GCA REPORT
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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 2004 at $432,851 for all applicable contracts no matter when awarded. The benchmark will apply to contract costs incurred after January 1, 2004 and should be used on all applicable contracts and subcontracts for FY 2004 and beyond until revised by OMB.

The new cap represents a 6.8 percent increase over the FY 2003 amount of $405,273. Contractors can, of course, pay their executives more than $432,851 but the additional compensation will not be allowable under their federal contracts. Recent DCAA guidance stresses 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 (Fed. Reg. 26897).

New FAR Changes Issued

The FAR Council issued FAC 2001-22 amending the Federal Acquisition Regulation addressing general cost principle revisions, disposing of government property, submitting unsolicited bids and unique contract and order identifier numbers.

1. *Cost Principles*. Though not substantive, definitions pertaining to composition of total cost, determining allowability and direct and indirect costs will be revised to make them consistent with those found in the Cost Accounting Standards (Fed. Reg. 17764).

2. *Disposing Government Property*. Making "minor changes" to the proposed rewrite of the government property rules made in January 2000, the changes have been made to simplify procedures, reduce recordkeeping and eliminate requirements related to disposing of government property in the possession of government contractors. The new FAR 45.6 (1) replaces five inventory disposal rules with one (2) delineates the responsibilities of the plan clearance officer (3) decreases time for government acceptance of inventory disposal schedules to 10 days, government inventory verification to 20 days and agency and federal screening time to 46 days (4) for scrap reporting, eliminates the requirement to screen most scrap and for those contractors with approved scrap procedures they may now submit scrap lists rather than inventory disposal schedules, eliminate reporting of production scrap and authorizes them to dispose of production scrap without government approval and (5) places government responsibilities in clauses rather than FAR text (Fed. Reg. 17741).

3. *Unsolicited Proposals*. Requires that a valid unsolicited proposal not address a previously published agency requirement and that before initiating a comprehensive evaluation, the agency must determine the proposal contains sufficient cost-related or price-related information for evaluation and that it has overall scientific, technical or socioeconomic benefit (Fed. Reg. 17768).

4. *Unique Identifiers*. Requires that agencies assign a unique identifier for every contract, purchase order, basic ordering agreement, basic agreement and blanket purchase agreement reported to the Federal Procurement Data System. The identifier must remain unique for 20 years (Fed. Reg. 17768).

DCAA Issues Guidance on Compensation for Employees Working in Irag, Overseas

In response to auditor requests on how to treat such compensation questions as higher base pay, hardship differentials, danger pay, sign-on bonuses, rest and

relaxation (R&R) allowances, etc, the Defense Contract Audit Agency April 12 issued audit guidance based on information received from 37 contractors working in Iraq. DCAA made clear that while the contractors surveyed had employees in Iraq, the general audit guidance can be applied to all contractors with employees working overseas.

The guidance first highlights the relevant regulations. FAR 31.201-3 (Determining Reasonableness) states in section (a) that costs incurred by a contractor carry no presumption of reasonableness and the contractor has the burden of proof to establish that a cost is reasonable if an initial review leads to a challenge of the costs. In addition, FAR 31.201-3 states auditors should consider factors determined to be relevant by contracting officers such as conformity with compensation practices of other firms of the same size in the same industry. FAR 31.205-6 (Compensation for Personal Services) section (b)(2) provides that compensation is reasonable if the "aggregate of each measurable and allowable element sums to a reasonable total." Bonuses and incentive compensation are allowable under section (f)(1) if they are paid or accrued under an agreement before the services are rendered or there is an established plan so there is, in effect, an agreement.

The guidance reports on the results of the survey and sets out the kind of factors auditors need to consider when evaluating other types of higher compensation elements common for overseas employees.

1. For special base pay scales, only 4 of the 37 contractors surveyed established higher pay scales than those used for employees working in the U.S. Auditors are told to determine why the special scale was implemented and whether it covers any other incentives.

2. All but five contractors offered hardship pay differential where 12 cited the Department of State Standardized Regulations (DSSR) that allows 25% of base pay to justify the differential. If hardship pay exceeds the 25% auditors are told to evaluate the pay according to the reasonableness standards.

3. All but four contractors paid some sort of danger pay allowance and twelve cited the same DSSR that allows an additional 25% premium. Auditors are told to look for similar reasonableness problems when the 25% premium is exceeded.

4. Of the 4 contractors offering sign-on bonuses, the guidance instructs auditors to ensure the reasons for such bonuses are justified and based on special circumstances.

5. If more than one R&R trip is provided, auditors must ensure that trips are justified to maintain employee performance and morale and is consistent with common industry and/or government practices.

6. For the 20 contractors offering assignment completion bonuses auditors must evaluate them and ensure they are in accordance with the FAR 31.205-6(f)(1) requirements.

7. For the 12 contractors offering foreign service pay auditors must ensure contractors can justify the pay through documented additional expenses and the pay reflects the duration of their deployment and the nature of their expenses.

Similar steps should be taken when evaluating other types of incentives and auditors are told to challenge the costs if contractors do not adequately justify and document their programs. If one or two elements are out of the norm, auditors are reminded that a contractor may use offsets to demonstrate reasonableness of the total cost of the compensation package (MRD 04-PPD-023(R).

DCAA Defines Its Role in GSA Schedule Contracts

DCAA April 9 issued guidance on certain key areas under General Services Administration Schedule contracts that it may be called on to audit.

1. *Prime/Subcontractor relations versus Contractor Teaming Agreements need to be clarified.* Many of the GSA Schedule contracts include a contract clause at FAR 52.232-7, Payments under Time-and-Material and Labor-Hour contracts where the GSA advises that if a prime contractor/subcontractor relationship exists, then the prime contractor should bill for labor services performed by the subcontractors at the prime contractor's GSA Schedule rates rather than at the subcontractor's rates. However, FAR 52.232-7(b)(4)(ii) specifically limits the reimbursement of costs in connection with subcontracts to the amounts paid by the prime contractor. This inconsistency causes uncertainty as to what rates should be used to reimburse the prime contractor for the effort of the subcontractor. Further uncertainty occurs under Contractor Teaming Agreements where the GSA website states that under a CTA each team member bills the government based on its own GSA Schedule rates.

2. *Open Market Items.* FAR 8.401 provides that for administrative convenience, an ordering agency CO may add items not on the Federal Supply Schedule (FSS) (referred to as "open market items") to an order issued

under the FSS contract. However, the term "open market" is confusing because it would tend to imply the items are commercial items whereas orders placed under a GSA Schedule contracts may include cost reimburseable line items such as material, travel, other direct costs and even labor.

3. *Travel.* Travel costs may be included in the Schedule as part of the rates for service, a separate schedule item or a directly reimbursable cost. Additionally, some contracts may place additional limitations such as limiting travel costs to FTR per diems.

4. *Audit Rights.* Based on FAR provisions, it appears that orders issued under the GSA Schedule contracts constitute acquisition of commercial items which are not subject to audit of contract performance costs. However, this conclusion is at odds with the inclusion FAR 52.232-7 for time and material/labor hour contracts which provides for audit rights.

The audit guidance calls for auditors to (1) brief the order, including the RFQ, to determine if a CTA or Prime/Subcontractor relationship exists and the order line items correctly correspond to the Schedule (2) brief the contract to determine the terms and conditions applicable to the Schedule items (3) develop a matrix that breaks out the items ordered by the Schedule versus non-Schedule items and the matrix should identify the applicable terms and conditions (e.g. payment clause, audit rights, travel cost limitations, etc.) (4) under a CTA relationship, make sure the procuring officer is aware of the requirement that each team member must be paid separately (MRD 04-PAC-022(R).

Final Rules for Cost Principles for Educational Institutions

The Office of Management and Budget (OMB) May 10th amended the cost principles in OMB Circulars A-21, A-87 and A-122. Though no substantive changes were made to the cost principles, the amendments are intended to "simplify" the cost principles, make the descriptions of similar cost items consistent across the circulars and "reduce the possibility of misinterpretations." The changes can be found in the Federal Register, May 10 edition on page 25969.

OMB Issues New Pay Raise and Inflation Factor Assumptions

(Editor's Note. It is not always clear what inflation factors are appropriate for contractor use but here are some that the government uses.)

The Office of Management and Budget is updating the annual federal pay raise assumptions and inflation factors used for computing the government's in-house personnel and non-pay costs in public-private competitions conducted under OMB Circular A-76. The changes are based upon the President's Budget for FY 2005. Federal pay raise assumptions for January 2004 are 4.1 percent for civilians and 4.15 percent for military and for January 2005, 1.5 percent for civilians and 3.5 percent for the military. The pay raise factors provided for 2005 and beyond shall be applied to all employees with no distinctions made for possible locality and base pay increases. For January 2006 and beyond, the OMB states that the Employment Cost Index of 4 percent should be used to estimate in-house personnel costs for A-76 competitions. The notification indicates that as future A-76 guidance is updated, the 4 percent assumption for out years may change.

Non-pay categories (supplies, equipment, etc) for 2004, 2005, 2006, 2007, 2008 and 2009 and beyond are 1.3 percent, 1.3 percent, 1.5 percent, 1.7 percent, 1.9 percent and 2.0 percent, respectively (Fed. Reg. 26900).

DOL Issues Final Rule Requiring Notices Regarding Union Dues Usage

The Department of Labor published a final rule implementing the controversial Executive Order 13201 issued February 17, 2001 that requires federal contractors to post notices regarding union dues usage. The EO requires federal contractors and subcontractors to post notices regarding union membership and the proper use of union dues. The EO supplied the text of the notice which provides that under federal law employees cannot be required to join or remain a member of a union to keep their jobs. In addition, the text notes that even when all employees are required to pay union dues, non-members will only have to pay "their share of union costs related to certain specific activities." Contractors are required to post the union notice in a conspicuous place and failure to comply can result in the contract being cancelled, terminated or suspended and the contractor may be suspended from future government contracts. The requirement will be included in all contracts and subcontracts through a contract clause.

Contracts less than $100,000 are exempt and exempt contractors are those (1) having less than 15 employees (2) using work sites where no union has been officially recognized by the prime contractor or certified as the exclusive bargaining representatives (3) located in a state where union-security clauses are forbidden and (4) working on contracts performed outside the U.S. and

workers are not recruited from within the country. The DOL will implement the final rule and the FAR will be amended. For more information on the required poster and related contract information go to http://www/dol.gov/esa/regs/compliance/olms/BechInfo/htm.

FHA Turns Down Pleas for Price Adjustments to Help With Steel Costs

(*Editor's Note. The following underscores the need to negotiate adjustment clauses whenever possible.)*

The Federal Highway Administration has told industry and state officials that it cannot legally allow federal funds to be used to reimburse contractors now facing higher steel costs unless adjustment clauses were part of the original contract. Scrap steel prices have gone from $100 a ton to over $210 ton with expectations of even higher costs, putting contractors holding fixed price contracts for federal-aid highway projects in the lurch. The FHA stated it would allow adjustments for steel price increases on new contracts but could not provide funds for equitable price adjustments to existing contracts.

GAO and Congress Weigh in on Federal Employees' Rights to Protest OMB A-76 Competitions

After almost a year of uncertainty where several cases have left the issue "murky" according to some commentators, the General Accounting Office ruled April 20 that individuals or representatives of federal employees affected by public/private competitions conducted by the Office of Management and Budget Revised Circular A-76 do not have standing to maintain a protest before the GAO. The GAO did recognize that "concerns for fairness" may require Congress to consider amending the Competition in Contracting Act to allow protests by the employees. In heeding this call, the House Armed Services Committee recently approved legislation to expand federal employees' rights to protest under A-76 competitions while Senator Susan Collins is introducing Senate legislation to provide similar rights.

OFPP and SBA Encourage Business With Service Disabled Vets

The Office of Federal Procurement and the Small Business Administration advised in an April 9 memo to all executive departments and agencies to "rethink" their contracting efforts in the light of the Veterans Benefit Act of 2003 to increase participation of businesses owned and controlled by service-disabled veterans in federal contracting. The new law, which has yet to be implemented, allows contracting officers to (1) award sole-source contracts to any responsible business owned and controlled by service-disabled vets for manufacturing contracts under $500,000 and other contracts up to $3 million and (2) restrict competition to such businesses under certain circumstances. To help agencies locate these small businesses the VA has created VETBIZ Vendor Information Pages at www.vetbiz.com. The SBA Act of 1999 set a 3 percent government-wide goal for participation of these companies.

DFARS Changed to Allow Multiyear Remediation Contracts at Military Installations

Effective May 13, the DFARS has been amended to allow the Department of Defense to enter into multiyear contracts for environmental remediation services for military installations (Fed. Reg. 26509).

CASES/DECISIONS

"Best Value" Contract Usually Weighs Price and Technical Factors Equally

A "best value" solicitation indicated that technical and price factors would be weighed in evaluating offers even though it did not specify what weight and importance it would give to each factor. The Contracting officer gave approximately equal weight to each factor and the protester asserted that price was not among the "primary areas" specified in the solicitation for use in determining which proposal offered the best value. The Federal Court ruled that the CO properly gave equal weight to the technical and pricing evaluations noting that the GAO has several times held that price and technical considerations will be accorded approximately equal weight and importance in a proposal evaluation when a solicitation indicates that price will be considered but does not explicitly indicate the relative weight to be given to price versus technical factors (*Banknote Corp. of America Inc. and Guilford Gravure Inc. v U.S., Fed. Cir., No. 03-5104*).

No Constructive Change When Contractor Followed Advice of Program Manager

(Editor's Note. The following illustrates the conditions needed to claim an equitable adjustment caused by a constructive changes.)

MC II had a contract to provide generator sets to DOD that contained performance specifications leaving the

method of performance up to the contractor. When it had problems with the engines and was warned of a possible termination, it met with the program manager (PM). MC 11's interpretation of the meeting was that the PM directed it to use more expensive John Deere engines and that it would be entitled to recover additional costs once the PM authorized the change. The PM testified that though John Deere was discussed as a potential supplier the choice was up to MC 11. MC 11 advised the CO it intended to use the John Deere engines but there was no notice that it had considered the PM to have directed the change nor that it faced additional costs. MC 11 sought a $5.6 million request for an equitable adjustment for constructive changes allegedly ordered by the government. In denying the claim, the government asserted that at no time did the government direct MC 11 to change engine suppliers, no authorized government official ratified any alleged constructive change and MC 11 failed to comply with FAR 52.243-7, Notification of Changes that requires the contractor to notify the ACO within 30 days of government conduct the contractor regards as constituting a change.

The Board stated that to establish a constructive change, the contactor must prove (1) it was compelled by the government to perform work that was not required in the contract (2) the person directing the change had contractual authority unilaterally to alter the contractor's duties under the contract (3) its performance requirements were enlarged and (4) additional work was not volunteered but was directed by a government officer. The Board opined that to sustain the claim it would have to agree that MC 11 was compelled to change engine suppliers (2) the PM had authority, either express or implied, to make the change (3) John Deere engines exceed MC 11's contractual requirements and (4) the change was not volunteer but the PM directed the change. The Board ruled none of these hurdles were met – no order or directive was proven but the meeting was intended as technical advise only which was the proper role of a PM and there was no proof the PM had contracting officer authority nor did MC 11 interact with the PM in that role (*MC 11 Generator & Electric, ASBCA 53389*).

Unbalanced Bid Analysis is Separate From Price Evaluation

The Invitation for Bids required bidders to supply unit and extended prices for 18 items where the bid price was calculated by multiplying the unit prices for each line item by the estimated quantities that were provided in the IFB. Burney's $2.46 million bid was the lowest where the next bid was $2.52 million. The Contracting Officer conducted a separate unbalanced bid analysis where it used prior year quantities rather than quantities identified in the IFB and concluded that Burney's overstated prices for some items presented an "undue risk" to the government and would likely cost the government more than the next lower bid. When the CO rejected Burney's low bid under FAR 14.404-2, which authorizes the CO to reject unbalanced bids if there is an unacceptable risk to the government that actual costs would exceed the bid amount, Burney protested claiming that the use of the historical data changed the IFB's evaluation criteria which was supposed to be based on estimated quantities. The GAO sided with the government, ruling use of historical quantities rather than estimates did not change the solicitation's evaluation criteria because the unbalanced bid analysis is separate from price evaluation. It concluded the estimates and historical quantities were vastly different and since a similar variation was realistic, Burney's overstated prices for some line items did present an undue risk (*Burney & Burney Const. Co., Comp. Gen. Dec. B-292458.2*).

When Contract is Terminated No Profit Is Allowed On Subcontract Costs Under Cost Type Subcontracts

In its appeal for reconsideration of its termination settlement proposals, the Board confirmed that Lockheed Martin was entitled to profit on its subcontractor's costs under a fixed price contract but was not entitled to profit on its subcontractor's costs under a cost type subcontract. The Board cited FAR 49.202(a), which applies to fixed price contracts, which allows profit on "delivered material or services" and it cited FAR 49.205-1(a), which applies to cost type contracts, which says the contractor's fee "shall not include an allowance for fee for subcontractors effort included in subcontractors' settlement proposals." Lockhheed claimed it was entitled to recover profit and cited FAR 49.002(d) which states contractors can recover profit for "completed" subcontract items on cost type contracts prior to a termination and in the event of a termination, the amount of the termination settlement proposal "shall be determined by deducting from the gross settlement proposed the amounts payable for completed articles or work at the contract price and amounts for settlement of subcontractor settlement proposal." The Board disagreed that this section allows for profit stating FAR 49.002(d) "exits for the benefit of the government and confers no contract rights on Lockheed Martin" (*Lockheed Martin Corp. ASBCA No 53032*).

Comparison Between Government Estimate and Proposed Price Did Not Mislead Offeror Into Raising Its Price

The Request for Proposal for lawn services anticipated a fixed price contract with an indefinite quantity term for a base year and four option years where price and technical factors were to be equally weighted. The RFP stated that offerors' prices would be evaluated against each other. During two rounds of discussions the Navy told each bidder about variances in their proposed prices to the government's estimated price. Thinking its proposed prices were too low, Kaneoche increased its bid prices. When it lost to a lower priced bid, it protested the award asserting the Navy, by pointing out areas where its proposed price varied from the government's estimate, led it to believe its prices were too low. The GAO sided with the Navy, noting that discussions in addition to being meaningful must not mislead an offeror into raising its prices. Where it released its pricing information and advised offerors where their prices varied from the government's estimate the Navy did not request Kaneoche or anyone else to raise its prices. Further, all offerors were told the Navy's price analysis involved comparison to the prices of other bidders not the government's estimate. The GAO concluded that rather than inducing Kaneoche to submit higher prices the Navy discussions "should have provided an incentive to all offerors, including Kaneoche to submit their lowest possible prices to remain competitive" (*Kaneoche Gen. Servs. Inc., Comp. Gen. Dec. B-293097.2*).

NEW/SMALL CONTRACTORS

DCAA Auditor Identifies How He Would Conduct an Accounting System Review

Since evaluations of contractors' accounting systems have formally become a more frequent area of audit scrutiny (e.g. up to once a year), we have, from time to time, addressed what the government considers to be an adequate accounting system. We could not resist recounting an article by Anthony Destefano in the May 2004 issue of Contract Management where the author provides a clear description of what auditors will be examining. The article is unique because Mr. Destefano is currently an auditor with the Defense Contract Audit Agency and in our experience as former DCAA auditors and now consultants helping contractors evaluate their accounting practices, we find his reporting on what to expect during a review of the accounting system to be unusually clear and accurate. Though the article stipulates the opinions are the writer's and not those of DCAA, we find the article is quite realistic.

The accounting system must be in accordance with Generally Accepted Accounting Principles (GAAP). The auditor will conduct certain tests to make sure the contractor has, or if not, intends to have an *accrual* basis accounting system. It is also best if the contractor has financial statements compiled, reviewed or audited by an outside CPA firm.

Controls for distinguishing direct and indirect costs. The author states the Evaluation Checklist at the FAR Standard Form 1408 will be followed. The contractor must have controls to preclude the direct charging of indirect expenses and vice versa. A flowchart or similar document is most helpful in demonstrating the flow of expense transactions from say a purchase requisition to a purchase order to a receiving document and then to the vendor invoice. For service-related expenses, a formal contract, subcontract or engagement letter is "helpful" in determining whether an expense is direct or indirect. The charge number (direct or indirect) should be shown on the documents at the earliest possible stage. Also, a system of review and approvals are considered essential in meeting this requirement. It is also important for the contractor to prepare and maintain written policies and procedures for the identification of direct and indirect costs and these policies disseminated to employees preparing and reviewing relevant documents.

Job-Cost Ledger. The contractor must have either a subsidiary job-cost ledger or accounts receivable ledger that accumulates costs by contract at a level consistent with that used by the contractor (e.g. contract, task or delivery order, contract line item).

Indirect Cost Rates. The auditor will determine whether indirect costs are accumulated in logical cost groupings (called pools) and the costs must be allocated on a causal or beneficial relationship with the base. For example, a facilities cost pool would not include costs of the accounting or personnel department. The contractor should have a chart of accounts that shows how indirect costs are grouped in relevant pools and will be asked to produce a current general ledger trial balance that matches the chart of accounts. It is important that the contractor formally document its cost accounting system in a written description of the contents of the pools and bases.

General Ledger. The next requirement is that costs be accumulated under general ledger control. This is a test that should be conducted before DCAA begins the audit. Simply, the contractor's job-cost ledger must reconcile with the general ledger. For example, on-site labor posted to each contract in the job-cost ledger must equal the same on-site labor account posted to the general ledger.

Timekeeping System. SF 1408 requires "a timekeeping system that identifies employees' labor to the appropriate cost objective" (e.g. contract, IR&D/B&P project, cost pool, etc.). This requirement is supposed to be simple but it causes contractors the most trouble both in getting employees to comply and generating negative findings during floorchecks by auditors. The author states timesheets or timecards, whether manual or electronic, should be prepared and that the documents be signed by employees and supervisors. (*Editor's Note. Though not mentioned by the author, additional requirements often cited as deficiencies are failure to complete timesheets each day, provide visibility of all changes – no "white outs", and enter "start-stop" times when multiple projects are normally worked on. Also along with a written policy addressing expense reporting and screening unallowable costs, a written policy and procedure on accurately completing the company's timesheet or timecard are considered principle elements of adequate controls.)*

Labor Distribution. The SF 1408 mandates a labor distribution system for proper assignment of direct and indirect costs. The labor distribution reports summarize labor charges by employees and cost objectives. Contractors need to determine that labor distribution reports reconcile to the payroll register each period and that they reconcile to corresponding general ledger accounts. (*Editor's Note. Use of labor distribution reports often represents the greatest gap between contractors' practices and government requirements because it is not a very common element of most companies' practices – or at least companies do not use the reports even if their systems provide for them - while auditors often insist it be in place*.)

Monthly Posting. Auditors are instructed to make sure contractors post direct and indirect contract costs at least monthly to the books of account (e.g. general ledger, job cost ledger, labor distribution reports and other subsidiary reports). GAAP needs to be followed so that year-end postings of certain costs such as depreciation, defined benefit pension costs, accounts payable, employee leave accounts, etc. will be estimated and posted monthly and then adjusted to actual costs at year end.

Exclusion of Unallowable Costs. Every contractor must exclude unallowable costs, as defined in FAR 31 and specific contract terms. Most contractors set up unallowable cost accounts in their general ledgers and identify each cost separately at the document-processing and review-and-approval steps. Accounting personnel must become knowledgeable of FAR 31 cost principles and auditors will need to make sure the contractor has a plan to identify and exclude unallowable costs.

Other Considerations. To properly *segregate costs,* manufacturing contractors must have a system in place that can segregate preproduction costs to assist in re-pricing or follow-on contract pricing in order to ensure that preproduction costs are not paid twice. To meet *funding limitation* requirements, auditors will ask how often they are reviewed, what controls are in place to notify that FAR limitations are approaching, do contractors prepare abstracts of contracts and is a person assigned to be in charge of comparing costs accumulated to date on a contract to the cost or funding limitation so appropriate notifications requirements are met. For *interim billings*, contractors must prepare interim billings of direct costs directly from the books and records (*rather than relying on gathering necessary documents, often rushed, during billing periods.*). Costs of items purchased directly for the cost type contract may be claimed only if the costs will be paid according to the terms of the subcontract or PO. The auditor will take a sample of bills submitted and trace them to the job-cost ledgers and provisional billing rate letters for indirect costs. These tests will be made for both current and cumulative costs so records should show that the current and cumulative costs are accrued. For *pricing follow-on work,* costs should be segregated by lots and engineering costs must be segregated from manufacturing costs so that a learning curve (i.e. unit costs reduced based on higher volume) can be computed and applied to pricing follow-on work.

Finally the auditor will ascertain whether the accounting system is currently in full operation. Because they do primarily government fixed price or commercial work, contractors may not have the system up and running when audited. If so, the auditor must report though the system is set up, it is not yet in operation. If this is the case, the auditor will usually indicate the system is acceptable for award of a prospective contract but that a follow-on accounting system review be performed after contract award. The author says he advices contractors to create adequate systems using data from their fixed price or commercial work just to demonstrate the system does everthing it is supposed to do.

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QUESTIONS AND ANSWERS

Q. We are developing software for our own internal use. What are the current rules covering this.

A. Though the FAR is silent on the issue, the DCAA Contract Audit Manual, Chapter 7-104 states that the AICAP Statement of Position (POS) 98-1, "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use" should govern. It defines internal use software as software acquired, internally developed or modified "solely" to meet the entity's internal needs and during its development, no "substantive plan exists or is being developed to market the software externally." (Note if these conditions of "solely" for internal needs and no "substantive plan" to market it externally are not met, you may be able to expense the costs in the years incurred). For such software, SOP 98-1 stipulates the relevant costs should be capitalized. Once the computer software is completed and ready for its internal use (usually considered when substantial testing is complete) additional costs such as implementation, training and maintenance are expensed. As for amortization of the expenses, SOP 98-1 provides the amortization of expenses should be over the "useful life" of the software on a straight line basis unless you can demonstrate an accelerated method is justified (e.g. greater use in the earlier period).

As for computing the costs to be capitalized a couple of government cost accounting issues will arise that may conflict with POS 98-1:

1. Though POS 98-1 stipulates interest costs should be included in the capitalized cost, FAR disallows actual interest costs. You can impute a cost of money or DCAA auditors have been instructed to allow the interest costs if the difference between it versus an imputed cost of money is not significant.

2. Whereas POS 98-1 provides that G&A, overhead and training costs should not be capitalized, CAS 410 and 418 provides these costs should not be expensed because such indirect costs must be allocated to all cost objectives including capitalized projects. If it turns out these costs are material, DCAA auditors are told to discuss the matter with the contracting officer to make sure the government's interests are protected but also to ensure the contractor is not unduly burdened. If they are not significant (say less than 2-3%) we would expense them and not worry about them being questioned. Since they would not be considered "explicitly unallowable", there should be no penalty attached.

Q. We have decided to reassign our contracts administration costs from G&A to overhead. We have four overhead pools and are not sure how much of the contracts administration costs should be allocated to each pool. What do you think?

A. You may consider contract administration costs, like other primarily administrative functions, to be a cost center and you can allocate the costs to various overhead pools on a representative base. Common methods are headcount or direct labor dollars in the individual bases. More precise methods can be developed where the usage factor represents contract transactions (e.g. number of contracts) but we usually don't like it because of the added administrative effort of tracking the data and your vulnerability to assertions that you have not accurately identified all relevant transactions. Alternatively, a simpler means may be to assign the entire department or individuals to a particular overhead pool(s) and justify this practice on the basis that those individuals primarily support the relevant overhead base or more precise measurements have an immaterial dollar impact.

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