GCA REPORT
(A publication of Government Contract Associates)

November-December 1999 Vol 5, No. 6

NEW DEVELOPMENTS

Changes to the FAR

On September 24, the government issued some interim and final rule changes to the Federal Acquisition Regulation. Significant FAC 97-14 changes include:

Determining Price Reasonableness for Commercial Items. FAR 15-403 is amended to state that when a CO cannot determine if a proposed price for a commercial item is reasonable by sources other than the offeror, the CO must require submission of information other than cost or pricing data. The FAR changes provide for procedures to obtain this information. For example, sales data is to be limited to the same or similar items proposed during a relevant time period and the scope of the request of information is to be in the form commonly maintained by the contractor as part of its commercial operations.

The rule also lists "preferred" price analysis techniques such as (1) comparison of proposed prices received (2) comparison of previously proposed prices and (3) previous government and commercial contract prices for the same or similar items. The rules leave the door open for most other means when the "preferred" methods are insufficient for determining price reasonableness. Other techniques identified in the FAR such as value analysis and field pricing requests from the Defense Contract Audit Agency are also considered appropriate under the circumstances.

Final rules include:

Late offers (FAR 52.212-1). For commercial items, late offers will be considered if the offer was mishandled by the government. Bids, proposals, modifications and withdrawals may be accepted late only if they are received before award is made, the acquisition will not be delayed and the offer is generally under the government control by the due date. Late modifications to bids that were received on time may be accepted at any time if they are favorable to the government. Bids and proposals may be withdrawn by written notice if received before the due date.

Uncompensated Overtime (FAR Part 15 and 37). The FAR has been amended to provide guidance on evaluating proposals that include uncompensated overtime hours (hours worked over the average 40 hour week without added compensation by employees who are exempt from the Fair Labor Standards Act). The rule requires COs to ensure the use of UOT to acquire services base on number of hours will not degrade the technical expertise needed for the work. COs are required to conduct "risk assessments" and evaluate proposals that might include unrealistically low labor rates or other costs that can result in quality shortfalls. COs are also to look for "unbalanced distribution" of UOT among skill levels and use of overtime in key technical positions.

Sharing Periods and Rates for Value Engineering Change Proposals (FAR Part 48 and 52). To encourage more VECPs, COs will be allowed to increase cost sharing periods from 36 months to a range of 36 to 60 months. Also, COs may increase from 50 percent to a range of 50 to 75 percent a contractor's share of instant, current and future savings as well as increase the contractor's share of collateral savings up to 100 percent for each VECP. Collateral savings are measurable net reductions in an agency's overall projected costs of operation, maintenance and logistics support or government furnished property.

HUBZone Contracting. This final rule implements into FAR the Small Business Administration's final guidance on the Historically Underutilized Business Program. The purpose is to expand employment opportunities in distressed communities by increasing contract set asides, sole-source awards and price evaluation preferences for companies located in distressed communities *(see our article on details of the HUBZone program in Vol. 1 No. 4 of the GCA DIGEST.)*

Conditionally Accepted Items (FAR 46.407). When the government accepts nonconforming items, the CO should withhold from payment amounts that are at least sufficient to cover costs and related profit to correct deficiencies and complete the unfinished work. The CO

should document the file for the rationale for amounts withheld.

Definition of Executive Compensation (FAR 31.205-6). For costs incurred under government contracts after January 1, 1999 (regardless of contract award date) ceilings on executive compensation will apply to the five most highly compensated employees in management positions at each home office and each segment, whether or not the segment reports directly to the contractor's headquarters.

Change to Paid Cost Rule Imminent

As anticipated, Director of Defense Procurement Eleanor Spector in a September 27 memo announced the imminent publication of a FAR final rule that will eliminate the so-called "paid cost" rule. Under the rule, a large business is required to have paid its subcontractors before including those payments in progress payments and other costs based billings while small businesses need only have incurred the subcontract costs to include them in their billings. Industry groups have been pushing for its elimination, arguing it was unfair to large contractors.

The major hitch is that such types of changes typically apply only to new contracts, resulting in the need to have two accounting and payment systems – one for new and one for current contracts. Sympathizing with this predicament, Ms. Spector recommends use of the "Single Process Initiative" to eliminate the "paid cost" rule from exiting contracts. Under the SPI procedure or simply by negotiating an agreement, the CO will be able to arrange a retroactive elimination of the paid cost rule. Such an agreement will have to be based on a demonstration the government will benefit from either improved cashflow and/or cost savings resulting from eliminating duplicative billing systems. We expect the government will issue more guidance how to make sure the change will apply to both new and current contracts.

Congress Passes FY 2000 Defense Bill

The Senate and House of Representatives overwhelmingly passed, with the President's signature, the Fiscal Year 2000 Defense Authorization Bill providing $288.8 billion in defense expenditures. All of the pricing and acquisition related items we identified in the last issue were passed such as:

Changes to CAS Applicability including (a) doubling the threshold for full CAS coverage (compliance with all 19 standards) from $25 million to $50 million (b) reinstating the "trigger" contract threshold so that CAS coverage will be triggered only by an award of a contract worth $7.5 million or more (c) permitting agency heads to waive CAS applicability for contracts worth $15 million or less and (d) exempting from CAS firm fixed price contracts that did not require submission of certified cost or pricing data.

Other changes included (1) Increased RDT&E spending (2) de-emphasize personnel experience to encourage newer organizations to bid on contracts (3) limit audits of participants in Other Transactions (4) develop guidelines to ensure task and delivery order awards are more competitive (5) expand commercial services to utilities and housekeeping, education and training and medical services (6) raise the application of simplified acquisition procedures for commercial items from $100,000 to $5 million (7) extend both the protégé-mentor programs and 5% goal of awarding contracts to small disadvantaged companies three years and (8) prevent release of proposals in government possession under Free of Information Act.

FAIR Inventory Lists of Potentially Commercial Jobs Issued

As required under the Federal Activities Inventory Reform (FAIR) Act, 52 agencies under seven major federal departments issued inventories of 320,000 jobs of which one third are deemed "potentially commercial" (that is, work that can potentially be contracted out to the private sector). The Department of Defense soon followed with its own list, over 2,000 pages long, identifying an additional 300,000 positions that can also be potentially competed out following Office of Management and Budget A-76 guidelines *(see our article on A-76 competitions in the last issue of the GCA DIGEST*).

Starting this June 30 (they were late), the FAIR Act required each agency to submit annually to OMB a list of activities performed that are not inherently governmental functions. After reviewing these lists, OMB must publish an announcement of the public availability of these lists. "Interested parties" (e.g. government employees, private sector representatives interested in obtaining jobs) then have 30 days to examine the list and challenge the inclusion or exclusion of an activity from the list. Agencies are not required to compete the positions at his time but only to identify them so industry groups may push for their transition to the private sector.

The first set of lists have been reviewed and released by OMB and the DOD lists are expected to be released in mid December. Several trade groups have examined the initial lists and have, in general, been quite critical. In an October 29 report prepared by various groups representing numerous functions (e.g. IT services,

consulting engineers, surveyors, etc.) the groups said the lists did not clarify whether they believe the positions identified were exempt from outsourcing (so-called "Exemption A") or were ready for outsourcing (Status "B"). The groups criticized the low number of functions identified as commercial, asserting that many identified as Exemption A included several functions that are currently outsourced. The agencies most commonly challenged included NASA, Departments of Agriculture and Commerce, the Environmental Protection Agency, HUD and the General Services Administration.

In addition both industry and Congress are critical of OMB's decision to release the lists of each agency separately, making it "cumbersome" and "time consuming" just to obtain the lists. The lists are not published in the Federal Register but must be obtained from individual agencies. Some are available on the agencies' website while some require contacting each agency and arranging different methods of obtaining the lists.

CAS Board Proposes Altering What Constitutes an Accounting Practice Change

The Cost Accounting Standards Board is taking a third crack at defining when a contractor's organizational changes constitute a cost accounting practice change. Previous versions were strongly criticized by industry and withdrawn on the grounds that efforts to streamline operations would result in determinations of accounting changes requiring burdensome cost impact proposals and contract price adjustments on contracts to ensure the government does not pay increased costs.

The proposal, like the two previous ones, is based on the CAS Board's position that a cost accounting change occurs when a contractor's organizational changes (often called voluntary restructuring) result in combining existing pools of indirect costs, splitting out existing pools, or transferring functions from one pool to a different one. These changes are usually associated with improving future operations and reducing costs through either work force reductions or physical reductions. The proposal will:

1. Exempt cost accounting practices changes associated with restructuring from cost impact requirements when the contractor demonstrates (a) the voluntary change is being made concurrently with the planned restructuring activities and would not be made but for the restructuring action (b) the planned restructuring action is expected to result in cost savings to the government and (c) reduced contract costs in the aggregate is expected for existing cost type contracts and expected future CAS-covered contracts.

2. Establish criteria for determining when voluntary practice changes that do not quality for the exemption may still be deemed "desirable". Such desirable changes will allow an "alternative process" to give COs flexibility in determining the level of detail required for cost impact and the parties to increase existing CAS contract prices in the aggregate to reflect increased cost to the government.

Audit Guidance

The Defense Contract Audit Agency as well as NASA auditors issued the following guidance to their auditors:

Adjustment for Defective Pricing (MRD99-PFC-105 (R) Following several recent cases, DCAA advises that when there is no evidence to the contrary, auditors should assume the defective data results in a dollar for dollar increase in contract price. The starting point (baseline) for computing a recommended price adjustment is the contractor's last proposal plus or minus the impact of subsequently disclosed cost or pricing data. If there is evidence (usually contained in the Price Negotiation Memorandum) the contract price was adjusted for a defectively priced cost element resulting in a price below the cost proposal then the negotiated value of the defective element is the baseline for calculating a price adjustment.

Rapid Rates (MRD99-OAL-113 (R). To provide information to procurement offices faster and reduce telephone requests for small contractor rates, DCAA is beginning a process to self-initiate rate reviews of selected contractors before receiving bids or proposals. Field offices are beginning to compute a list of contractors where reviews will occur.

Idle Facilities for NASA Contractors. The National Aeronautics and Space Administration is asking its COs to look for idle facilities at contractors having high facility costs. Idle facilities are considered unused facilities that are excess to contractor's current needs (FAR 31.205-17). Contractors will be selected who, for example, have changes in scope of their contracts, have undergone external or internal restructuring, reduced workforce, terminated contracts or subcontracts or site locations have moved. Idle facility costs are generally allowable for one year and can be for more depending on initiatives taken to use, sublease or sell the facilities. If the CO determines the actions to reduce idle facilities are insufficient, the costs will likely be disallowed.

BRIEFLY...

Second Phase of CCR Issued

The success thus far of the Central Contractor Registration database (over 160,000 contractors have registered) led the Department of Defense to launch Phase II of the program. Phase I represents the requirement of CCR to be the single place to register all contractors and to have financial information used by the Defense Finance and Accounting Service for payment. Phase II is intended to be (1) a "one stop shop" for COs attempting to target appropriate contractors with invitations to bid (2) open to all departments government-wide (currently used by NASA, the VA, Interior and DOD services) and (3) expansion of information to include debarment, financial responsibility and certifications and representations. For more information visit CCR at http://www.ccr2000.com.

OMB Issues Final Rules on the Prompt Payment Act

The Office of Management and Budget issued final revisions to its rules on the Prompt Payment Act that supercede its prior Circular A-125. Highlights include: (1) agencies may use electronic media in place of paper when adequate controls and safeguards are in place (1312.3); (2) agencies may accelerate payments for invoices under $2,500 as soon as invoices, receipt and acceptance documents are matched (1315.5); (3) allows for contracts containing the FAR 52-213-1 "Fast Payment Procedure" clause payments within 15 days of receipt of invoice when contractor certifies supplies have been shipped and will be replaced, repaired or corrected if they are lost, damaged or do not conform to specs (1315.6) and; (4) requires payment on individual purchase card invoices under $2,500 within 30 days and does not require matching documentation such as invoices to acceptance (1315.12).

OFPP Not Likely to Soon Eliminate MAS Post Award Audits and Defective Pricing Clauses

Considered as contrary to the goals of making federal acquisitions more consistent with commercial practices, industry groups have been heavily lobbying the government in recent years to rescind two clauses used by the General Services Administration in Multiple Acquisition Supply (MAS) contracts. The two clauses are (1) Examination of Records by GSA – the post award audit clause which allows audits up to two years after contract award to verify discount information used to negotiate prices and (2) "Price Adjustment – Failure to Provide Account Information" – the defective pricing clause that entitles the government to a refund where a contract has been overpriced due to defective contractor data.

Deidre Lee, head of the Office of Federal Procurement Policy, wrote to an industry group acknowledging the clauses are not customary in the marketplace but they are still "reasonable" to protect the government's interests. She defended their use by referencing FAR Part 12 that does not require use of commercial practices in all cases but only "to the maximum extent possible". Lee also said that the use of post award audits have not, in practice, been used. Industry and bar representatives have criticized the OFPP's response as a "narrow interpretation" of the rules and a decision where "everyone losses".

DOD Allows Contractors to Follow Prior or Current Travel Regulations

The Director of Defense Procurement extended a December 23, 1998 FAR class deviation that (1) authorizes the DOD to deviate from the travel cost regulations in FAR 31.205-46 by allowing contractors to either adhere to current maximum per diem rates or those in effect on December 31, 1998. The current maximum per diem rates remove lodging taxes from per diem rates and allow them to be a miscellaneous expense while the older ones include the tax in the per diem rates. Once a decision is made, only one rate may be used for all travel, preventing using different rates on a trip by trip basis. Only DOD and NASA contracts allow the choice – current rates only are allowed by other agencies.

Procurement Executives Told to Scrub CBD Notices

Responding to numerous complaints about the quality of Commerce Business Daily announcements, the Director of Defense Eleanor Spector told service procurement executives to improve. Poor quality CBD notices have included incorrect phone and fax numbers, web site references connected to general home pages of the organization rather than specific solicitations, hard to understand item descriptions and inconsistent statements of whether planned procurements were competitive or sole source. The review stated the CBD notice quality should be made a "special interest" item by procurement management and that procurement specialists should review the notice issued by buyers before they are sent to the CBD.

CASES/DECISIONS

Task Order Exceeding Scope of Contract Is Anti-Competitive

The Army sought to modify a real property maintenance contract by issuing a task order for housekeeping services. Following a protest of the task order, the GAO rejected the Army's contention that "maintenance" is a "catch all" phrase that includes housekeeping services. The GAO usually does not review contract modifications but stated it will make an exception where the modification is alleged to be beyond the scope of the original contract since, as in this case, the modification would be subject to a statutory requirement to be competed.

The GAO said in determining whether a modification triggers the requirement of competition, it looks to see if there is a "material difference" between the modification and original contract. This material difference would be evidenced by (1) changes in the type of work (2) performance period and (3) costs. Another consideration would be if the original solicitation adequately advised offerors of the potential for the type of change found in the mod. The GAO recommended the task order be terminated and the Army procure housekeeping services through a competitive procurement (Mahro Janitorial Services, Inc., GAO B-282690).

Sole Source Award Not Justified

The contractor protested a Defense Logistics Agency contract for supplying tubing from an original equipment manufacturer (OEM). Though the solicitation stated offerors could provide alternative products provided they were interchangeable, the solicitation did not identify any specs, plans or drawings for the tubing but only referred to the OEM's part number. The purchase item description of the part number included specifications the protester asserted could have been easily provided and further alleged DLA failed to properly evaluate its proposed alternative product. DLA justified its sole source award by stating (1) the tubing was only available from the OEM and (2) the need for the tubing was "unusual and urgent" and the government would be harmed if the competition was not limited.

The Comp. Gen. found the justification for the sole source award inadequate. It noted the DLA's justification and approval for the sole source award consisted solely of check marks on a preprinted form identifying statutory authority to make a sole source award. There was no analysis or explanation supporting the conclusion on the form and there was no certification from the original requestor on why serious harm would result from delay. The Comp. Gen. continued by saying even if a sole source award was justified, DLA was required to provide the protester with a reasonable opportunity to demonstrate the acceptability of an alternative product. Though the Comp. Gen. sustained the protest and ordered recovery of all protest related costs, it did not order the contract terminated since performance had begun (National Aerospace Group, Inc., Comp. Gen. Dec. B-282843). *(Editor's Note. The case also points out the need to retain qualified counsel not only for the protest but to ensure performance is not begun.)*

"Bait and Switch" Tactics Not Proven

A protester challenged a scientific and engineering support services award where six of 15 key personnel the solicitation required to be identified were from employees of the awardee's subcontractor. The protester claimed the awardee "baited" the Navy by identifying key personnel in its proposal and then planned to "switch" the key personnel with employees from the incumbent contractor. The allegations were based on an email sent by an employee of the subcontractor that stated (1) the subcontractor did not have people "waiting in the wings" to work on the contract and (2) it was the awardee's intention to use incumbent personnel since the Navy did not want to displace the employees.

The Comp. Gen. said for a "bait and switch" to exist a protester must show (1) the awardee represented it would rely on specified personnel (2) the government relied on the representation in evaluating the proposal and (3) it was foreseeable the individuals named in the proposal would not be available to perform contract work. There is no dispute about the first two elements and the Comp. Gen. considered whether the email constitutes evidence the awardee intended to utilize other key personnel. Though the email indicates the awardee expected the Navy to direct it to use incumbent employees, such a statement is consistent with the awardee's proposal that stated it would consider hiring incumbent employees. The substitution would not be a misrepresentation and there would be no harm to the government since the incumbents presumably had equal or similar qualifications and hence is allowable by the contract that allows for substitution of key personnel with proper notice and approval. Finally, though there may not be employees "waiting in the wings" its proposal was not prepared in bad faith because it is unrealistic to expect

an awardee to have a full cadre of qualified workers on standby in the event it prevails in a competition. The fact the awardee had signed statements by the subcontractor's employees indicating their availability to work on the project was good enough. Thus the protest was not sustained (A&T Engineering, Technology, Comp. Gen. Dec. B-282675).

Service Contractor Must Pay Wages and Fringe Benefits At Least Equal to Predecessor Contractor for Entire Period of Multiyear Contract

An offeror challenged a solicitation that stated a multi-year contract covered by the Service Contract Act (SCA) would require minimum wages and benefits paid the first year equal to the predecessor's and wages and benefits equal to the collective bargaining agreement (CBA) negotiated by the contractor in the years after. The protester asserted the terms of the new contract would allow for lower wages in out years. This violated the SCA rule covering multiyear contracts that required periodic wage adjustments at least every two years that would be based on either prevailing wages in the locality or under the predecessor's CBA.

The Court agreed with the protester saying the SCA requires a successor contractor to pay wages and fringe benefits no lower than those of the predecessor contract for the *full term* of the multiyear contract. The Court stated the RFP violated the intent of Congress to make sure wages were not cut as a result of a new contract and having only a one year limitation would delay rather than eliminate the undesirable practice of cutting wages on each new contract. The Court concluded the SCA "creates a wage floor" for the entire term of the contract not just the first year (American Maritime Officers v. Hart, No. 99-104).

Three Year Past Performance Rule Runs from Contract Completion Date Not Date of Performance

The protester received a lower rating on its proposal due, in part, from a low performance rating received because of problems occurring during its five year predecessor contract. The protester challenged the award stating the agency had improperly considered incidents that occurred more than three years before the solicitation was issued, violating the rule that past performance should cover only the last three years. The Comp. Gen. rejected the protest stating FAR 42.1503(e) limits considerations of past performance to three years "after completion of contract performance". In spite of incidences occurring more than three years ago, the completion of the contract was within the three year period (D.F. Zee's Fire Fighter Catering, Comp. Gen. Dec. B-280767.4).

Court Reverses Allowability of Defense Costs for Wrongful Termination Defenses

In a recent decision, legal costs were found to be allowable for litigating a case where employees were found by a civil court to be wrongfully terminated because of their allegations the company fraudulently invoiced the government. The Board of Appeals found the costs allowable because there was some doubt about the fraud in spite of the court's ruling and the consideration of whether the costs were reasonably incurred business expenses rather than the outcome of the case should determine their allowability. A Federal Circuit Court overturned the decision ruling a contractor may not charge government contracts the costs of an unsuccessful defense because (1) no benefit to the government can be shown when the employees were fired for divulging fraudulent behavior against the government and (2) the Board should not have second guessed the civil court (Sec. Of the Army v. Northrup Worldwide Aircraft Services, Inc., Fed. Cir. No. 98-1500).

QUESTIONS & ANSWERS

Q. We are saving all contract documentation of current and prior contracts and the boxes are becoming quite numerous. I'm not sure how long we have to keep this stuff? Could you let me know the requirements?

A. The data that contractors must make available must generally be maintained for three years after final payment, except where other periods are prescribed in FAR 4.705. Two year retention periods are required for labor cost distributions, petty cash records, time cards, payroll checks, and material and supply requisitions. Four year retention periods are required for Accounts Receivable invoice and supporting data, material or service work orders, cash advance recapitulations, paid-canceled-voided checks, payroll registers, maintenance work orders, equipment property records, purchase orders and supporting data, material inspection and receiving reports, and production and quality records.

By the way, sad experiences have taught us to clearly mark the contents on each box and maintain a log of each box and its contents.

Q. We have a staff of full time employees and are considering using a group of individuals for two contracts that will not be employees. How should we account for them for costing and billing purposes? What will the auditors accept and reject?

A. The most common methods include: (1) charging them as subcontractors applying only normal indirect rates appropriate to subcontractors or temporary labor (2) charging a portion of the billed costs as "direct labor" and then charging the remaining costs to overhead and/or fringe benefit pools and applying normal overhead and or fringe benefit rates to the direct labor for billing purposes or (3) creating a special rate to apply to the direct labor portion.

Let me illustrate, assuming a $50 per hour billed cost for the temporary individual (this category of cost is usually referred to as purchased labor). For the first option, $50 dollars would be booked as a subcontractor or temporary labor and would incur the normal indirect rate applied to this category of cost (e.g. G&A if subcontractors are included in the G&A base). In the second example, the average labor rate incurred by employees for comparable work would be charged to direct labor (say $35) and the remaining $15 would be charged to overhead. Variations can be devised where a normal fringe benefit rate of 25% could result in $40 being charged to direct labor and $10 to fringe benefit. Or, applying the company's ratio of direct labor to overhead (say 50/50) could result in $25 charged to direct labor and $25 to overhead.

As for auditors' evaluation, the DCAA Contract Audit Manual Part 7-2100 covers reviews of purchased labor. Auditors are first instructed to determine whether purchased labor is a significant cost. If it is, they are advised to review the need for purchased labor including obtaining technical input into the effectiveness of such relationships, the duration of their engagement and what contracts are worked. As for accounting for the purchased labor, auditors are instructed to evaluate contractor's practices on a case-by-case basis with the primary criteria being whether costs are allocated on a "causal or beneficial" basis. For example, it is common for employees to pay little if any fringe benefits to purchase labor so auditors may question applying the same fringe benefit rate applied for regular employees. They may ask for a reduced fringe benefit or none at all. In the case where separate fringe benefit and overhead pools are maintained and the overhead rate is applied to the direct labor component of the purchased labor, the direct labor costs of the purchased labor should be included only in the overhead base and not the fringe benefit base. If the overhead and fringe benefits are combined in a pool, then an auditor may want to see some variation of the above examples where the $50 is split up. In some cases, auditors may want to see a "special allocation" where a separate overhead would be designed where, for example, supervisory costs would be included but not facility costs for off-site purchased labor.

I would suggest conducting a sensitivity analysis of different treatments of purchased labor and either select one and wait to see if it is challenged or negotiate beforehand with the reviewers of the proposal one or two desirable methods. Since auditors are asked to identify contractor's standard practices of costing and pricing purchased labor, it is also advisable to have written policies and procedures in this area.

Q. We have a large staff of indirect labor. On our largest subcontract, the prime contractor has given us permission to use many of our indirect staff to help set up the work and charge it directly. Does that cause a problem for our other work?

A. It is not unusual for certain contracts to create, for example, a task order representing administration or project management functions where normally indirect personnel accumulate their costs and charge it directly to that task order. There should be no problem as long as "double counting" is avoided – if the indirect personnel salaries are included in an indirect pool, the portion of salaries charged direct should be credited to the same pool.

NEW & SMALL CONTRACTORS

Entertainment (Unallowable) Versus Employee Morale and Welfare (Allowable) Costs

Are such common costs as picnics, holiday parties, Friday get-togethers, sporting team events, recreation activities, etc. allowable costs under FAR 31.205-13, Employee morale, health, welfare, food service and dormitory costs and credits or unallowable costs under FAR 31.205-14, Entertainment costs? As consultants, we frequently encounter instances of government challenging costs as being unallowable entertainment costs that contractors believe are allowable employee morale expenses. Many times contractors have legitimate claims because the

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regulations are not really clear but choose not to fight auditors' conclusions because the amount is too small to press the issue either by appealing to the CO or litigation. In this article, we intend to identify those type of costs that clearly fall under one of the two categories and then identify those costs that, in our experience, are less certain and how auditors are likely to view these uncertain costs.

FAR 31.205-13, the so-called employee morale and welfare cost principle explicitly cites such costs related to improving working conditions, employee-employer relations, employee morale and employee performance as allowable. It offers several examples such as house publications or newsletters, health clinics, recreation activities, employee counseling services and food and dormitory services. FAR 31.205-14, Entertainment, provides that costs of amusement, diversion, social activities and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation or gratuities are unallowable. The cost principle also states that costs specifically unallowable under this cost principle is not allowable under another cost principle even if it is called, for example, employee morale and examples are included such as social, dining or country clubs or other organizations having the same purpose.

Both contractor and government auditors and COs have been very inconsistent in whether certain costs are allowable under the employee morale and welfare criteria or unallowable under the Entertainment principle. Courts have been asked to settle many of the questions. For example, Cotton & Co. (DOE BCA No. 426-6-89) ruled certain challenged expenses allowable such as (1) a $100 gift certificate to an employee hosting a company picnic (2) three birthday luncheons (3) luncheon and dinner parties with key personnel for career counseling and (4) occasional Friday afternoon pizza parties. Effective October 1, 1995, the government amended the FAR to explicitly state that unallowable entertainment costs cannot be deemed allowable under another cost principle. In addition, gifts were made explicitly unallowable unless they are part of compensation or part of an established plan to recognize employee achievement and recreation expenses were made unallowable with the explicit exceptions of costs of employee participation in company sponsored sports teams or employee organization to improve company loyalty, team work or physical fitness.

The Defense Contract Audit Agency has interpreted the rather broad 1995 changes to make numerous costs unallowable. Even when court decisions issued before 1995 allowed many activities (e.g. picnics), DCAA interprets the 1995 changes as making such events as picnics, holiday dinners, retirement parties, etc. unallowable. Unless such events are designed to improve employee loyalty, morale or fitness they will likely be questioned. Though auditors are now generally consistent in their views about allowability of the above events, their guidance stresses that such costs should be reviewed for reasonableness and materiality. In our experience, many auditors will not question such costs if they are not "material" while other auditors will attempt to identify such events and question the amount no matter how significant the dollar expenditures are. Though several commentators have taken issue with DCAA's more aggressive position since 1995, the low dollar amount of questioned costs makes expensive challenges doubtful for now.

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