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NEW DEVELOPMENTS

FAR Proposal Will Permit Use of Statistical Sampling to Screen Unallowable Costs

Adding to a previously published rule in 2003, the FAR Council is proposing to provide specific criteria for acceptable use of statistical sampling as a method to screen unallowable costs. Under the proposed rule, which would amend FAR 31.201-6, statistical sampling of accounts would be “an acceptable practice” for accounting for and presenting unallowable costs when (1) the statistical sampling results in an unbiased sample that is a reasonable representation of the sampling universe (2) all large dollar and high risk transactions are separately reviewed and excluded from the sampling process and (3) the statistical sampling permits audit verification. The proposed rule would also require the government and contractor to make an advance agreement specifying the basic characteristics of the sampling process being used.

Whether for incurred cost or forward pricing proposals, contractors would be required to exclude amounts projected to the sampling universe for any expressly unallowable costs in the sample. For penalty provisions under FAR 42.709, any amounts that are not excluded are subject to the penalties. However, these penalties would not apply if they are for (1) contracts of \$500,000 or less (2) fixed price contracts without cost incentives or (3) firm fixed price contracts for the purchase of commercial items.

If a directly associated costs (i.e. a cost that would not have been incurred without the primary cost being incurred – e.g. travel costs to an unallowable entertainment event) are included in a cost pool that is allocated over a base including the unallowable cost with which it is associated then the directly associated cost must remain in the pool. When a selected cost item under the FAR cost principles provides that directly associated costs be unallowable then such directly associated costs would be unallowable only if they are “material in amount” in accordance with materiality criteria in FAR 31.201-6 except where allowance of any

of the directly associated cost would be considered “contrary to public policy” (Fed. Reg. 58013).

(Editor's Note. The provisions related to statutory penalties on unallowable costs and the requirement for an advance agreement are amendments to the original proposal following receipt of extensive comments from industry and government representatives. Though DCAA provides for use of statistical sampling techniques under limited circumstances, the FAR proposal will clarify conditions and hopefully expand opportunities for its use.)

FY 2005 DOD Authorization Act Passed

The House and Senate gave final approval and the President signed October 28 the FY 2005 National Defense Authorization Act providing \$447.2 billion in new budget authority of which \$420 is for defense and Energy Department defense related programs and \$25 billion for ongoing military operations “to combat terrorism” in Iraq and Afghanistan. Congress already passed and President Bush signed a \$447 billion defense appropriations measure for FY 2005 where the appropriations measure provides actual funding and covers FY 2005 only while the authorization measure specifies how the funds will be spent and provides policy until it is otherwise superseded. Highlights of acquisition-related provisions are:

Raises TO/DO cap to 10 years. The revision corrects an oversight in last year’s defense measure that set a maximum period of five years, including options, for performance of task and delivery order contracts. The revision doubled the maximum duration of TO/DO contracts to 10 years, including options. The 10 year cap is considered a compromise between Industry and House attempts for an open-ended performance period and the Senate measure limiting the total contract period, including options, to eight years.

Cost and pricing data on noncommercial modifications of commercial items. Made clear that the numerous exceptions to the requirement to submit cost or pricing data does not include noncommercial modifications of a commercial item that is expected to cost more than \$500,000 or 5 percent of the total price of the contract, whichever is lower.

Retains streamlined competitions. Overcoming a congressional mandate to suspend for one year public-private competitions under recent revisions to the Office of Management and Budget Circular A-76, the bill decided to keep the streamlined procedures. The OMB A-76 Circular sets the ground rules for private-public competitions and the proposed ban on following the revised circular would have removed use of streamlined competition procedures for evaluating competitions for functions performed by 11 to 65 full time equivalents. However, language in the earlier passed appropriation act prohibited expenditures of FY 2005 funds on streamlined competitions as well as requiring that proposals be evaluated so that there was comparability on employee health care costs. Thus reading the appropriations and authorization acts together, most commentators conclude that it appears DOD *will* have to conduct formal – “standard” competitions where the government submits most efficient organization (MEO) statements and the work stays in the public sector unless the private sector can beat the federal proposal by the lower of \$10 million or 10 percent - rather than streamlined competitions for all DOD functions when there are more than 10 FTEs.

Limited federal employee protest rights. The Act contains compromise language that authorizes award protests by federal employees. The Act gives authority to file protests to the official responsible for submitting the federal agency tender – agency tender officials (ATOs) - in public-private competitions conducted under OMB Circular A-76. If requested by a majority of agency employees the official will file a protest “unless the official determines there is no reasonable basis for the protest.” Still, if a so-called interested party files a bid protest a federal employee representing the majority of those workers “may intervene” for future A-76 competitions.

Impact of Required Treatment of IR&D Costs on Intellectual Property Rights

In two recent GCA DIGEST articles (First and Second Quarter, 2004) we reported on and analyzed the implications of the recent *Newport News Shipbuilding* case. The case basically established that once a contract is signed, then the research and development costs related to that contract, whether they are “explicit” or “implicit” requirements of the contract, must be considered direct expenses of the contract and hence may not be charged as an indirect independent research and development expense. We came across a recent article by Professor Ralph Nash in the September 2004 issue of the Nash & Cibinic Report where he discusses how the accounting issue can directly affect the government’s rights to

contractors’ patents, copyrights and trade secrets where those rights are minimal if the work is a result of IR&D effort but substantial if the work flows out of directly funded work.

Work that is directly funded by the government normally provides it with unlimited rights to the intellectual property that results from that work while work partially or totally funded by the contractor creates only limited rights for the government. The traditional view is that since IR&D effort is not considered work on a contract, the government’s rights in intellectual property from such work are limited. For patent rights, this means that an invention during the performance of IR&D work would not be a “subject invention” and hence the government would get no rights to any patent on the invention. For technical data and computer software, the treatment of IR&D is covered by contract clauses giving the government either limited rights or restricted rights when work is done “exclusively at private expense” where one clause (DFARS 252.237-7013) defines the term as “accomplished entirely with costs charged to indirect cost pools.” FAR 52.227-14, “Rights in Data – General” also uses the “private expense” test to determine whether the contractor can protest its proprietary rights in data and computer software – either by withholding delivery or furnishing it with limited rights or restricted rights legend. Though the FAR does not contain a definition of “private expense”, Professor Nash says “it is fair to assume the term would be given the same meaning as the DOD definition” above, resulting in the conclusion that IR&D would be considered private expense.

FAR Interim Rule Prohibits Ban of Telecommuting for Contractor Employees

The FAR Council has issued an interim rule to the FAR that prohibits agencies from including in a solicitation the requirement that a contractor may not permit its employees to telecommute. The provision also prohibits agencies to unfavorably evaluate an offeror’s proposal that includes telecommuting unless it would adversely affect agency requirements such as security. The interim rule implements the Services Acquisition Reform Act of 2003 (Fed. Reg. 59701).

Industry and Government Weigh in on Proposal to Increase Use of T&M and LH Contracts

Industry representatives said in a public meeting that providers of commercial services need flexibility under time-and-material and labor hours (T&M and LH)

contracts if the government is to obtain maximum benefits of new proposed statutory authority to use such contracts. (*Under a T&M contract, the government acquires goods and services by paying a fixed hourly rate based on wages, overhead and profit for direct labor and obtains materials at cost (including handling costs) while an LH contract is like a T&M for labor charges while materials are not provided by the contractor.*) Industry representatives urged that (1) offerors should be allowed to propose either fixed price or T&M and LH contracts (2) prime contractors should not have to flow down to subcontractors the statutory requirement that T&M and LH contracts for commercial services be awarded competitively (3) requirements for government access to records that substantiate labor hours or material costs must take into account the record retention practices of commercial companies (4) commercial warranty provisions – such as the Uniform Commercial Code – may provide ways of dealing with nonconformance and (5) T&M and LH for commercial items should be exempt from Cost Accounting Standards.

Some government representatives expressed the view that T&M and LH gives the contractor more latitude to inflate costs (inspiring more oversight – see article below) saying adoption of more T&M and LH contracts should proceed “cautiously” to protect the public interest while others argued such contracts are more appropriate than fixed price vehicles where it is not possible to estimate accurately in advance. Government representatives largely questioned the need to issue a “determination and findings” that other contract types are not suitable saying such D&F provisions should apply only at the contract, not task or delivery order level. Government representatives also expressed sympathy with exempting T&M and LH contracts from CAS but questioned how items taken out of inventory or how costs should be computed for material handling and subcontract administration since such indirect rates are based upon actual costs.

Congress Extends the \$5 Million Test Program of Simplified Acquisition Procedures

The House and Senate October 9 agreed to extend by two years the test program enabling the Defense Department to use “simplified acquisition procedures” for procurement of commercial items up to \$5 million. Simplified acquisition procedures are described in FAR Part 13 and are normally applicable to contracts between \$2,500 and \$100,000. This is the eighth extension for the test program which will expire January 1, 2008.

Executive Order Calling for More Contracting with Disabled Vet Businesses

President Bush October 21 signed Executive Order 13,360 requiring heads of agencies to provide increased federal contracting and subcontracting opportunities for service-disabled veteran businesses (SDVBs). A SDVB is considered a small business concern owned and controlled by a disabled veteran. Under the new order, agency heads must develop strategies to implement the policy, report annually to the Small Business Administration and designate a senior-level official to be responsible for implementing the strategy. Each agency, in turn, must reserve contracts exclusively for SDVBs, encourage SDVBs to participate, encourage prime contractors to subcontract with SDVBs, monitor these efforts and train agency personnel.

DOD Calls for More Oversight and Conversion to Fixed Prices of Certain Cost Type and T&M Service Contracts

In spite of efforts in some quarters to expand use of T&M and labor hour contracts (see article above) other parts of the government want to take steps to lessen their use. Implementing an earlier Department of Defense Inspector General report calling for better guidance on certain types of service contracts, DOD Director of Defense Procurement Deidre Lee instructed procurement officials to take steps – both before and after awards – “to ensure the government receives good value” from such contracts. The September 13 memo told procurement officials of the need for “increased vigilance and oversight” of service contracts intended to be let on a cost-reimbursement or time and material basis. Specifically, agencies should appoint contracting officer representatives where, for example, the COR can verify categories of labor and reasonableness of hours worked and materials used on T&M contracts. When preparing requirements for a follow-on contract for cost type and T&M contracts, agency personnel should work with the COR “to determine if any portion can be broken out and ordered on a fixed price basis.” Lee indicated that the experience gained on the prior contract should serve as a background to reasonably price the follow-on effort on a fixed price basis. The memo states that fixed price contracts can result in cost savings and efficiencies.

TRAVEL...**Regulation Changes**

The Joint Travel Regulations, Section C4553-B, C and D have been revised to clarify that the 75% of the Meals and Incidental Expenses (M&IE) rate for the temporary duty (TDY) location is applicable for the day of departure and the day of return to the permanent duty station. Rather than compute what percent of the first and last day was spent on travel and meals, employees have the option of charging 75% of the M&IE per diem rates to those incomplete travel days.

The Joint Travel Regulations, Section C4678-C3 was amended to allow *lodging* reimbursement up to the maximum rate for TDY location when a traveler goes to a location other than their permanent duty station or home on weekends while on TDY. The revision clarifies that *transportation* expenses to locations other than the permanent duty station (PDS) while on TDY are not reimbursable.

Can't be Reimbursed the Cost of the Most Expensive Travel Arrangements

(Editor's Note. The Federal Travel Regulation generally permits employees to make personal choices about their type of transportation while on official travel yet the following makes clear the limits of reimbursement can be the cheapest possible cost if there is a range of amounts.)

Rather than take a taxi, Mr. Pruett drove from his house and parked his car at the airport and when he returned, he retrieved his car and drove to his office. His request for reimbursement was \$92 – \$12 for mileage and \$80 for parking fees. Pruett asserted this amount was virtually equal to the cost paid for a taxi, explaining he had previously paid between \$42 and \$45 for trips to the airport and \$35 for a trip to the office. The agency reimbursed him only \$65, indicating the “constructive” taxi fare should be \$77 - \$42 and \$35 for the two trips and no expense for the mileage expense. The appeals board agreed with the agency about the constructive taxi fare limit asserting (1) FTR 301-70.100 requires agencies to limit payment of transportation expenses to those costs that result in the “greatest advantage to the government” (i.e. cheapest) (2) FTR 301-10.420(b)(1) provides that employees may be reimbursed the “usual fare” for taxis between home and airport and (3) FAR 301010.402 permits employees to drive to the airport rather than take a taxi and be reimbursed that expense plus parking fees as long as the limit of reimbursement is the “constructive cost of a taxi.” The Board ruled the agencies calculation of the taxi’s

constructive cost was reasonable because they can properly compute the lowest possible base when there is a range of possible charges. Despite the correctness of the agency’s constructive cost calculation, the Board ruled it was improper to deduct Pruett’s claimed mileage expense because such a deduction was not supported by the FTR (*GSCBA 16409-TRAV*).

Accidents Are Traveler’s Responsibility if They Occur on Personal Time as Opposed to Official Business

Tasso’s trip to Ogden, UT was scheduled to begin on Wednesday, June 9 and end on Friday June 11. He decided to take a weekend trip to Jackson Hole over the weekend and return on Sunday June 13. While returning to Ogden at 4:00 A.M. for his 10:00 A.M. flight, Tasso hit a deer and the rental car company billed him \$2,600 for repairs representing his collision deductible. The Board ruled the agency could not reimburse him because FTR 301-2.2 states the agency can pay expenses only for the transaction of official business, adding that FTR 301-10.451 provides that employees may only be paid “deductible amounts paid by an employee...if the damage occurred while performing official business”. If Tasso had returned as originally scheduled, the incident would not have taken place and therefore any expenses incurred by Tasso in using the car after Friday were his responsibility (*GSCBA 16477-TRAV*).

Employees Have Discretion to Use Maximum Lodging Rates

Kahn’s overseas travel orders included a per diem rate of \$190 for lodging in New Delhi based upon GSA per diem rates. Upon arriving in New Delhi, Kahn secured a room for \$100 per night, which represented the hotel’s government employee rate but he found the room unsatisfactory so he obtained another for \$190, reasoning he was covered since the maximum limitation of \$190 was not exceeded. Kahn’s agency limited his reimbursement to \$100 per night asserting the “better” room was not necessary for performance of his duties and that changing rooms for an extra \$90 per night violated the “prudent person rule.” The Appeals Board sided with Kahn saying (1) the prudent person rule was not violated because the cheaper room probably “left much to be desired” and hence a private party traveling on personal business would likely take similar action (2) since Kahn was authorized to spend up to \$190 per night whether Kahn used some or all of that per diem was up to his discretion and (3) refusal to pay Kahn represented an unauthorized reduction of prescribed

maximum per diem lodging, violating FTR 301-11.200 (*GSBCA 16356-TRAV*).

CASES/DECISIONS

An Interested Party Must Be in Line For Award to Prevail in a Protest

In a proposal to provide security services in Iraq, the government considered two offerors' bids – Aegis and Offeror A - who received a “good” and “excellent” technical/management rating, respectively while the protester and Offerors B, C and D were rated as “marginal.” After ruling the “marginal” ratings were reasonable, the GAO rejected the protest, concluding the protester was not an “interested party.” To sustain the protest the GAO said the protester had to be an “interested party” – that is, be “in line for award” and since there was another technically acceptable proposal it was considering, the protester would not be in line for the award. The GAO denied the protest on the grounds the protester “lacks the direct economic interest necessary to pursue these challenges.” (*DynCorp International LLC, GAO B-294232*).

Protest Clarifies Conflict of Interest and 50% Prime-Subcontract Rule for Supply Contracts

Radian protested the award to Chenega to design and develop a “Camel” transportable water system asserting there was an organizational conflict of interest and that Chenega would not satisfy the rule that at least 50 percent of the cost of the contract be performed by the prime contractor. As for the OCI, Radian claimed that through its work on other contracts, Chenega may have shaped the Camel requirements or procurement rules in its favor, had access to government documents and other information about the acquisition that the other offerors did not have and had access to proprietary information of its competitors under the Camel solicitation. The GAO rejected the OCI claim saying substantial facts and hard evidence are needed to establish a conflict not just inference or suspicion of an actual or apparent conflict. None of the OCI allegations “rise above innuendo and suspicion.”

With regard to the 50 percent rule, GAO said much of the argument that Chenega would not satisfy the rule was based on the assertion that the award was only for the prototype work while the production quantities could

not be considered because they were “speculative”. The GAO disagreed saying the prototype is merely the initial order while the production quantities are part of the contract as a whole because when there is no option years, as here, the subcontracting limitation applies to the contract as a whole, not to individual task or delivery orders. Stressing the contract is for supplies, not services, the 50 percent rule is different: for a supply contract, the 50 percent rule applies to total contract cost – including profit – less materials and subcontracting costs to be compared with all subcontracting costs less the same types of costs. In contrast, for services contracts, overhead costs, G&A costs and profit should be excluded from the computation of the total contract cost (*Mechanical Equipment Co. GAO, B-292789*).

Bid is Properly Rejected When Cover Letter Qualifies Performance

The solicitation for work to improve, operate and maintain a wastewater treatment facility contemplated award of a fixed-price contract for improvements and two option items. An amendment to the solicitation provided the contractor would be responsible for operation and maintenance of the facility “from the effective date of the notice to proceed...until 3 months after final acceptance by the contracting officer.” Integrated acknowledged receipt of the amendment but in its cover letter to the bid it stated “operation of the plant is included for duration of the construction project until 3 months after substantial completion.” Due to the wording in the cover letter, the government rejected Integrated’s bid as “non-responsive” asserting the cover letter’s qualification made the bid ambiguous because it was uncertain whether the bidder unequivocally offered to perform in accordance with stated terms. The Comp. Gen. agreed with the government noting that to be responsive “a bid must contain an unequivocal offer to perform” the exact thing called out in the solicitation. If in its bid – including its bid cover letter – a bidder conditions or modifies a material requirement, limits its liability to the government or limits the rights of the government under a resulting contract “then the bid must be rejected as non-responsive.” Also, the Comp. Gen. added that a non-responsive bid cannot be made responsible through post-bid-opening clarifications and mistake-in-bid procedures may not be used to make the bid responsive (*Oregon elect Construction, DBA Integrated System Group, Comp. Gen. Dec. B-294279*).

Unrestricted Competition is Improper Without Adequate Market Research

(Editor's Note. The following demonstrates the type of "market research" agencies should pursue to determine if a solicitation will be limited to small businesses or to all-sized bidders)

On May 28 the Department of Interior, Minerals Management Service (MMS) published a pre-solicitation notice announcing its intent to procure a report addressing more innovative health activities. The notice set forth a two-step process where interested parties were to request a copy of the solicitation by June 4 and then submit by June 17 a capabilities statement. Twenty businesses requested a copy of the solicitation by June 4 including six small businesses, two of which included capability statements with their requests. Notwithstanding the expressions of interest on the part of small businesses the RFP was not set aside for small businesses but was issued on an unrestricted basis. Prior to the new due date for receipt of capabilities statements, Information Ventures (IV) filed a protest challenging the fact the procurement was not set aside for small business concerns in accordance with FAR 19.502-2(b). The provision generally requires COs to set aside for small businesses all procurements exceeding \$100,000 if there is a reasonable expectation of receiving fair market price offers from at least two responsible small business concerns where the government must undertake reasonable efforts to ascertain whether it is likely to receive offers from the two.

In response to the protest the CO stated MMS contracting personnel reviewed the GSA Advantage online database, GSA "in stock" programs and GSA special order programs that may be purchased from supply schedule contractors. All eligible contractors, including several small businesses, were identified from these sources and when they were contacted by telephone, indicated they could not perform the contracts leading the CO to conclude there was not a reasonable expectation that two small businesses could perform the work. IV asserted and the Comp. Gen. agreed that a proper market research should have included researching the Central Contractor Registration (CCR) database and obtaining input from the Small Business Administration and the Department of Interior small business representative. The Comp. Gen. ruled the CO was on notice that substantial small business interest in this procurement existed prior to issuance of the solicitation on June 18 and concluded the CO did not reasonably consider whether the procurement could be set aside for small business participation (*Information Ventures, Inc. Comp. Gen. Dec. B-294267*).

NEW/SMALL CONTRACTORS

Basic Requirements for Labor System Internal Controls

Unless labor costs are a small percentage of costs, internal controls over labor charging has become perhaps the greatest area of audit scrutiny by government auditors. Evaluation of general controls has largely replaced detailed audits of individual labor transactions. Both new and veteran contractors can generally be assured auditors will examine labor controls during one of their accounting system reviews (e.g. preaward survey, post award accounting system audits) or one of their other audits such as forward pricing, incurred cost proposals or periodic floorchecks. Some contractors can also expect to experience a separate audit in this area. An audit opinion of "inadequate" can lead to considerable adverse results such as suspension of billings, failure to obtain additional work, etc while a more positive opinion can provide contractors a competitive advantage over other firms. The following article will address most of the key areas you can expect to be reviewed so you should use it as a checklist to ensure your practices are in line. The sources of the article includes Chapter 5-900 of the DCAA Contract Audit Manual, several of DCAA's audit programs as well as our experience as both former DCAA auditors and consultants when we are asked to conduct "mock audits" of contractors' accounting practices.

DCAA's stated purpose in auditing contractors' labor internal controls, as opposed to an evaluation of reasonableness of compensation or proper utilization of labor, is to "evaluate the adequacy of the contractor's labor system and assess control risk related to the allowability and allocability of labor costs charged to government contracts." Labor costs are a key focus area because they are normally a significant cost component and there are numerous opportunities for inaccuracies due to the fact labor costs are not supported by third party documentations such as invoices, purchase orders, etc., the contractor has complete control over the documents and responsibility for accuracy is diffused over the entire organization. DCAA has established eight areas of control that need to be effective:

1. *Internal Compliance Reviews.* There should be policies and procedures for monitoring the labor system that

would include regular compliance audits that would address adequacy of written policies, employee knowledge and compliance with the policies and procedures, consistency of practices and timely follow-up to corrective actions. The contractor can satisfy this requirement by conducting its own floorchecks, by testing a sample of labor charges for accuracy, requesting external audits or any combination. Procedures for conducting the tests, identification of responsible personnel, and identification of documentation that adequate steps have been taken should exist.

2. *Review of Employee Awareness.* There should be adequate policies and procedures for training employees in proper time charging, indoctrination for new hires, management's responsibility for accuracy, refresher courses for existing employees where there is documentation to verify training occurred, explanations for any penalties and demonstration of proper segregation of duties (e.g. timekeeping and payroll functions separate, supervisors accountable for contract profitability should not have opportunity to initiate changes in labor charges).

3. *Labor System Authorization/ Approvals.* There should be procedures in place that address the control and issuance of work authorizations and job assignments (e.g. segregation of duties between assignment of duties and those responsible for performance, opening and closing work authorizations) and proper work descriptions that are sufficiently detailed to distinguish between allowable and unallowable work as well as direct and indirect work.

4. *Evaluation of Timekeeping.* Whether a manual or electronic timekeeping system exists, detailed written procedures should be in place addressing accurate and complete recording of labor hours, how corrections are made, how an audit trail of corrections is maintained, approvals, prevention of unauthorized changes, etc.

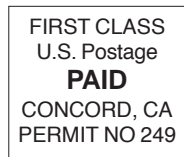
5. *Evaluation of Labor Distribution.* Proper policies assuring there is accurate recording of labor costs to cost objectives is a major audit area. These policies need to address (a) all hours worked, whether or not they were paid, to ensure that uncompensated overtime is taken into account (see May-June 2002 issue of the GCA REPORT for a detailed discussion of uncompensated overtime) (b) a summary of hours and costs allocated to cost objectives are identifiable on appropriate labor distribution reports (c) total labor hours that are reflected on the labor distribution reports agree with the total labor charges that are entered into the

timekeeping and payroll systems and (d) direct and indirect labor hours can be traced to timecards and approved work authorizations.

6. *Audit of Labor Cost Accounting.* The contractor needs to have procedures in place that demonstrate labor costs are charged to the government in compliance with Cost Accounting Standards, generally accepted accounting principles and contract terms/clauses. If relevant to your operations, areas DCAA point to are: (a) significant increases or decreases in sensitive labor accounts should be flagged and examined (b) adequate briefing of contracts should be maintained where the contractor identifies all contract terms that have government costing implications such as military standards, overtime, skill mix requirements, etc. (c) procedures should be written that require direct and indirect labor costs directly associated with unallowable costs be identified (d) procedures that ensure lump sum wages resulting from union contracts (e.g. a payment in lieu of a labor rate increase) are accounted for properly such as being deferred and amortized over periods benefited (e) overtime authorization procedures are in place that are in accord with FAR 22.103 to meet, for example, delivery schedules, performance requirements or to make up for delays and (f) policies and procedures should address record retention needs that are consistent with current FAR requirements.

7. *Review of Payroll Preparation and Payment.* Segregation of duties should be addressed and steps required to assure accuracy of labor costs such as pay rates being supported by written authorization from HR, cross checks exist for verifying accuracy of names, pay rates, hours worked, extension and accounting distributions required and labor hours used for payroll purposes are based on labor distribution records.

8. *Review of Labor Transfers and Adjustments.* The contractor should have in place procedures to provide reasonable assurance that transfers or adjustments of labor distribution are adequately documented and approved. For example, there should be a system to document, approve and review the transfer of labor costs from one cost objective to another where written justification is required for each transfer. The contractor should also have procedures that ensure labor distribution edit errors are processed into a suspense account and billed to customers only after correction and that reports of suspense labor and edit errors are generated and provided to appropriate personnel.



QUESTIONS AND ANSWERS

Q. We are working on a project that we intend to capitalize and write off so I have a few questions related to capitalizing assets for government costing purposes. In addition to labor costs, can we include material and ODCs? Can it be considered an overhead project? Should we include overhead and G&A costs (we don't for financial costing purposes)?

A. Yes to all. You should capitalize all direct costs including material and ODCs. You can consider it an overhead project in the sense that the amortization costs (e.g. depreciation) will be included in your overhead cost pool. For purposes of computing overhead and G&A costs, direct costs of all projects including capitalized projects must be included in the relevant overhead and G&A bases so you might as well include these expenses in the capitalized account for government costing purposes.

Q. A large percentage of our sales and marketing expenses this year relate to obtaining a commercial contract and we have been discussing the need to exclude the costs from our G&A pool. I seem to remember you discussing a particular case that provided justification for keeping the costs in but I don't remember it. Could you jog my memory?

A. There are actually numerous court decisions that have made the point that all sales and marketing expenses, no matter what type of contracts are associated with the effort, are allocable to the G&A pool because such costs expand the business base which benefits government contracts by lowering G&A costs. As for the specific case you are discussing, I believe it is the

Aydin case (*Aydin Corp/ v/ Widnall. 61 F3d1571*) where the contractor's normal established practice was to include sales commission expenses in its G&A pool. One year, about 93% of the commission expenses were related to a foreign sale and the government asserted these costs should be removed from the G&A pool and charged directly to the foreign contract rather than allocating a significant amount to government contracts. The Appeals board sided with the government stating it was proper to permit such a special allocation of the costs to the foreign contract because to allow such a "disproportionately" large cost would result in an "inequitable" allocation to the government. The US Court of Appeals reversed the Board's decision, asserting that the different treatment of sales commissions violated CAS 402 (requiring consistent treatment of like costs incurred under like circumstances), concluding the costs had to be treated consistently (i.e. charged to G&A) and in response to the assertion of "inequitable" allocation, the Court ruled the "chips should fall where they may."

Q. Why are interest costs unallowable? They are normal business costs, deductible for tax and financial accounting purposes and are not associated with more controversial costs like alcohol, entertainment, excess travel costs.

A. As a matter of policy, the government does not want to fund contractor borrowing. Contractors vary widely in how they finance their operations where some borrow heavily and others use their own capital. The government feels it would not be fair to pay a contractor more because it incurred borrowing costs which would effectively penalize the contractor who financed their business internally. To put contractors on more of an equal footing, the government substituted cost of money for actual interest expenses but it applies only to assets not, for example, financing working capital.