GCA REPORT
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NEW DEVELOPMENTS

Three Percent Withhold Rule Delayed

Both the House and Senate passed legislation that would delay for one year, until Dec 2011, a requirement that federal, state and local governments withhold 3 percent from all payments for goods and services. The delay is intended to allow the Treasury Department to study the impact of the withholding requirement on contractors. The 3 percent withholding mandate was inserted into the conference report of the Tax Increase Prevention and Reconciliation Act of 2005 and has since generated considerable opposition from Industry. Meanwhile, members of both the House and Senate are working to repeal the withholding requirement entirely (*H.R. 3056*).

New Rule Requiring Ethics Code and Related Internal Controls; Proposed Rule to Require Reporting Violations of Criminal Law in Contracting

Federal contractors receiving awards worth more than $5 million and involving work in excess of 120 days will be required to put in place a written "code of business ethics and conduct" under a new government-wide rule taking effect Dec. 24. The new rule will also require covered contractors to display fraud hotline posters provided by the office of inspector general of the contracting agency but an exemption from this rule will apply to contractors who have an "established mechanism by which employees may report suspected instances of improper conduct." The covered contractors will have 30 days from contract award to prepare a code of business ethics and 90 days to establish an ethics awareness and compliance program and internal control system though a contractor can request an extension and the CO should grant it (*Fed. Reg. 63084*).

The rule states a contractor's "internal control system shall facilitate" timely discovery of improper conduct in connection with government contracts and ensure corrective measures are promptly instituted and carried out. For example, the internal control system should provide for (1) periodic review of company business practices, procedures, policies and internal controls for compliance with the company's code of business ethics and "special requirements" of government contracting (2) an internal reporting mechanism such as a hotline (3) internal or external compliance audits and (4) disciplinary action for improper conduct. The requirements will flow down from the prime to subcontractors. Small businesses are exempt from requirements to have a formal training program or internal control system and further the mandatory aspects of the rule do not apply to commercial items, either at the prime or subcontract level (*Fed. Reg. 65873*).

In a separate action, a proposed government –wide rule issued Nov 14 would require federal contractors to report to their contracting officers and agency inspectors general if they discover violations of federal criminal law in connection with the award or performance of federal contracts or subcontracts valued at $5 million or more. Contractors would be suspended or debarred from federal contracting if they fail to do so. This latest proposal is issued at the request of the Justice Department as a means to promote business ethics and involve contractors in combating improper conduct. According to the DOJ, the new requirement for mandatory disclosure is necessary because "few companies have responded" to their invitation to the Defense Department to report or voluntarily disclose suspected instances of violations of federal criminal law related to contracting or subcontracting (*Fed. Reg. 64091*).

DCAA Guidance

The Defense Contract Audit Agency issued three new significant guidelines to its auditors recently.

1. *Adequate Incurred Cost Proposal*. An internal task force concluded that incomplete incurred cost proposals were causing increased hours required to perform preliminary audit steps and the guidance states auditors should either request additional information or return the submittal as inadequate. The following is a listing of information that is generally either not included or is inadequate:

- Reconciliation of books of account (e.g. general ledger) to claimed costs
- Reconciliation of total payroll to total labor distribution

- Schedule of direct costs by contract and indirect expenses applied at claimed rates
- Listing of auditable subcontracts and related information
- List of costs billed/claimed on T&M/Labor Hours contracts
- Schedule of cumulative direct and indirect costs claimed and billed (*97-PPD-033(*R)

2. *Application of Non-DOD Agency FAR Supplements.* Audit guidance was issued alerting auditors of the importance of ensuring that all applicable non-Department of Defense Agency FAR supplements are considered when conducting audits of non-DOD contracts. Though stating the list is not all inclusive, the guidance includes a table identifying specific agencies, their FAR Supplement and categories of costs that are treated differently than the FAR Part 31 cost principles. These include:

Agency for International Development (AIDAR): Compensation for personal services (FAR 31.205-6) and travel costs (31.205-46). In addition, two additional cost categories are addressed in the AIDAR – overseas recruitment incentives (731.205-70) and salary supplements for Host Government employees (731.205-71).

Department of Energy (DEAR): Independent research and development/bid and proposal costs (31.205-18), Insurance and indemnification (31.205-19), Precontract costs (31.205-32), Professional and consultant services costs (31.205-33) and costs related to legal and other proceedings (31.205-47).

In addition several agencies treat precontract costs (31.205-32) differently than the FAR including Homeland Security (HSAR), Justice (JAR), Transportation (TAR), NASA (NFS) and National Science Foundation (National Science Foundation) (*07-PAC-037(R)*.

3. *Reporting Questioned Costs on T&M and Labor Hour Contracts.* The guidance addresses questioned costs when an auditor determines that incurred labor hours do not meet the labor qualifications or requirements prescribed in the contract for the labor category billed. When reviewing contractor billings or claimed amounts under T&M or LH contracts, auditors are told to selectively evaluate billed/claimed labor hours to ensure employees meet the labor category qualification in the contract. If the employee does not meet the labor category qualification, the auditor is told to question that employee's labor hours and dollars billed in total. For example, if the auditor determines a junior engineer is working and charging a T&M contract that calls for a senior engineer labor category, the auditor should question the hours and dollars billed by the junior engineer (*07-PPD-038(*R).

Industry and Government Spar on Proposed FAR Changes on Price Data

A proposed FAR change the drafters assert are intended to resolve "confusion" regarding what data may be obtained by federal contracting officers to allow a determination that a contract price is fair and reasonable generated a lot of controversy at a Nov 15 public meeting held to discuss the rule. Much of the discussion on the rule, which was issued April 23 and discussed in the third quarter issue of the GCA DIGEST, focused on the proposed addition of a new term "data other than certified cost or pricing data" which would mean "any data, including cost or pricing data and judgmental information necessary for the contracting officer to determine a fair and reasonable price or price reasonableness." The term would replace the current term "information other than cost or pricing data" to make the regulations more consistent with Truth in Negotiations Act requirements according to the rule writers. COs would still be instructed to obtain "data other than certified cost or pricing data" when the data needed to determine price reasonableness and certification is not needed according to TINA.

Contractor representatives said the change would apply the same "all facts" requirement under TINA (contractors must certify all factual data is current, accurate and complete as of price agreement date for contracts, mods and subcontracts valued at $650,000 or more) to other non-TINA covered contracts including commercial items. This would be a great problem since commercial contractors do not maintain systems required to provide "all facts," which would likely result in them refusing to sell to the government. Several government speakers disagreed asserting the proposed rule "does not change the standard one iota" but only expresses the policy in "clear terms." It gives COs no rights or requires no data from contractors that is not now required. They also point out the current directive to obtain only the minimum data necessary to support price reasonableness is still in force.

In written positions one industry representative said the proposed rule would blur the current "bright line" test between certified and non-certified data which would increase, not reduce confusion. It discards the current

preferences for determining price reasonableness based on sales information in favor of a requirement for cost data while the requirement for submitting judgmental information "goes beyond even traditional TINA requirements" of submitting only factual cost data. Another industry rep stated that when commercial sales information cannot be provided (e.g. IBM desk tops or servers) there is the assumption the item is not commercial in which case the CO would be entitled to obtain for a clearly commercial item all the cost data required for non-commercial items subject to TINA.

A Defense Department rep said the rule changes were necessary because "the big guys argue that everything is commercial, even items that they have developed at DOD expense." He asserted large defense contractors often have "few" commercial sales to support their pricing and frequently refuse to provide commercial sales information when it is available. His response was that the government should "get the cost data, get the cost data, get the cost data." Additional comments are being invited.

Proposed FAR Rule Gives Contractors Options for Treating PRB Costs

Federal contractors who use the accrual method for accounting for post retirement benefit (PRB) costs under their contracts will have a choice as to the criteria used to measure these costs. Currently, the FAR requires that when a contractor uses an accrual basis to account for PRB costs, these costs must be measured based on the criteria set forth in the Financial Accounting Standard 106. However, the tax deductible amount that is contributed using the Internal Revenue Code 419 uses a different measurement criteria which usually results in a lower cost calculation. As a result, according to the new FAR rule, contractors who accrue PRB costs for government reimbursement face a dilemma: whether to fund the entire FAS 106 amount to obtain maximum government reimbursement, regardless of tax consequences, or fund only the tax deductible portion and not be reimbursed the entire FASB 106 amount. The new rule seeks to "alleviate this dilemma." Under the new rule, FAR 31.205-6(o), compensation for personal services, would be amended to give contractors the option of measuring accrued PRB costs using criteria based on IRC 419 or FAS 106. The rule writers state this change would allow the contractor to fund the entire tax deductible amount without having a portion disallowed because it does not meet the FAR current measurement criteria under FASB 106.3

FAR Rule Clarifies Criteria for Local Set-Asides

An interim FAR rule was published Nov 7 to further awards to local firms of federal contracts for cleanup and assistance following a major disaster or emergency under the Robert Stafford Disaster Relief and Emergency Assistance Act. The Stafford Act provides that once the president declares a major disaster or emergency under the Act any award of an emergency response contract that is made to a firm located outside the area must be justified in writing and that work performed under an existing contract must be transitioned to a local firm. The rule establishes new criteria for what firms will be eligible for local set-asides. Under a new Section (c) of FAR 52.226-3 an offeror is considered to be residing or primarily doing business in the area if during the last 12 months (1) it had its main operating office in the area and (2) that office generated at least half of the offeror's gross revenues and employed at least half of the offeror's permanent employees. The new rule is asking for input as to whether a branch office should be eligible for local set asides when that branch office does business in the affected area *(FED REG 63084)*.

DOE Abandons Its Proposal to Decrease M&O Medical and Pension Costs

The Department of Energy has announced it will abandon its attempt to lower medical and pension costs it pays its management and operations contractors. Under a plan announced in April 2006, the department would continue to reimburse medical benefit and pension costs for current and retired employees under existing provisions but would have required market-based medical and pension plans for new employees. Following considerable opposition, it put the plan on a 12 month hold to seek other ways to lower these costs. The department's announcement stated it will leave in place its long standing policy of reimbursing M&O contractors for their allowable health benefit and pension costs of current employees and retirees.

New FAC Issued

The FAR Council has issued changes to the FAR in the form of Federal Acquisition Change 2005-21. Two significant changes include:

SAFETY Act. Effective Nov. 7, the FAR is amended to implement Department of Homeland Security regulations on the Support Antiterrorism by Fostering Effective Technologies Act of 2002 (SAFETY Act). The SAFETY Act provides a system of "risk management" and "litigation management" that is

intended to encourage development of antiterrorism technologies by limiting the liability of companies that provide these technologies that are either "designated" or "certified" by DHS as eligible for the act's protection. Several sections of FAR Part 50 have been revised to implement the SAFETY Act. For example, a new FAR Section 50.204 sets the "overarching policy" where it states agencies should (1) determine whether the technology to be procured is appropriate for SAFETY Act protection (2) encourage offerors to seek SAFETY Act protection for their offered technologies even before the solicitation is issued and (3) not mandating SAFETY Act protections recognizing that such protection should be a choice of the offeror. Also, a new section in 50.205-1 provides that sufficient time in acquisition planning be given to ensure SAFETY Act considerations be made an integral part of any acquisition.

The DHS rule provides a streamlined review procedure for extending the act's liability protection to well defined categories of anti-terrorism technologies by allowing for "block designations" or "block certifications" and it allows an agency to seek a "pre-qualification designation notice" which is a preliminary determination of SAFETY act applicability. New sections of the FAR that address these procedures are at FAR 50.205-1 (*Fed. Reg. 63027*).

Patents, Data and Copywrite Rewrite. Effective Dec. 7, the FAR will be amended to "clarify, streamline and update text and clauses on patents, data rights and copyrights." The rewrite of FAR Part 27 and associated clauses in Part 52 is intended to provide "plain language." The rewrite is not intended to substantially change the FAR except to bring them up to date to reflect current statutory and regulatory changes, executive orders and to resolve any internal inconsistencies (*Fed. Reg. 63045*)

New Rule Waives Specialty Metals Restrictions on COTS Items

The Defense Department Nov 8 released a final rule that waives statutory domestic sourcing restrictions that apply to acquisition of specialty metals when the department is buying commercial off-the-shelf (COTS) items. Under the rule, a COTS items is defined as any items of supply that is (1) a commercial item defined in FAR 2.101 (2) sold in substantial quantities in the commercial marketplace and (3) offered to the government without modification in the same form sold to the commercial market. The rationale for the change is to eliminate the costly, time consuming and burdensome requirements to comply with the requirements to use specialty metals melted or produced in the U.S. or qualifying countries (*Fed. Reg. 63113*).

CASES/DECISIONS

Legal Costs Unallowable on Fraud but Allowable for Sexual Harassment Settlement Cases

Rockwell was found liable for three False Claims Act violations in its contract to manage the Rocky Flats nuclear weapons plant. In denying Rockwell's claim for legal costs in defending the case, the Board said the contract made unallowable the costs for defense of fraud or similar proceedings brought by the government where the contractor is found liable. The Board stated that the FCA has always been considered by the courts to be a fraud statute where FAR 31.205-47 makes such costs unallowable and specifically defines fraud to mean acts of fraud or corruption and acts which violate the FCA (*The Boeing Co. vs. DOE, CBCA No. 337-339*).

In a separate, unrelated case, an employee and Tecom settled a sexual harassment case where the employee received direct payment for alleged harm to her. In its rejection of Tecom's claim for the settlement costs, the government contended that *Boeing North American Inc.* applied where it ruled that in order to recover these similar settlement costs the contractor was required to show the employee's claim had "very little likelihood of success." The government, citing the *Boeing* standard, stated the costs were "related" to the category of costs disallowed by FAR 31.205-47 which states contractor legal costs related to criminal conduct and fraud are unallowable. After reviewing the case the board concluded that the Boeing standard did not apply here because the private sexual harassment litigation did not meet the conditions for disallowing legal costs namely it did not (1) involve a criminal prosecution (2) require a finding, absent a settlement, of contractor liability on fraud or other similar misconduct nor was a monetary penalty to be imposed nor (3) require a final decision to debar or suspend a contractor, rescind or void a contract or terminate for default a contract. The Board also rejected the government contention the settlement payment was a substitute for a fine or penalty stating the payment was paid to her not to any state or government entity to address a harm to the public. Finally in response to the government's claim that the costs are allocable only if there is "some benefit to the government" according to a *Northrup* decision, the Board stated a different subsequent *Boeing* case held that the "benefit to the government" test fell squarely under FAR 31.201-4, criteria for allocating indirect costs. In that case the Board stated the Court ruled the word "benefit" is a cost allocation concept describing

the “nexus between required accounting purposes between the cost and the contract to which it is assigned” – the question of whether a cost should be recoverable as a matter of policy is to be resolved by applying cost allowability regulations not allocability rules (*Tecom, Inc. ASBCA Nos. 53884, 54461*).

A Termination is Inappropriate for Recovering Losses Due to Faulty Estimates

(*Editor's Note. The following illustrates the need to critically examine the best vehicle to use for quantifying entitlement for additional cost or price recoveries.*)

Admiral's contract required it to maintain a minimum of mechanics on site at all times to perform elevator maintenance at two Social Security Administration (SSA) buildings. Before award offerors asked many question to confirm the need to have mechanics on hand and the SSA clearly stated and restated its intent to have mechanics on hand in spite of planned renovations that would indicate maintenance was unnecessary for certain periods. When it turned out that SSA's estimates were wrong Admiral submitted a claim that would entitle it to the per unit, per-month contracted amounts that were shortfalled and would include whatever labor, material, overhead and profit that Admiral had factored into its pricing. The government asserted that the circumstances for losses suffered from the erroneous estimates should be settled by a partial termination of the contract which precludes Admiral from recovering lost revenue and anticipatory profit. The Board ruled against the government stating the sole purpose of the partial termination was for SSA to unilaterally renegotiate the contract so as to reduce its financial liability. The board cited several cases that were applicable here where the agency was found responsible for losses suffered by a contractor because it had reasonably relied on significant but incorrect agency representations involving pricing (*Admiral Elevator v. Social Security Admin., CBCA, No. 470*).

Awardee's Prior Contracts Do Not Provide Unfair Advantage

(*Editor's Note. It is quite common for an offeror to have significantly more experience when bidding on a contract where its prior activities were closely related to the contract work. The following case addresses whether these prior activities constitute an unfair advantage.*)

Prior to awarding Denysys and its subcontractor Bearing Point a support services contract for a new medical logistics information system, the Army conducted an analysis to determine whether there was a potential organizational conflict of interest (OCI) resulting in an unfair advantage resulting from its prior contracts and concluded there was none. Nonetheless, after Denysys received the award, MASAI protested arguing that any time an offeror, through performance of another government contract, gains knowledge or information that is not generally available to other offerors, that offeror has an OCI and must be excluded from the competition. The GAO disagreed stating such an interpretation would, in effect, exclude virtually any government contractor from competing for procurements that is in any way related to its prior contract performance. The GAO concluded that the Army, before awarding the contract, “gave a thorough and comprehensive consideration” to Denysys and its subcontractor's prior activities and found no reason to disagree with its conclusion. The GAO explained that the government is not required to equalize competition to compensate for an advantage unless there is evidence of preferential treatment or other improper action. If an agency has conducted a thorough documented consideration of an offeror's activities and potential for OCI, the GAO will not substitute its judgment for that of the agency (*MASAI Technologies Corp., GAO, B-298880*).

Option to Extend Services Covered by Specific FAR Clause

(*Editor's Note. The following decision illustrates how different clauses used to extend a contract period can result in more or less recovery.*)

After Arko completed its base year and four one year options the government notified Arko that its successor contractor was delayed and modified the contract to extend performance two months. The government cited FAR 52,217-8, option to extend services which allows the government to require continued performance at rates specified in the contract for a period not to exceed six months. Seeking additional compensation, Arko argued the extension could only have occurred under 52.237-3, continuity of services, that would have allowed Arko to recover “all reasonable phase-in and phase-out costs” as well as a prorate share of fee under the contract. The judge ruled against Arko stating there was no indication any of the services rendered by Arko fell into categories covered by the continuity of services clause while the unforeseen delay that triggered the extension “fit like a glove” the purposes of the FAR 52.217-8 clause. Here, there was no overlap between Arko's tenure and that of the successor contractor, there was no requirement to provide phase-in training nor was there effort to effect a transition to the successor contractor. Further, other requirements of 52.237 were not satisfied such as written

notification by the CO invoking the clause, no development of a transition plan with the successor and no steps to facilitate the transition of personnel from the incumbent to the successor (*Arko Executive Services, Inc. v US, Fed. Cl No. 05-1193C*).

Not Due Claimed Contingency Costs

(*Editor's Note. Be wary of recovering contingent professional services costs.*)

The GAO sustained ALF's protest but since the Army had already proceeded with performance and the supplies were urgently needed, the GAO decided not to reopen competition but rather agreed to reimburse ALF for its proposal and protest costs. Its submittal for protest costs included total number of hours worked for its consultant, rate of compensation and total cost but provided no evidence he had been paid during the one year that had elapsed between receipt of the consultant's invoice and its filing the costs claimed. The GAO ruled only if there is evidence of a non-contingent obligation to repay a subcontractor for its expenses – that is the protester must pay regardless of whether it recovers costs from the government – will it consider them as recoverable (*Al Long Ford – Costs, GAO, B-297807*).

NEW/SMALL CONTRACTORS

Getting the Most Out of a Termination – Case Study

Our consulting practice has been preparing numerous termination settlement proposals lately. The rules are unique but if you understand them you can generate significant dollar recoveries. In the case study discussed below, we were able to increase the original estimated amount of the proposal more than tenfold by carefully analyzing the contract and facts of performance and applying the termination rules to identify numerous cost recovery opportunities. The case study below is a real proposal we prepared for a client and accurately describes the process we followed to assemble the entitled costs submitted in the proposal. (The identity of our client is not given and dollar amounts have been changed.) We would strongly recommend obtaining expert advice if you are planning on preparing a termination settlement proposal since all such help is almost always a reimbursable cost of the termination.

Our client had a cost type professional services contract and asked us to prepare a termination proposal as soon as they received their termination notice. Following a 10 month period after award that included some performance work, a protest and an unsuccessful rebid of the contract, the contract was terminated and our client decided to seek the maximum dollars they were entitled to. We began the process by asking them to provide all of the costs that were chargeable to the contract. We received some accounting data that included some direct labor and equipment costs that was approximately $100,000. We observed there were several categories of costs that probably should have been included but were not and decided to assemble the termination costs from scratch. First, we developed a time line of events for the ten months, next identified types of effort and expenditures that might potentially be included in the proposal, then identified those activities that should be included and quantified the amounts and finally presented the costs in a manner most likely to be accepted by the government.

- **Establish Timeline.**

Before formal award, Contractor was verbally notified of award and held a major kick of meeting bringing in personnel from all over the country. After the award was made, Contractor secured space for additional employees and equipment and prepared the facilities for occupancy, ordered a variety of equipment such as desktops, servers and telecommunications and incurred significant labor costs to get ready to "go on-line." Once the protest and rebid process was initiated, direct project work ceased but several activities had to continue in order to be ready to perform. Finally, after receiving the termination, certain activities continued.

- **Identify Potential Types of Costs**

Detailed inquiries into the types of activities that occurred during this period revealed that significant effort by normally indirect labor was expended for equipment (e.g. receiving, inspecting, installation, software, maintenance) and other labor intensive activities (project management and organizational readiness - status meetings, recruiting, training, preparing written policies and procedure, etc.). In addition several other expenses continued – rent, a law suit, idle labor that could not be laid off without permanently loosing them, severance payments, subcontractor payments, returning government owned equipment, getting other equipment and facilities ready for other uses, etc. Our inquiries included a trip to the Contractor where two intensive days were spent with key individuals probing their memories which, in turn,

generated recollections of several other activities related to the contract. Once all potential activities were identified, we distinguished between those that were clearly identifiable with the terminated contract and those that were likely not or were questionable.

- **Quantify Results**

Once those activities clearly related to the terminated costs were identified, we began quantifying the costs related to them. Costs we considered to be direct labor – already billed, IT (they maintained their own separate timekeeping system) and project management (they were dedicated full time to the project) were distinguished from indirect labor e.g. support from HR, contracts, finance and accounting, project heads. We asked all employees who do not normally prepare timesheets to estimate time spent on their relevant activities and asked them to be prepared to document as much as possible the basis for these estimated hours (e.g. personal journals, emails, expense reports, etc.). Hours were then multiplied by hourly rates. Facilities that were and were not usable on other projects were distinguished and the rental costs for the unusable facilities were computed for the remaining period of lease. (Though estimates of related utilities costs could be justified we chose not to do so.) We determined that equipment usable for other purposes could, on average be ready in six months after termination and we computed six months of depreciation to be charged to the terminated contract. Costs of purchasing and installing other equipment not usable for other purposes (e.g. telecommunications) were computed. Subcontracts and consulting expenses were included at invoiced amounts for costs incurred while estimates of future costs for consultants and in-house finance were estimated for liaison with auditors and negotiations. Overhead and G&A rates were computed, making sure that normally indirect costs charged to the termination were deducted from the respective overhead and G&A cost pools. Finally, a fee was proposed which coincided with expected profit rate.

- **Presentation**

Allowability and allocations issues related to terminations are complex and most auditors and COs have little experience with terminations. We realized certain categories of costs are an "easier" sell than others so assigned all of the allocable costs we computed into "buckets" we believed could be most easily defended.

Indirect costs charged direct. Since there is long case history, authoritative texts and even DCAA recognition of charging certain indirect costs as direct termination costs, we charged all labor costs, whether normally classified as direct or indirect, as direct labor costs of the termination.

Unexpired leases and settlement with subcontractors. These costs are relatively noncontroversial and we assigned unusable facilities costs.

Idle capacity. Though more controversial yet still defensible, we used the category of "idle capacity" (underutilized resources) as the category for assigning both the depreciation costs of the hardware and software costs of the equipment that would eventually be used for other purposes. We also assigned the three months of costs incurred by two idle employees who were hired to support the terminated contract and could not be assigned to other work until they were eventually laid off.

Special equipment. The telephone communications costs were charged to this category that provides for "special tooling, test equipment and special equipment." This category was used for that equipment not classified as "common items" e.g. not usable for other work.

Settlement costs. The costs related to preparing a termination are probably the least controversial and both consultant and in-house financial costs were charged here.

Initial Costs. Costs related to getting ready for the contract before it was formally awarded is a normally allowable precontract cost when it would be an otherwise allowable cost of the contract. We charged the costs associated with the initial kickoff meeting to this category.

Other costs continuing after termination. These include severance pay and projected legal costs associated with a lawsuit brought by an employee who was laid off.

Indirect costs. Indirect cost rates, adjusted for the costs charged direct on this contract, were applied to the respective costs they normally are charged to – overhead to labor, G&A to all other costs except settlement costs.

Unrealistic documentation requirements. To preempt the common practice of inexperienced auditors questioning labor costs as unsupported costs if no timesheet is provided, we educated the auditors on certain key provisions of FAR Part 49 that deemphasizes "strict accounting records" and pointed out it would be unreasonable to expect indirect labor that do not normally use timesheets to do so on this contract in expectation of a termination. We are prepared to cite relevant supporting decisions if we need to.

Once the costs were grouped in the above categories,

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they were regrouped into the cost categories identified in the specific termination proposal form used. However, the cost data and categories identified above will be the basis on which auditors will conduct their review. Of course, auditors and contracting officers are usually motivated to challenge proposed costs and they will likely have something to say about the proposed costs but a clear understanding of the rules and proper presentation of the costs can go a long way to maximizing recovery of your costs

QUESTIONS & ANSWERS

Q. Do most companies segregate tax prep fees as directly associated unallowable cost or keep them in reasoning the expenses are a cost of doing business and the prep fee is not a direct result of the tax expense? Also is this email (the question was emailed to us at gcaconsult@earthlink.net) a good way to ask you questions.

A. Yes, email is a good vehicle to submit questions. If you would like to talk to a real live person, either follow up your email with a call to (925)362-0712 or simply call us. As for your question, I assume you are asking about tax preparation expenses associated with preparing taxes that may be unallowable e.g. federal income taxes. That is a particularly interesting question since I rarely see either internal or outside tax preparation costs segregated as to allowable or unallowable costs (unless it relates to a business combination). Rather, all audit and accounting costs, including tax preparation, are normally included as G&A expenses and I have never seen auditors question those costs (they are usually immaterial). However, in a technical sense, since federal income taxes (not state taxes) are unallowable, then you could argue the costs for preparing them are associated unallowable costs.

Q. I just joined a company whose philosophy on unallowable costs is explicitly "when in doubt leave it out" which is contrary to my other company where the practice was "when in doubt leave it in." What do you think?

A. I tend to side with the leave it in school. In my experience as a DCAA auditor, CFO/controller and consultant I have seen too many times contractors unnecessarily reduce and even eliminate profit on government contracts when they excessively bend over backwards to make sure unallowable costs are screened. Remember a 10 percent profit fee does not translate into 10 percent profit but the profitability of the contract can be significantly lower and even a loss if a lot of costs are excluded from the price. The fact is, except for those instances where a cost is unmistakably unallowable in accordance with the FAR 31 cost principles (e.g. liquor, bad debt, interest) most costs are clearly allowable while others are in the grayish area where varied and valid interpretations of allowability or allocability rules can make the same cost allowable or unallowable. Unless those costs are subject to penalties (e.g. explicitly unallowable cost where a cost principle clearly makes it unallowable) or the cost was deemed unallowable in prior decisions by the ACO I would not be in a hurry to "leave it out" if a plausible case can be made for its allowability. Reasonable people can differ in their interpretations of the cost principles and cost allocation rules and fear of adverse reactions by auditors for these grayish areas is often unfounded. Feel free to use our "Ask the Experts" service to discuss the allowability of costs you are unsure of – that's what its there for.

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