// GCA REPORT
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NEW DEVELOPMENTS

Measures to Limit Contractor Pay Gain Steam

Several proposals by the Obama Administration and bipartisan proposals from Congress are attempting to significantly limit both executive and all contractor employee compensation. The Obama administration's recommendation to the 12-member deficit reduction "super committee" in September included a proposal to cap compensation reimbursed to federal contractor executives at the government contract compensation level paid to cabinet level personnel (currently $199,700). This new formula would be a departure from the current method of capping executive compensation to what is paid to commercial firms whose revenue exceeds $50 million which in 2010 was $653,951 (there has been no updated cap for 2011). Three senators followed up with a letter to the "super committee" recommending a $200,000 annual salary cap which would apply not just to the current highest paid executives but to all contractor employees. On October 14 the chair and ranking members of the Senate Homeland Security and Government Affairs Committee put forth their own proposals that would cap all contractor employees at $200,000. Rationale for the severe reductions range from budget reduction measures to assertions of fairness when "millions of Americans are unemployed" and normal employee paychecks are not going "as far as they used to."

All early industry reactions to these proposals are, not surprisingly, highly critical. Typical comments include they will adversely affect the government's ability to obtain the best goods and services because contractors will be at a significant competitive disadvantage for recruiting executive and non-executive talent with commercial companies not subject to government reimbursement rules.

DCAA Staff Allocation Plan Shows Their Audit Priorities

DCAA issued its FY 2012 staff allocation to each of its regional offices. The staff plan shows a wish list of 12,511 work years where it has resources to cover only about 40 percent. The memo emphasizes its priority audits given the shortfall of audit resources as:

1. Demand requested audits – requests from procurement agencies – such as high risk proposal audits.

2. Partnering audits with DCMA to recover costs associated with open issues such as cost impact proposals.

3. Billing and accounting system audits at pilot test sites of certain major contractors.

4. Post award (defective pricing) audits of "high profit" contracts identified by DOD.

In addition, much of the memo discusses the agency's plan to reduce the backlog of incurred cost proposals where the goal is to complete audits through 2009 and earlier. Any additional resources granted to the agency will be assigned to incurred cost proposals. However, since current incurred cost audit resources will accomplish only 28 percent of the audits needed to meet this 2009 goal, DCAA has established priorities for incurred cost audits that are:

a. "Reachback" and DCMA priority audits that include major contractors and other contractors with overseas contingency operations that DCMA has responsibility over. The principle focus of these audits will be on corporate, group office, home office, service centers and subcontractors that are listed on DCMA's priority list.

b. In process audits carried over from 2011.

c. Overseas contingency operations for CY 2009 and earlier.

d. Major contractors' corporate home office and service center proposals for FY 2009 and earlier if the proposals are adequate.

e. Non-major contractors' incurred cost audits with three or more years of adequate submissions. The focus will be on older unaudited proposals which will take priority over more current ones. We have seen several approaches taken by DCAA in these circumstances such

as auditing multi-year proposals where audit procedures may be applied to several proposals at the same time to selecting the highest auditable dollar proposal and then negotiating an agreement to apply a resulting "decrement" factor to other proposed years.

President Obama and OMB Order Agencies to Pay Small Contractors Even Faster

The Office of Management and Budget issued a memorandum to all executive branch departments and agencies that implements President Obama's call to have all agencies pay small businesses even faster than they do now to spur hiring. The Prompt Payment Act generally requires an agency to pay its contractors within 30 days of receipt of relevant documents such as a proper invoice and confirmation that goods and services have been received and accepted by the government. Under the new memo, the goal will be within 15 days of such receipts. Agencies are supposed to notify the OMB by Nov 1 the date they will begin making accelerated payments.

DOL Final Rule of Displacing Incumbent Work Force Under New Contracts

Department of Labor unveiled its final rule to require contractors that take over as successors from other contractors on service contracts to offer employment on a right-of-first refusal basis to qualified employees of the predecessor contractor who would otherwise loose their job. The rule replaces an executive order issued soon after President Obama took office. Exemptions are allowed if implementation of the rule would impair the government's ability to obtain services economically and efficiently. The final rule replaces certain provisions in the proposed rule where now the predecessor contractor rather than the agency notifies affected workers and if there is an exemption decision, notification be given to workers five days after the solicitation is made rather than at contract award to allow more time to challenge the exemption.

The final rules provide more detail on making an exemption decision. The agency must provide a "detailed written analysis" that explicitly addresses the presumption that retaining a predecessor's employees usually serves the government's interest. Also because the Service Contract Act commonly establishes the wages and fringe benefits that a successor contractor must pay, the exemption decision normally would not be based on wages to be paid so the written analysis must demonstrate that cost savings other than wages and fringe benefits clearly outweigh retaining predecessor employees. The final rule also says a contracting agency may consider predecessor's job performance subject to the exemption where it reasonably believes the entire predecessor workforce failed, individually and collectively, to perform suitably on the job.

Proposed One-Bid Rule Generating Lots of Commentary

A recent proposal to treat acquisitions when a competitive award is expected but only one bid is received is generating a lot of commentary from a variety of quarters. The rule would create a new DFARS 215.371 section that would require COs to specify in a competitive solicitation what cost or pricing data may be required if only one offer is received. If only one bid is received and the period to submit was less than 30 days, the rule would require the CO to consider whether a revised order to promote more competition is called for and to re-solicit for at least 30 days. If the submission period was 30 days or more, the CO should obtain from the offer any necessary data and conduct price or cost analysis or negotiate with the offeror to obtain a fair and reasonable price.

Some commentators are claiming the proposed rule does not go far enough to ensure adequate competition while others believe it has gone too far. An example of the latter position is the American Bar Association (ABA) has criticized the rule's presumption that a single offer precludes adequate price competition. Pointing to the FAR, ABA says if there is a reasonable expectation that two or more responsible offers would be made, competing independently, then adequate competition would be the result even if only one bid is received. The ABA recommended DOD conduct further study of adequate price competition in one-bid circumstances before issuing a rule but if DOD proceeds with the rule, it should exempt procurements of commercial items and services worth less than $10 million.

Amendments Made to Past Performance Evaluation Proposal

A proposed rule that would amend the FAR to standardize past performance evaluation factors and performance ratings into the Contractor Performance Assessment Reporting System (CPARS) has added to the proposal a contractor appeal procedure that was "inadvertently omitted" the first time around. The proposed rule would make government-wide the five-scale rating system and evaluation factors found in CPARS – (a) technical or quality (b) cost control (c)

schedule and timeliness (d) management or business relations and (e) small business contracting. It clarifies that contracts and task orders over the simplified acquisition threshold should be evaluated annually and provides that incentive fee and award fee contract performance ratings be entered into the CPARS.

The additional material instructs agencies to allow contractors at least 30 days to submit comments, rebutting statements or additional information to supplement agency evaluations of performance. It also directs agencies to provide for review above the contracting officer level and gives ultimate authority on the performance evaluation to the contracting agency.

DCAA Told It Needs Policy on Testing Audit Data

(*Editor's Note. The following report addresses a common problem our clients face when an audit report is issued long after the audit began and the information or data the auditor used to support its audit position is no longer valid.*)

During a sample review of two DCAA audits on a large contractor's accounting system, the DOD Office of the Inspector General (OIG) found that accounting data reports reflecting transactions being tested were over one year old from the date of the reports and the final audit report. The OIG found that instead of an agency-wide written policy on timeliness of data tested in its reports, it said each of the five DCAA regional offices had its own rule of thumb as to when data became outdated. The OIG recommended DCAA develop agency-wide written policies requiring auditors to test current data throughout the period of the audit and retest outdated data.

DCAA Issues Guidance

DCAA has issued several audit guidelines to its auditors through October where the most significant include:

- **Lobbying Costs Related to Legislative Earmarks**

The new guidance re-emphasizes an earlier guidance issued in 2008 reminding auditors to make sure contractors properly identify and account for costs associated with lobbying relating to legislative earmarks (i.e. a congressional provision directing funds be spent on specific projects, which in 2010 represented 1,759 earmarks worth $4.5 billion). Efforts and related costs incurred by company representatives or professional services for the purpose of influencing or attempting to influence government officials in connection with earmarks or any associated costs are considered to be unallowable as defined in FAR 31.205-22 and FAR 52.203-12. In planning and conducting audits of incurred cost submissions, forward pricing proposals and others, auditors are told to evaluate contractors' procedures for properly identifying and accounting for these lobbying activities. The guidance says these costs would likely be included in such expense categories as program management, contracting, public relations, travel, conferences, consultants or technical personnel. Auditors are to assess the risk of such costs, perform substantive tests based on this risk assessment, question any costs and consider citing the contractor for a CAS 405 violation. (*Editor's Note. There is no mention in the guidance whether such costs would attract penalties but based on DCAA's recent proclivity to recommend penalties on many unallowables, the costs likely would.) (11-PAC-015(R).*

- **Discontinuation of Purchasing System Internal Control Audits**

(*Editor's Note. We are personally glad to see DCAA's decision to stop initiating purchasing system internal control audits because though there was significant overlap, the areas of focus between these audits and DCMA's Contractor Purchasing System Reviews required explicit satisfaction of two sets of requirements. In our consulting work with contractors to help prepare for CPSRs, we often had to add what to expect from DCAA's separate audits. We will see whether DCAA stays out of this purchasing system business and if so, we and all contractors can then focus solely on CPSRs.*)

Effective immediately, the guidance states that DCAA will no longer initiate audits on contractor Purchasing System Internal Controls. The guidance stresses that purchasing system reviews are under the responsibility of the Defense Contract Management Agency where review of contractors' purchasing system will be conducted solely by the growing resources of special CPSR teams within the DCMA. However, as a notice that it is not completely out of the purchasing system audit business, the guidance states DCAA will continue to audit purchases and subcontract costs as part of their forward pricing and incurred cost audits and report significant deficiencies to the ACO for resolution. The guidance also states it will meet with the CPSR team prior to a system review to share their insights in reported business deficiencies, risk areas and other concerns DCAA has with the contractor's purchasing system (*11-PPD-018(R)*.

- **Review Subcontract Commercial Items for Forward Pricing Proposals**

The guidance reminds auditors that when a contractor's proposed costs include significant subcontract costs for

commercial items the prime contractor/higher tier subcontractor (we will use the term prime here) makes sure the item meets the definition of commercial item (they call this a commercial item determination – CID) and the prime performs "appropriate cost or price analysis to establish a fair and reasonable price." The guidance references FAR 15.403-1(c)(3) that states if a CO or auditor determines that an item claimed to be commercial is not, the CO will then require submission of certified cost or pricing data if no exemption applies. Further, if the auditor opines that the prime contractor did not make a proper CID, failed to conduct a proper cost/price analysis or failed to follow its policies and procedures in this respect then it is considered to be a "significant" estimating deficiency and a flash report should be issued.

An adequate CID should generally include market analysis and sales history. An auditor may coordinate with the ACO to see whether a prior CID was adequate but cautions against excessive reliance on such determinations since conditions change. As for adequate cost/price analysis, pricing, sales or other data will be used to conduct a price analysis where an evaluation of overall price without evaluating individual cost elements and profit should be made. If the prime cannot determine reasonableness of price using price analysis, then cost analysis may be used where cost data may or may not be certified. If the CID is considered inadequate the first step is for the auditor to recommend to the CO that he communicates in writing that the prime should proceed with a CID. If still not completed the auditor is to inform the CO it is still not complete or adequate and that they may need to request certified cost or pricing data. If either the CID or cost/price analysis is not adequate, then the proposed amount, less any questioned costs, should be classified as unsupported and the report on the proposal should be qualified for the unsupported costs.

In the Frequently Asked Questions section of the guidance a couple of interesting points were made:

1. Use of catalog pricing should be suspect because they don't take into account quantity discounts.

2. If the prime conducts a CID but the subcontractor does not release needed information to conduct a price analysis then the unsuccessful efforts should be documented in the proposal and the responsibility then goes to the ACO. However, the prime is not completely relieved of responsibilities where he should perform a portion of price analysis e.g. market analysis.

SBA Issues Proposed Rules to Stem "Bait and Switch" Practices in Using Small Businesses

On Oct 6 a proposed rule to lessen "bait and switch" practices (i.e. a prime contractor references a small business as it subcontractor in its bid but does not utilize it in actual performance) was proposed by the Small Business Administration. The proposed rule will require a prime contractor to notify the CO if the prime decided not to use a subcontractor it included in its bid. In addition, it will require a prime contractor to tell the CO whenever it reduced payments to a subcontractor or made those payments 90 days or more past the due date. The proposed rule would also (1) clarify that the CO is responsible for monitoring and evaluating small business subcontracting plans and (2) clarify which contracts must be included and not included in subcontracting data reporting. The rule will apply to "covered contracts," those for which a small business subcontracting plan is required – currently procurements above $1.5 million for construction and $650,000 for non-construction (*Fed. Reg. 61626*).

Senators Plan to Shift More Costs to Contractors

A bipartisan bill is being prepared by senators to force contractors to pick up the bill for development costs and absorb cost overrun expenses. The proposal is being touted as a way to help cut budget deficits while avoiding severe cuts to the Defense budget anticipated if Congress fails to agree to major cost reductions. The bill proposes three major acquisition reforms: (1) force contractors to share 25 percent of the cost of developing major weapons systems (2) promote fixed price contracts in lieu of cost plus contracts and (3) hold contractors liable for cost overruns on contracts.

OFPP Finalizes Policy Letter on Inherently Governmental Work

The Office of Federal Procurement Policy has issued a final policy letter outlining when work must be performed by federal employees rather than contractors which sets out a number of obligations for agencies to ensure "inherently governmental work" is performed in-house. The final policy letter adopts the definition of "inherently government function" that was included in the Federal Activities Inventory Reform (FAIR) Act of 1998 that originally defined the term as "so intimately related to the public interest as to require performance by federal government employees." Responding to public comments, the policy letter states it does not believe it

would be appropriate to expand the definition to include closely associated functions or critical functions. The letter states agencies must give special attention to activities that might fall under these functions so that the government does not lose controls of either inherently government functions or activities that are at the core of an agency's mission where, in appropriate circumstances, they may be performed by contractors. The final letter, along with testimony to the Senate by OFPP's chief administrator, makes clear that its guidance is not intended to discourage the appropriate use of contractors who "can provide expertise, innovation and cost-effective support to federal agencies for a wide range of services" (*Fed. Reg. 56227*).

Senators Take Action to Avert Decertification of 3,400 HUBZone Firms

Leaders of the Small Business Committee of the Senate are rushing to take urgent action to prevent the decertification of 40 percent of HUBZone companies. As of this writing, the bill has passed the Senate but not the House so the status of the decertification is up in the air. The decertification of 3,400 companies qualifying as HUBZone companies was due to take effect Oct 1, 2011 where they were statutorily required to be decertified because they were located in "redesignated" areas (i.e. areas 2010 census data indicates no longer qualify for being economically disadvantaged). To qualify as a HUBZone concern, a small business must have its principle office in a qualified HUBZone and at least 35% of its employees must reside in a HUBZone. Prior amendments to the original HUBZone Act provided a grace period under which affected businesses could continue to qualify as HUBZone concerns or make arrangements to move to another HUBZone area if they were redesignated but that period has expired. So unless the authority for redesignation is renewed, which there is no indication the Small Business Administration is trying to do, all HUBZones that were redesignated will lose their HUBZone status all at once. SBA estimates at least 40% of the currently certified HUBZone companies will lose the right to claim that status.

Firms that lose their HUBZone status can continue to perform any HUBZone contracts they already have but for new contracts HUBZone status will be as of the date of contract award. Prime contractors or team members of joint ventures that receive HUBZone status for teaming with other HUBZone companies will also cease to have that credit, irrespective of the firm's status at the time of proposal submittal. Though recent changes allowing firms 90 days to reapply after decertification (rather than the prior one year period) will be helpful in some cases, it will not provide relief to those who do not meet the 90 day period (or even longer if there are an avalanche of new reapplications).

Contractors Must Display DOD Fraud Hotline Posters

Companies with Defense Department contracts must now display the DOD Inspector General Fraud hotline posters in common areas both within business segments working on the contracts or at contract work sites. The new rules are intended to supersede the FAR 52.203-14(c) provision that exempts contractors from displaying agency fraud hotline posters if they have implemented a business ethics and conduct awareness programs that may include a company provided hotline poster. The DOD inspector general found these provisions make the DOD hotline program less effective since they provide less optimal exposure and the company made posters may be less effective in advertising the hotline number.

Three-Percent Tax Withhold Measure is Voted Down by Committee

Following intense industry group and congressional opposition from all ideological sectors to an IRS rule to impose a 3 percent withhold on certain payments to contractors for goods and services sold to the government, legislation from the influential House and Means Committee of the Congress was passed to repeal the rule. Representatives claimed imposition of the rule would be equivalent to using a "sledgehammer" to discourage tax avoidance of a few firms where cash flow of firms needing it would be harmed and cause unemployment. The unanimous voted bill now goes to the full House where there is widespread opposition to the IRS rule due to become effective in January 2012.

CAS Board Discontinues Review of CAS 403 and 416 and Adds a New Proposed Rule

The Cost Accounting Standards Board has issued two notices of discontinuation of rulemaking. The CASB initiated actions to possibly change the dollar thresholds that requires use of the three-factor formula in allocating residual home office costs under CAS 403 and possible changes to the "catastrophic losses" feature under the insurance based CAS 416 that requires contractors to make a determination on what such losses are. The CAS Board determined that further review of the CAS 403 threshold was not needed since the current thresholds did not create an inequity nor that any changes would result in a substantial change of outcome. As

for possible changes to CAS 416 the Board noted the standard had been in effect for over 30 years where there were never any problems or disputes related to the catastrophic loss term (*Fed. Reg. 53377 and 53378*).

Meanwhile, the CAS Board invited comments on a proposed rule to clarify the application of the CAS exemption found at CFR 9903.201-1(b)(15). The proposed rule would clarify that the exemption to CAS coverage found in that section applies to firm-fixed price contracts and subcontracts awarded on the basis of adequate price competition without submission of certified cost or pricing data (*Fed. Reg. 61660*).

CASES/DECISIONS

Bid Protests Over Adequate Accounting System

(*Editor's Note. The following case demonstrates how determinations of inadequate accounting systems and failure to resolve issues can quickly sting.)*

DCAA had issued a report stating Sygnetics had an inadequate accounting system and had not updated that report in over two years. Sygnetics submitted a proposal but the government rejected it because the offeror lacked an adequate accounting system as required by the solicitation. The company protested the action stating the audit report should have been updated to reflect accounting system changes so in response the GAO ordered the agency to take corrective action by requesting a new DCAA audit. During the audit, DCAA agreed the prior deficiencies had been adequately addressed but it found additional new issues. In response, Sygentics stated it would adopt policies to fix five of the six deficiencies where it asserted the sixth was compliant with FAR requirements. DCAA disagreed and stated in its final audit report it was withholding system approval and recommended further review and revisions to their practices. The agency concluded Sygentics' accounting system was unacceptable and rejected the proposal and the GAO agreed it was not unreasonable for the agency to rely on DCAA's recommendation to further review the system before finding it acceptable (*Sygnetics, B405130*).

No PIA or OCI Violations When Employee Uses Info Gained From One Company to Help Another

GEO assembled a team to prepare its proposal for a follow-on contract with the Bureau of Prisons where the team include the Vice President that had supervised the existing contract. The VP had access to sensitive competitive information including GEO's staffing costs and resigned shortly after meeting with GEO team members to review the proposal. The VP took a position with CSF who subsequently won the award where the Court noted the fact their proposal included wording almost identical to GEO's strongly indicated the VP had a hand in their proposal. GEO protested the award asserting the VP violated the Procurement Integrity Act (PIA) by inappropriately using CEO information to assist CSF and the VP's actions gave rise to an unmitigated organization conflict of interest (OCI). The Court rejected both assertions. As for the PIA, the prohibition against obtaining bid or proposal information or source selection information before a contract award applies to government officials and their agents where here the VP did not obtain information from any government sources. As for the OCI issue, the prohibition about unequal access to information arising when performing on a government contract does not apply when an individual takes information about his former employer to his new employer (*The GEO Group v U.S., Fed. Cl. No 11-490C*).

Mutual Mistake Justifies Reforming Agreed to Indirect Rates

In 1988 Kearfott sold its parent company to another firm where the higher value of assets were recorded on its books where the FAR at the time allowed these costs (FAR 31.205-52 made these costs unallowable after 1990). Kearfott recorded these costs differently – for tangible assets they were correctly charged as operating expenses but for higher value intangible assets they were mistakenly recorded as a deduction in income rather than a cost. The audit determined indirect rates sent to Kearfott excluded the intangible asset costs which the CFO "accepted" where there was no release or other binding agreement. Shortly after, the CFO noticed the rates did not include the intangible assets and after notifying the ACO was told to submit a new schedule of rates where he would then correct the mistake. When the new rates were submitted to DCAA they objected to the new value on the grounds the parties had previously agreed to the lower rates and that Kearfott had intentionally left the intangible assets out. Based on this audit advice the ACO reversed his decision and Kearfott appealed.

The Board first decided the recording of the higher value of the intangible assets as a deduction from income was a mistake and not an "established accounting practice." Because the recording was a one time bookkeeping entry

of millions of dollars of allowable costs the Board concluded it was unlikely the contractor would intentionally not claim these costs while the government did not provide evidence such a practice was an established accounting practice. Though the mistaken entry was a unilateral mistake by the contractor the Board ruled the mistake was mutual because the parties had agreed to the rates in the mistaken belief those costs were included. Though a unilateral mistake would normally not justify the allowance, the mutuality of the mistake made them clearly allowable (*Kearfott Guidance & Navigation Corp, ASBCA 55626*).

FEATURE ARTICLE

A Good Summary of the Recent Business System Interim Rule

We have reported extensively on recent proposals and amendments related to the requirements to have adequate business systems and the penalties for not having them. The proposals and subsequent changes are quite confusing and have generated a great deal of commentary from all sources. We came across a good summary of the current rule and problems in the October 19th issue of the Government Contractor written by David Nadler, Justin Chiarodo and Christian Curran of the law firm of Dickstein Shapiro LLP so thought we would summarize it here.

On May 18 of this year the Department of Defense promulgated an interim rule amending the DFARS that imposes compliance standards for contractor business systems that can be enforced by payment withholds. DOD first issued a proposed rule addressing contractor business systems in Jan, 2010 whose purpose was to combat "waste, fraud and abuse" by improving "effective DCMA and DCAA oversight of contractor business systems." Several changes to the original proposal were made based on commentaries such as reducing the amount of penalty payment withholds (originally up to 100 percent), types of contractors and contracts subject to the rules and vagueness of what constituted deficiencies. Some of these questions were resolved by the final interim rule while others were not.

The interim rule requires insertion of a business system FAR clause in all contracts covered by the Cost Accounting Standards. Small businesses are exempt but unlike earlier versions, contracts under $50 million are subject to the clause. The rule covers six categories of "business systems" where definitions were added – accounting systems, estimating systems, purchasing systems, earned value management systems, material management and accounting systems and property management systems.

Payment withhold penalties will apply under cost type, incentive type, time and material and labor hour contracts as well as withholding payments under progress-based contracts. The final rule limited payment withholds over earlier proposals to 5 percent if one or more significant deficiencies are present in any one business system and 10 percent if deficiencies are found in multiple contractor systems. Much controversy revolved around the meaning of "significant deficiency" where a definition was finally put forth as a "shortcoming in the system that materially affects the ability of officials of DOD to rely upon information produced by the system that is needed for management purposes."

Procedures were also put forth where first, if an auditor finds a significant deficiency in any one system the CO must make a determination to confirm it. If the CO finds the system not deficient, they must notify the contractor in writing; if the CO confirms the auditor's finding they must issue a written finding that details the deficiencies. A contractor has 30 days to respond to this initial determination where once the CO has received the contractor's response, they are to make a final determination. If significant deficiencies are found, the contractor then has 45 days to either submit a corrective action plan or correct the deficiencies. It is after this forty-five day period the contractor faces the payment withholding until the CO "determines there are no remaining significant deficiencies."

The authors point out that the interim rule leaves open several questions. First, though there is a definition of significant deficiency, it is ambiguous enough to essentially be left to the subjective judgment of the CO. Second, the discretion is left to COs who are usually not trained in the intricacies of business systems and internal controls where the rule does not address this insufficient training. Third, as a result, CO must rely on the very people who are asserting the deficiencies, namely the auditors, which impairs the independent judgment the rule was intended to provide. Fourth, there appears to be no guidelines regarding follow-up to ensure timely reviews for compliance if a system is disapproved. Unlike prior versions of the rule that allowed for payment approvals when the CO found "substantial correction" now the rule simply states a contractor will not receive withheld payments until there are "no remaining significant deficiencies." The authors state the future will be one of heightened regulations

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and audit scrutiny under vague guidelines and stress contractors need to take a proactive approach to evaluating their current business systems and begin working more closely with DCAA and their COs to understand what is expected of them.

QUESTIONS AND ANSWERS

Q. We are bidding on a DOD contract and are subcontracting one or more positions. What is a typical markup on subcontract positions?

A. Unlike the commercial world where there are typical markups common in your industry, the government world is quite different in some ways. In that world, what you are calling "markups" really have two components – a cost based indirect rate (normally G&A) applied to all costs and a negotiated fee or profit. You are normally allowed to charge whatever cost based indirect cost rate you apply to subcontracts and then free to negotiate a profit on those costs. Normal G&A rates fall in the 10-15% range where profit rates on subcontractor costs might be in the 5-10% range also but these are very rough estimates where practices in your specific industry should dictate what is the norm. Also, keep in mind that your government customer may have an acceptable "markup" in mind where they may take the position that "we don't care what your costs or desired profit rate is, we will not accept an add-on more than X percent." Your objective should be to determine what that X amount would be.

Q. The legal expense cost principle at FAR 31.205-47 is very confusing. We have a pending suit from another contractor claiming we and two of our subcontractors reversed engineered software and conspired to obtain government business at their expense. We believe the assertions are false and have spent over $100K in legal expenses. Are they allowable?

A. Though the majority of legal expenses commonly incurred by contractors in their normal operations are allowable, it sounds like you may have struck one of the unallowable ones – patent infringement (or in this case, copyright infringement). The exception could be if the software is required for a specific contract or the assertions are clearly proved false. We need to discuss further to establish the facts.

Q. We are bidding on a large government contract that will require purchase of significant equipment and supplies that we want to offer as a simple pass-through with nothing added to the costs. Do you anticipate any problems?

A. Yes I do. Since these equipment and supplies are presumably direct costs of your contract, the government will usually take the position they should be included in your total cost base (again, usually the G&A rate). If they are included, they will probably significantly lower your G&A rate applied to all other costs where you will receive no benefit since you are not charging G&A on those items. A few options come to mind: (1) include the costs in the G&A base and reconsider not offering any add-on (2) possibly create a special handling rate for these type of items where they would be excluded from the G&A base yet the pool costs would need to be identified or (3) establish an advanced agreement with your customer justifying a pass through and exclusion of those costs from the G&A base. The third option can be tricky. If your contract is not CAS covered you have more flexibility than if it is.

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