer status to the government and increased conditions for when items qualify for commercial. Recent court cases and government guidance are currently going through the process of expanding opportunities for classifying products and especially services, as commercial items (*we intend to soon publish an article in the GCA DIGEST updating what is and is not a commercial item*).

Though it is not uncommon for the government to dispute a contractor's assertion its offered products and services qualify as commercial items or that adequate competition occurred, most questions and government challenges we encounter center on costing issues.

#### ◆ Costing Interorganizational Transfers

The Defense Contract Audit Agency takes the position that an item that is (1) proprietary (2) sole source or (3) produced solely or substantially for government end use is not subject to the competitive forces of the marketplace and hence does not meet the conditions for acceptance at price. Amounts in excess of actual or estimated cost are to be questioned. Some of the more frequent questions we encounter related to assertions of excess cost are:

*Pyramiding Costs.* With the exception of profit, purchase orders placed with divisions should be treated like any other purchase from a third party. ***There is no prohibition against pyramiding of cost***, only against pyramiding of profit. Unless a business unit uses a value added base where the base excludes the type of item being transferred, then G&A and overhead costs are to be applied to the costs being transferred. Even inter-division charges of independent research and development and bid and proposal costs should be treated like all other costs and they should be included in the transferor's G&A base to allow for allocation of G&A.

*Labor costs.* When one company or division temporarily utilizes the services of personnel from another division, there are many ways to handle these costs. If the employee, whether direct or indirect, is physically relocated from one to another division, then it is appropriate to transfer associated costs of payroll and fringe benefits for that individual where the transferor company will experience less costs in its books and the transferor will have more. If the employee is not physically transferred but is working on a project for

another company at its permanent workstation then direct employees working under supervision at their permanent workstation should have full overhead applied. On the other hand, if the direct employee is simply utilizing his own facilities but is under the supervision of another company, then a less than full rate is usually appropriate. Direct personnel loaned to other divisions are most frequently transferred at actual labor costs plus fringe benefits so adding additional (though abated) overhead may need to be justified. For indirect employees loaned to another division but still working at their workstation, it is equally common to apply either an abated rate or a fringe rate. When inter-organizational labor transfers are common, many companies establish a policy for what costs will be transferred depending on the duration of the project. For example, if the transfer exceeds 30 days, then the employee may be formally transferred to the payroll of the receiving company.

*Rental Costs and Common Control.* FAR 31.205-36(e) provides that the cost for rent of property between divisions under common control be limited to the cost of ownership which includes depreciation, taxes, insurance, cost of money and facilities cost no matter what the "market rent" is. The meaning of "common control" is sometimes murky and subject to a case-by-case determination. Normally, an interest of 50 percent or more would be necessary for common control but often less is needed, especially when stock or ownership interest is dispersed. In *Brown Engineering Co.* the NASA Appeals Board ruled as little as 37 percent could constitute control while in *A.S. Thomas, Inc.* the DOD Board found that common control did not exist when one individual owned one firm outright and about 43 percent of the other company's stock. In *Data Design Labs*, several executives of a publicly traded contractor formed a leasing company to build and lease office space to the contractor yet the Board ruled control did not exist since the owners of the leasing company held less than 10 percent of the contractor's stock.

## QUESTIONS AND ANSWERS

**Q.** We laid off several direct and overhead employees recently and gave them severance payments in accordance with our normal company policies. Since they had unique skills and the remaining employees were not sufficient to cover all the work, we used some of them to work on specific projects with definite time lines. We use the term "variable employees" for these

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individuals but they do not receive most fringe benefits (we pay payroll taxes) and they are paid on an hourly basis. Recently, DCAA told us they are considering disallowing the severance payments since they were hired back as “employees.” What do you think?

**A.** We are beginning to see auditors questioning the severance payments made to individuals who are brought back on an “as needed” basis to work on specific projects. Since the IRS has very specific criteria for categorizing “independent subcontractors” (e.g. separate business, minimal supervision, etc.) many of the ex-employees brought back do not qualify for this term and, instead, are being called “variable employees”, “temporary employees”, etc. Though FAR 31.205-6(g) provides that most severance costs are allowable (e.g. reasonable, consistent with company policies, etc.) FAR 31.205-6(g)(i) provides two conditions when the severance costs would be unallowable: if the terminated employees were (1) hired back on the basis of “continued employment at another facility, subsidiary, affiliate or parent company” or (2) hired by a “replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment.” DCAA is likely to allude to this section as a basis to challenge the severance payments – after all, “variable” and “temporary employees” sound like employees and payment of payroll taxes smell like “employees.”

One of the best challenges that comes to mind is to assert their new relationship with the company is not one of “continued employment.” Unlike regular employees, they do not receive fringe benefits (or, at least, minimal), are paid hourly rather than a salary, paid only when they work, do not accumulate seniority, work

only on specific, defined projects, work less time than employees, etc. In addition, you can assert the “variable employees” are, in effect, subcontractors. If you choose to stress this point, make sure you demonstrate they are treated like subcontractors for costing purposes (e.g. normal fringe benefit and overhead rates applied to employees are not applied to them, only indirect costs applied to subcontractors are used, etc.).

**Q.** We are negotiating a multi-year cost type subcontract and the prime contractor is insistent that we provide a ceiling on our overhead and G&A rate. Is this common and if so, can you suggest any ways to protect ourselves?

**A.** It is becoming increasingly common for the government to require prime contractors to cap their indirect cost rates to minimize cost overruns and surprises and we are also seeing numerous prime contractors taking the same action with their subcontractors. If you cannot negotiate your way out of the caps, the following represent a few conditions that come to mind to lessen the sting:

1. Provide that overruns and underruns in any indirect rate (e.g. overhead vs. G&A) be allowed to offset the other.
2. Ensure the caps apply on a cumulative basis so that overruns in one year may be offset against underruns in other years.
3. Make sure the caps do not apply to terminations for convenience or claims. Since the method of calculating indirect rates differ under these circumstances (e.g. some indirect costs are direct), your firm should be entitled to recover actual indirect expenses calculated in accordance with the relevant cost principles.