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# GCA REPORT

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## NEW DEVELOPMENTS

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### **DCAA Issues Guidance on Auditing Commercial T&M/LH Contracts**

The Defence Audit Agency issued guidance to its auditors to include DOD commercial time and material and labor hour contracts as part of their overall audit coverage. This coverage is to include provisionally approving interim vouchers and reviewing final amounts billed under contracts for compliance with contract terms. As for what costs should be approved for payment the guidance reminds auditors that acceptability of costs billed under commercial T&M/LH contracts are not subject to FAR cost principles or CAS but are determined based on the terms and conditions of the contract.

The guidance alludes to DCAA earlier guidance of July 31, 2007 addressing allowable costs on commercial T&M/LH contracts that provides:

- Hourly rates will be paid at the rate specified in the contract and blended rates (combined prime, subcontractor and/or interdivisional rates) may be used
- Hourly rates will be paid only for contract labor meeting labor qualifications specified in the contract
- Material, subcontracts not included as part of the labor schedule and other direct costs will be based on actual costs and other direct costs should be listed in the contract by type of expense (e.g. travel, computer usage, etc.)
- Indirect cost, as applicable, will be reimbursed at a fixed amount prescribed in the contract
- For labor hours, including subcontract hours reimbursed at the hourly rate in the schedule, access to original time cards (electronic or paper), contractor timekeeping procedures and labor distribution reports showing distribution of labor between jobs and contracts
- Access to invoices, proof of payment and subcontract agreements for any material and subcontract costs that are reimbursed on an actual cost basis

The guidance also alludes to a contract clause that allows reimbursement to the government for any

payments later found to be not payable under the terms of the contract and requires submission of a final voucher within one year of contract completion. The guidance reminds auditors that for contractors with incurred cost audit activity (i.e. submitted an incurred cost proposal) the DOD T&M/LH commercial contracts should be part of their overall audit coverage and the vouchers should be governed by the same billing system applied to other work. Also the contracts should be included in the universe for transaction testing for system reviews and the employees charging time should be included in the universe for floor checking. At contractor locations where DCAA has no current incurred cost audit scrutiny, audits are limited to provisional approval of vouchers, floor checks and audits of final vouchers. Auditors are told to consider reviewing the first voucher submitted to DCAA then review subsequent vouchers on a randomly selected basis (08-PPD-014(R)).

### **CAS Board Finalizes Rule on ESOPs**

Culminating a four step process begun in 2000, the Cost Accounting Standards Board issued a final rule, effective June 2, on the measurement and recognition of costs of employee stock ownership plans (ESOPs) under cost type contracts. The key elements include: (1) defining ESOPs more broadly by including not only plans that meet the GAAP definition of an ESOP but any other plan designed to invest primarily in the stock of a contractor (2) provide the cost of the ESOP is the amount contributed to the plan by the contractor based on the market value of the contributed stock or property at the time the contribution is made and (3) the contractor's contribution to the ESOP is assignable to a cost accounting period only to the extent the stock or cash is awarded to employees and allocated to individual employee accounts by the tax filing date for that period, including permissible extensions.

The rule revised CAS 415, Accounting for deferred compensation, making clear that ESOP costs will be covered only by that standard. Until now, there have been varying interpretations as to whether ESOPs are covered by CAS 415 or CAS 412 covering pension costs. The final rule also states when contractors have established advance agreements on treating existing

ESOPs those agreement will still be valid unless the parties agree to modify them to incorporate the new CAS. The change will apply to all ESOPs, whether or not they are a qualified plan under ERISA and IRS rules and the new rules do not distinguish between leveraged and non-leveraged ESOPs.

### **Proposed Rule to Evaluate Orders Under Multiple Award Contracts**

Reflecting federal agencies' increasing use of task and delivery orders under larger master contracts the FAR rule makers are proposing to have contracting officers evaluate contractor performance when work on these individual orders are completed rather than focus only on the overall contract. The proposed rule would require COs to evaluate past performance on orders exceeding the simplified acquisition threshold (currently \$100,000) for orders placed against Federal Supply Schedule contracts, multi-agency or government-wide contracts or single agency contracts. The proposed rule would also (1) add a new definition of "past performance" to include both active and completed contracts (2) state agencies are to submit reports electronically to the Past Performance Information Retrieval System (PPIRS) (3) clarify agencies are to identify the individual responsible for preparing the interim and final evaluation of a particular contract or order and (4) consolidate all past performance information collection rules into FAR Part 42. The new proposal is made in response to several government reports indicating government acquisition officials do not have sufficient past performance information to make informed decisions (*Fed. Reg. 17945*).

### **DOD Seeks Ways to Reduce Use of T&M Contracts**

Citing a recent GAO report addressing the proliferation of use of time and material type contracts for procuring services, Director of Defense Procurement Shay Assad issued a memo to defense agencies instructing them to analyze their use of T&M contracts, reduce use of this "least preferred contract type" and increase justification for using T&M contracts. The memo states use of T&M contracts have exploded because they are convenient to use, can be awarded quickly and adjusted easily but the problem is they provide little incentive for cost controls and labor efficiencies. The Azad memo reminds agencies that FAR Part 16 requires COs to make a written determination and finding no other contract is suitable, that a T&M contract includes a ceiling price which the contractor exceeds at its own risk and that government monitoring be documented in spite of the fact these requirements are often not followed.

### **DOD Rejects Industry Groups Urgings to Waive CAS Pension Requirements**

The Defense Department has issued a memo rejecting recommendations of two influential industry groups asking for the CAS Board to temporarily waive the pension cost accounting standards at CAS 412 and 413 to allow contractors to include in their forward pricing rates a factor to account for the estimated impact of the Pension Protection Act (PPA) of 2008. In recognition of the fact that the PPA requires a higher contribution to pension funds than what a contribution would be applying CAS, the industry groups requested the CAS be waived because until the two requirements are "harmonized" contractors are left "holding the bag" by requiring a higher contribution than they can recover from the government. Director Shay Assad rejected the request stating the funding changes of the PPA will not necessarily result in increased costs on negotiated contracts because the impact of the PPA will not be known until the CAS Board determines the impact of the changes which, by statute, must occur by Jan 2010. The memo stated if contractors are fully CAS covered they may be entitled to an equitable adjustment for increased costs while those not subject to CAS will be unaffected by any revision to the CAS since they are obligated under FAR 31.205-6(j)(2) to continue to apply the CAS in effect at the time of contract award. Under current DOD policy, PPA-required contributions in excess of CAS compliant pension costs represent "prepayment credits" under CAS 412.50(l)(4) which are not reimbursed in the period the contribution is made but in future accounting periods in which the credits are applied to fund the pension costs of the periods. The Groups had argued without success that without a waiver, the negative impact on contractor cash flow between what PPA funding requires and current CAS standards will be in the "billions".

### **DCAA Issues Guidelines On Unallowable Costs Associated With Legislative Earmarks**

DCAA has issued guidance to its auditors to be sure that contractors have properly identified and accounted for costs related to its legislative efforts at obtaining earmarks from the FY 2008 legislature. Citing FAR 31.205-22, it states that costs incurred with any attempt to influence legislation – such as earmarks – are unallowable. The guidance cites specific websites for earmarks in FY 2008 legislation associated with the house and senate defense appropriations to identify earmarks for companies. As part of their incurred cost audits or other related audits, auditors are told to review the earmark data on these

sites. They are told that unallowable lobbying effort may not be limited to company executives and hired lobbyists but also may include program management, contracting, public relations, consultants and technical personnel as well as associated costs such as travel and conference expenses (08-PAS-015(R)).

## **New FAR Rule Bars New Contracts to Tax Delinquent Debtors**

The FAR council agreed to a final rule, effective May 22, amending the FAR to add conditions to standards of contractor responsibility for violations of criminal tax laws and delinquent taxes as well as causes for debarment or suspension. In order to ascertain whether contractors comply with tax law, member of the Council stated the government should not be asking whether a contractor has been indicted or convicted but rather whether they have had any “criminal tax law violations in the last three years, whether they have any outstanding tax indebtedness more than one year old or whether they have any outstanding unresolved federal or state tax liens” (*Fed. Reg. 21791*).

## **DOD Amends Excessive Pass-Through Rule**

The Defense Department issued a new rule amending the DFARS rule that went into effect a year ago to ensure it does not pay “excessive pass-through charges” on certain contracts and subcontracts. The new rule leaves unchanged the basic requirement that offerors and contractors identify the percentage of work that will be subcontracted and when those subcontract costs exceed 70 percent of the total cost of work to be performed they provide information on indirect costs and profit and the value added by the contractor with regard to the subcontract work. In the narrative to the new rule, the rule writers stress the 70 percent requirement is “just a reporting mechanism” intended for the CO to make a one time determination that excessive pass-through costs do not exist.

The rule changes were largely a reaction to industry concerns that the determination be a one time event rather than continuing. The changes from the initial rule are:

- Adds a definition of “added value” to make clear that “management functions that the CO determines are of benefit to the government (e.g. processing of orders for parts and services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, performing quality assurance functions).”
- Requires a contractor to notify the CO if it decides, after contract award, to subcontract more than 70 percent of

total cost and verify the contractor will add value

- Establish a minimum threshold for coverage tied to the FAR threshold for cost or pricing date (currently \$650,000) and
- Incorporates definitions of “subcontract” and “subcontractor” consistent with the FAR

## **Approval of Payments on Flexibly Priced Contracts Limited to DCAA and ACOs**

As part of its continuing effort to ensure flexibly priced contracts are appropriately used and to tighten up management controls over such contracts the Defense Department Director of Procurement and Acquisition Policy Shay Azzad issued a memo stating (1) the Defense Contract Audit Agency will be the “sole authority” for verifying claimed costs and approving interim payment requests on cost reimbursable and time and material and labor hour contracts and (2) the administrative contracting officer will be solely responsible for approving final payment requests under these contracts. The memo states Contracting Officer Representatives (CORs) will not be delegated authority to approve these types of payments. Though CORs may review contractor billings as part of their contract performance surveillance duties (e.g. making sure hours billed and mix of labor under T&M and LH contracts are correct) they are now expected to coordinate with DCAA when any cost verification is necessary. The memo also states these same requirements apply to payments on commercial T&M/LH contracts as well as non-commercial contracts.

## **Controversial Exemptions from Contractor Reporting Requirements Are Dropped**

Several exemptions from a proposed bill requiring disclosure of violations of federal criminal law in connection with certain contracts or subcontracts have been removed. The draft of a November 2007 proposal seeks to suspend or debar contractors who fail to disclose to the agency inspector general and the contracting officer when it has reason to believe there has been a violation of federal criminal law in connection with a contract or subcontract valued at \$5 million or more. While the original proposal exempted contracts for acquisition of commercial items and for contracts performed overseas a bill was voted on to remove those exemptions from the bill and add that violations of the Civil False Claims Act had to be added.

## **Electronic Subcontracting Reporting System (eSRS) Not in Effect**

The FAR Council agreed to an interim rule change to the FAR to require that small business subcontract reports

now be submitted using eSRS rather than Standard Form 294, Subcontract Report for Individual Contracts and Standard Form 295, Summary Subcontract Report. eSRS is intended to streamline the small business subcontracting program (*Fed. Reg. 21779*).

### **DCAA Will Audit DHS Contractors**

DCAA and the Department of Homeland Security have entered into a memorandum of understanding for reimbursable audit services. Though DCAA originates in the Department of Defense, it frequently enters into agreements with other agencies to provide audit services to them.

## **CASES/DECISIONS**

### **Contractor is Vicariously Liable Under FCA for Employees' Acts**

*(Editor's Note. The following shows the liability companies have when their employees conduct fraud even though the company had no knowledge of employees acts and did not benefit.)*

Two former employees of DRC pleaded guilty to multiple counts of conspiracy to defraud the government in connection with DRC's contract to provide technical services and advice to the Air force in its acquisitions of computer systems where they orchestrated arrangement for the Air Force to buy goods and services from third party vendors and, in turn, received kickback payments. In the government's claim that DRC violated the False Claims Act DRC asserted (1) the claims were not false or fraudulent since their billings reflected accurate information for DRC services and DRC was not obligated to advise either purchase of the lowest price or disclose wholesale costs and (2) they lacked knowledge of the employees' actions who took several steps to hide their actions. The Court rejected the first claim stating the employees were obligated to provide advice concerning best value without conflict of interest and here the employees provided advice in contravention of these obligations and reaped substantial profits so the claims were false. With respect to the direct liability issue the FCA requires a false claim be made knowingly and though the employees certainly had direct knowledge it could not be imputed to DRC. Further, their acts were not motivated to benefit DRC but only themselves so the court ruled DRC did not have direct liability where damages would likely accrue.

However the Court concluded that DRC nonetheless is "vicariously liable" for its employees conduct under the "theory of apparent authority" and hence were liable under the FCA. The court ruled that the theory is recognized under the FCA and under the apparent authority doctrine a company does not need to benefit from an employee's conduct for vicarious liability to attach. The Court argued that to insist that the company had to intend to benefit for it to be liable runs counter to the rationale behind apparent authority doctrine – the law should protect the interests of those that reasonably believe the agents with whom they deal will have authority to act and that vicarious liability provides an important incentive for contractors to self-police for the type of corruption that occurred here since they are in the best position to control undesired conduct. DRC failed to self police in the form of ensuring its employees did not have conflicts of interest and the Court concluded it was appropriate to hold DRC responsible for its employees' fraudulent conduct (*US v Dynamics Research Corp., D. Mass No 03cv11965*).

### **Discontinuation of Portion of Services Is a Partial Termination**

*(Editor's Note. The following demonstrates the need to understand subtle differences between similar clauses and highlights the need to understand claims and partial terminations.)*

WSI held a base operations support contract to provide facilities services to two bases – NMIC and NAC. During the third option year the Navy informed WSI it intended to exercise the fourth option year but that services at NAC would be discontinued. WSI submitted a proposal for increased costs associated with the discontinuance of services at NAC, explaining its original cost proposal provided that indirect labor and material costs were evenly split between NAC and NMIC so the deletion of services at NAC resulted in insufficient funding to recover labor costs associated with six key management positions that remained since they were "essential to successful operation." Accordingly, it sought the costs associated with these six persons that were included in the indirect cost pool that was original split. The Navy found no justification for the proposed costs so WSI converted its cost proposal into a request for equitable adjustment and then a claim for \$690,000 when the CO denied entitlement. WSI claimed that under its NAVFAC Option to Extend Services clause, which did not provide for extending the term for only part of the contract, the elimination of NAC constituted either a deductive change or partial termination for which it was entitled to compensation. The Navy asserted that under the FAR

Option to Extend Services clause it was entitled to discontinue services at on one facility without compensating WSI. The Board found the exercise of the option for the fourth option year could only be done under the NAVFAC because the FAR clause limited total cumulative contract time extension to no more that six months and ruled unlike the FAR clause the NAVFAC did not contain language expressly stating the government may require the continued performance “of any services.” It granted WSI motion for entitlement (*Wackenhut Services Inc. ASBCA No. 55691*).

## EPA Wrongly Adjusted Fixed-Price Proposal Upward

In its request for proposals the EPA said it would perform both a cost realism and price realism analysis. The RFP provided that offerors could propose how they were to be reimbursed (e.g. on a cost, T&M or fixed price basis) where IBM selected a firm fixed price. In performing its cost and price evaluation of IBM’s fixed price proposal, the EPA noted there were no costs proposed for certain services and hence adjusted IBM’s proposed price upward for \$7.1 Million for evaluation purposes. In its protest IBM asserted the EPA inappropriately increased its proposed price. The GAO sided with IBM stating the EPA improperly adjusted its price upward explaining that a cost realism analysis is required by an agency evaluating a cost reimbursement contract or task order because the government is bound to pay for actual allowable costs but when a solicitation contemplates a fixed-price the agency may perform only a price realism analysis for limited purposes of measuring an offeror’s understanding of requirements or to assess risk (*IBM Corp., GAO, B-299504*).

## Court Summarizes Entitlement for EAJA Fees

In ruling that ACE was entitled to attorney and consulting fees in its claim for defective specifications and constructive claims the Court established the criteria for reimbursement of such litigation costs under the Equal Access to Justice Act (EAJA). The court said EAJA entitles a litigant in a civil action by or against the government to fees and other expenses if (1) a claimant is a “prevailing party” (2) the government’s position is not “substantially justified” (3) no “special circumstances” make an award unjust and (d) the fee application is timely submitted with an itemized statement. EAJA requires a claimant, if a corporation, not exceed \$7 million in net worth or 500 employees when the action was filed. In EAJA applications, the claimant bears the burden of proof except as to whether

the government’s position was substantially justified where the court must make that determination based on the government position, litigation arguments and the agency’s administrative position. A decision against the government does not give rise to the presumption its position was not substantially justified.

The Court noted it is not the intention to necessarily reimburse the contractor for all costs it incurred. The EAJA caps attorney fees at \$125 per hour unless “an increase in the cost of living or special factor, such as limited availability of qualified attorneys” justify a higher fee. The “special factor” is not usually factors applicable to litigation such as complexity of the case but rather specialty of the lawyer (e.g. patent law, knowledge of foreign language). Cost of living is usually a lower hurdle. Courts are also often more generous in use of experts costs where, for example, in this case, a rate of \$162 was considered to be “very reasonable, even modest” (*ACE Constrs., Inc. v US, 2008 WL 763067*).

# NEW/SMALL CONTRACTORS

## Basics Of The Fair Labor Standards Act

*(Editor’s Note. The issue of uncompensated overtime, which we have addressed in numerous articles, continues to be a hot issue. The need to appropriately account for uncompensated overtime applies only to those employees exempted from the Fair Labor Standards Act (FLSA). Increasing use of non-traditional employees performing on government contracts (e.g. variable employees, temporary labor, variety of subcontractors, unique teaming and cooperative arrangements) has made familiarity with FLSA more important than ever. The determination of what employees are exempt from FLSA not only affects government accounting issues but of course leaves contractors vulnerable to significant liabilities of unpaid overtime, attorney fees, loss of exempt status for certain employees not to mention harm to reputation. Since all companies need to address the question of who is exempt from FLSA we thought we would provide some basic rules and areas of vulnerability we have seen clients faced within our consulting practice. Though we have encountered the issue in numerous practical ways we should stress we are not human resource specialists so more detailed information should be sought from them. Rather, we present just the basics of the rules to non-HR specialists who work for government contractors. We have used an article written in the Government Contract Audit Report (no longer published) written by Andrew Hollowell and Frank Gulin, attorneys at Piliero, Mazza & Pargament) as well as our reading of the FLSA.)*

## Exempt Status Under FLSA

FLSA provides that employees who work more than 40 hours per week must receive compensation at a rate no less than one and one-half times their regular rate. The requirements operate separately from the Service Contract and Davis Bacon Acts that address minimum wages and benefits for employees working on certain government contracts. The FLSA exempts from overtime pay requirement “any employee employed in a bona fide executive, administrative or professional capacity.” In order to qualify as exempt employees they must qualify as one of the three and be compensated on a salary or fee basis. Other categories of employees may also be entitled to exemptions such as “outside sales” and computer-related personnel. The latter are exempt if they are paid at least \$445 per week. In addition, programmers and systems analysts may also fall into the administrative or professional categories.

If the employee is paid \$445 per week the so-called “short test” for exempt status is:

*Administrative:* (1) Primary duty is the performance of office or non-manual work directly related to management policies or general business operations of the employer or its customers and (2) duties include work requiring the exercise of discretion and independent thought.

*Executive:* (1) Primary duty is the management of the enterprise in which the employee is employed or a recognized department or subdivision of the enterprise and (2) regularly directs two or more employees

*Professional:* (1) Primary duty consists of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized study, not by a generalized academic education or apprenticeship or training in routine processes and (2) consistently exercises discretion and independent judgment.

Most of the problems center on duty tests for the administrative exemption. It is the broadest and least defined of the three exemptions and hence is the grayest. Employers should be aware the single most important factor in application of the exemption is that the employee must exercise discretion and independent judgment where it must be related to matters of significance to the employer. In examining any of the exemptions a court will examine employees’ duties in actual practices where job titles will not necessarily be critical.

As noted above, the FLSA also requires that exempt employees be paid on a salaried basis which is considered to be payment if they receive a predetermined amount of pay that is not “subject to reduction” because of variations in quality or quantity of work performed. Subject to certain listed exceptions, employees must receive their full salary for any week in which they perform work without regard to the number of days or hours worked. Hence, to maintain an exempt status, an employer may not make deductions for absences occasioned by the employer or the requirements of the business such as a work slowdown.

Deductions from salary are permissible only for (1) absences of a day or longer when employees are absent for personal reasons (2) absences of a day or more due to sickness or disability when employees have no more leave time or have not yet worked long enough to accrue sick leave or (3) intermittent leave under the Family and Medical Leave Act. In addition, penalties for infractions of safety rules of “major significance” may be made. Safety rules of major significance include only those related to prevention of major danger to the facility of employees such as rules prohibiting smoking in explosives plants, oil refineries or coal mines.

## Practices that May Make Employees Non-Exempt

- **Leave Deduction Policies**

The courts have ruled employees who are docked pay or missing a fraction of a day must be considered hourly rather than salaried. Employees need not actually suffer a dock of pay but are considered hourly if they are *subject* to reduction. Some courts have ruled that docking exempt employees’ accrued compensatory time (comp time) for partial day absences also cause them to lose exempt status. For example, the establishment of a comp time “bank” where accumulated comp time was subject to deductions for lateness or partial days off was held to be inconsistent with salary status (*Klein v Rush Pres-St. Luke Med Center*, 990 F.2d). In *Klein*, employees accumulated comp time in lieu of overtime and in addition were required to expend an hour of accumulated comp time from a comp time bank for very hour they were late or left early. If they did not have enough comp time banked, they went into “negative comp time.” The court held that when employees were forced to go into negative comp time they were going into a form of debt which was similar to docking them and since the supervisors were not subject to this and they needed their department head’s authorization, they were not exempt.

However other courts have held that deducting comp time or leave time for partial days absences do not affect employees' exempt status. For example in *LAFF v City of Alexandria* (720 F.Supp. 1230), the court upheld the exempt status of employees who were docked from their accrued comp time for partial absences noting that personal sick leave or comp time may be a part of their compensation package, not constituting a salary.

Given the split legal authority it may be wise to avoid the practice of reducing comp time balances for partial day absences. If you choose to practice this, you may want to avoid permitting employees to maintain "negative" leave balances. At a bare minimum, if negative balances are allowed, employers should ensure that when employees terminate their employment their final paychecks are not reduced to account for the negative balance because such a pay reduction might constitute a reduction in pay for partial day absences and result in a loss of exempt status.

- **Payment of Extra Wages**

Many employers provide exempt employees with comp time or straight time wages for overtime work. Federal court decisions and the Department of labor have ruled that employers are free to pay exempt employees extra wages for such work.

- **Suspensions Without Pay**

Many employers have established policies providing for suspensions without pay for violations of various work rules not involving safety issues. Courts have held that actual suspensions of exempt employees for less than a week for non-safety infractions will result in the loss of the employee's exempt status. The rationale for this is the suspension would make the employees' pay subject to deduction based on "quality" of the employee's work which is impermissible. However, a salaried employee may be suspended without pay for a full work week for non-safety infractions. This is because the FLSA does not require salary to be paid where no work has been performed for a whole week.

In addition, employees may lose their exempt status merely because they were "subject to" improper suspensions without pay even though they never actually suffered deductions from pay. In *Auer v Robbins*, (519 US 452) the Supreme Court held employees may be rendered non-exempt even if their pay had not been reduced if the employer has a "clear and particularized" policy which effectively communicates that deductions will be made under specified circumstances. So, for example, a provision in an employee handbook stating

clearly that exempt employees will be suspended without pay for three days for a rule violation may render all employees subject to the handbook non-exempt, whether or not the policy has been applied.

- **Erroneously Classifying Employees as Independent Consultants**

The FLSA applies only to employees and not to independent contractors. In recent times employers' classification of personnel as independent contractors have come under attack by state and local governments seeking to recover unpaid payroll taxes or independent consultants themselves seeking to recover unpaid overtime or other employee benefits. Employers should review whether independent contractors are not in fact employees.

Federal courts have applied a multi-factor test in making determinations of independent consultants or employee status. The basic factors articulated are (1) the permanency of the relationship between the worker and the employer (2) degree of control exercised by the employer (3) the amount of skill and initiative required on the part of the worker (4) relative investments of the employer and worker (e.g. equipment and supplies) (5) the worker's opportunity for profit or loss and (6) the extent to which the work performed is an integral part of the employee's business.

In applying the multi-part test the courts have emphasized that no single factor is dispositive and that the resolution of the issue is dependent on the facts of each individual case. Courts often weigh the "economic realities" of the relationship – is the worker economically dependent on the business or is he in business for himself.

Improper misclassification can cost the firm dearly from liability for unpaid overtime for up to three years to penalties for failure to make mandatory payroll deductions and paying for benefits. Employers need to be careful in how they structure their contracts used with independent contractors to ensure they are protected from challenges.

## **FLSA Damages**

The statute of limitations for the FLSA is two years unless the employer's violation was "willful" in which case the period is three years. A violation is willful when the employer knew or showed reckless disregard for the truth. It is not uncommon for multiple employees to join together in a "collective" action of an entire group. In addition to payment of overtime employees may be

May - June 2008

GCA REPORT

entitled to an award of liquidated damages in an amount equal to the unpaid overtime. However if the employer satisfactorily shows the court its act giving rise to the underpayment was in good faith and it had reasonable grounds for believing it was not in violation of the FLSA the court, at its discretion, will likely reduce or decline a liquidated damage award. An employer violating the FLSA may attempt to cure any violations by repaying amounts owed and promising to comply with the Act in the future. Finally, it should be noted that individual state and local laws may impose greater obligations than the FLSA.

We have covered just the basic, commonly encountered issues related to FLSA. Contractors should be aware of potentially other pitfalls such as those related to unique entities that may arise (e.g. joint employees of prime and subcontractors or joint ventures) or whether there may be violations with personnel provided by temporary staffing agencies.

## QUESTIONS & ANSWERS

**Q.** We have been monitoring our rates and since certain work did not materialize we see our actual rates are lower resulting in about \$600,000 of underbilled amounts out of a total of \$6 million billed. We may be proposing additional work with the same agency so we want to be careful but don't want to wait until incurred costs proposals are audited and resolved. What do contractors do?

**A.** The most common way is to bill now for underbilled amount. After all, you are supposed to monitor your indirect rates and adjust billings when provisional rates are determined to be inaccurate. If you are worried

about the impact on current negotiations, you can still bill for the adjustment later by increasing your provisional rates. However, you need to be careful that the increase will not lower the types of direct costs you will be allowed to charge because funding limits have been exceeded.

**Q.** I would like to comment on your answer related to tax preparation expenses for Federal Income Tax as a directly associated unallowable cost where you addressed the concept of directly associated unallowable cost. It would have been better to provide your reader with an argument against such treatment. A local (San Diego County) DCAA auditor did raise the issue that costs for preparing unallowable income taxes is a directly associated costs and should be questioned. Our response to the auditor was that the cost is not unallowable as a directly associated cost as defined in FAR 31.201-6(a). Rather, the expense is a reasonable cost of doing business, similar to the labor cost of an Accounts Payable clerk processing allowable and unallowable employee reimbursement requests/travel expense reports. A company has an obligation under the IRC to file its income tax return. While Federal income tax expenses are not allowable government contract costs, the cost of preparing the tax return, whether done by in-house or external CPAs is an ordinary business expense.

**A.** Though I had something different in mind when I discussed the issue I think you make a compelling argument for why the costs should not be questioned. Though I have not personally seen costs related to preparing federal income taxes questioned if they were, your argument would be quite strong. I especially liked your A/P clerk analogy.