GCA Digest

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Case Study…

LOWERING G&A BY CHARGING CERTAIN G&A COSTS DIRECT

(Editor's Note. The following is a highly edited memo we drafted in response to our long term client's desire to lower their G&A rates to be more competitive on their existing large contract. We first discussed the nature of the request for proposal and the contract to see what types of costs included in G&A might be candidates for direct charging. Next we identified activities included in G&A costs and computed what costs were significant enough to change. Finally, we identified ways to implement the changes and what documentation and disclosures to the government were needed. We refer to our client as Contractor.)

You have been the incumbent on a cost reimbursable contract for several years where now there are hungry competitors who have high technical capabilities and low prices seeking to "eat your lunch." You have been able to estimate your competitors' pricing (through a protest action) where though hourly rates, fringe benefits and overhead rates are similar to yours, your general and administrative (G&A) rate is too high. Therefore, the objective is to lower the rate by lowering the pool costs. To that end, you want to determine what costs in the pool can be deleted by charging them direct to the contract.

The first step in this process is to examine the RFP and contract to determine which G&A costs can be considered direct. For estimated costing and funding purposes, the RFP requires identification of various labor categories and assumed hours for each category. The contract itself is silent about what costs should be direct or indirect.

Next we analyzed many of the functions in support of the contract that could be included in the broad definition of program management, a direct cost category. New task orders and constant modification to existing work required considerable (1) security administration and HR by various people to revise security documentation and handle certain HR functions for new personnel (2) administering many contract modifications by contract and subcontract administrators (3) reviews of contract deliverables by different layers of management and (4) funding changes conducted by accounting and financial personnel. There were more support functions we identified but concluded they were either too insignificant in amount or provided more potential controversy about whether they could be considered direct. Our conclusion is that "program manager" category offers opportunities to the four support functions and corresponding individuals providing them.

Next, we examined Contractor's timekeeping practices and existing written policies and procedures. The timekeeping procedures and practices were well established (several floor checks revealed no significant deficiencies) and provided simple ways of having G&A personnel identify charges to any contracts. They needed to follow established practices set for all other direct labor, identifying contract and task order numbers, hours charged and ensure their time was credited from G&A pool costs.

The written policies justifying charging of these individuals was more challenging. Though there were adequate procedure instructions identifying how direct charges were to be made, there was no written policy on how direct versus indirect costs were distinguished and how the types of activities we wanted to charge direct could be justified. Since challenges of whether costs can be charged one way or the other often comes down to what are the disclosed practices, we determined that a written policy would be needed. It should provide some general verbiage in how direct and indirect costs are distinguished (e.g. direct costs identifiable with a final cost objective, indirect costs in support of multiple projects or the company as a whole) and examples of direct versus indirect costs where the examples should include the types of support activities to be charged here. Special care should be used to address CAS 402 requirements to charge similar costs charged in similar circumstances consistently as either direct or indirect but not both. I pointed out the rather famous example in CAS 402 that provided normally indirect facilities security costs can be charged direct when security costs can be shown to support one contract.

Finally, is the issue of communicating the change. Though the altered way of accounting for these functions would likely be considered an accounting change, disclosure of such changes are significantly less since Contractor has no contracts covered by the cost accounting standards because it is still considered to be a small business. We recommended that the proposal include a narrative addressing that "program manager" includes the four functions we identify below. As for informing either DCAA or DCMA, we held off a decision on whether we should submit written notification. Reasons to delay disclosure was such notification was not required until submittal of the next incurred cost proposal and we did not want to highlight any potential problem with acceptance of the proposal. However, reasons to disclose the change included (1) contractor has a long history of excellent relations with both DCAA and contract administrators (2) the accounting change could be defended on grounds that it represented more precise accounting practices and (3) financially benefited the government since it represented lower G&A costs and lower program manager costs since billed hourly rates on the cost reimbursable contract would lower than those hourly costs presented in the proposal reflecting a full time, higher paid program manager.

KEY ISSUES FOR RECOVERING COSTS FROM TERMINATION FOR CONVENIENCE

(*Editor's Note. Since we last addressed several years ago issues related to maximizing recovery of costs for contracts terminated for convenience, several things have changed. The Defense budget increased markedly where now defense spending appears to be shrinking with the withdrawal from Iraq and Afghanistan resulting in more terminations. In addition, the proliferation of different types of contracts and changes in some rules now require an understanding how different contract types are unique and must be treated differently. We were glad to have come across a September 2014 Briefing Papers article by Patricia Meagher and Olivy Zamaray of Rogers Joseph O'Donnell and Greg Bingham and Jeffrey Duval of the Kenrich Group where termination for convenience for three different contract types are discussed. We will address the treatment of specific costs in a separate article. The section "Other General Recommendations" below comes from us, based on practical insights gained from our helping prepare client termination settlement proposals.*)

Cost Reimbursable Contracts

- **Fee Recovery**

In addition to normal issues related to identifying costs, a major issue for terminated cost type contracts involves the recovery of fee. The FAR states that a determination of what fee is recoverable is generally based on the percentage of completion of the contract where after termination the contractor typically receives the percentage of the original fixed fee amount that was negotiated. However, recovery of fee under cost-plus-award-fee is more complex because the basis of such awards differ significantly in each contract where often the contract is silent on how to treat fee under a T of C. Generally, the fee proposal section of a termination settlement proposal (TSP) will be similar to fee proposals submitted as part of fee during performance. Make sure the award fee proposal addresses the factors the FAR requires the TCO to consider such as extent and difficulty of work, planning, technical study, product and supervision, placing and supervising subcontracts, work involved in stopping performance, settling terminated subcontracts and disposing of termination inventory.

Commercial Item Contracts

There are important differences for recovery under commercial item contracts. Clause 52.212-4 explains how both price and fee may be recovered under such a contract. Specifically, the contractor will be paid a percentage of contract price reflecting the percentage of work performed prior to the T of C notification plus reasonable charges the contractor can demonstrate using its standard record keeping system. Note there are two elements here – one is based on price (percentage of the contract price) and one is based on cost (reasonable charges). The FAR provision neither requires the contractor to comply with the cost accounting standards or FAR cost principles nor does it give the government the right to audit the contractor's records. As a result there is no one standard method to determine "the percentage of work performed" or whether "charges" resulting from the termination are "reasonable."

- **Measuring Percentage of Work Performed**

What is considered a proper way to measure "percentage of work performed" has been addressed in several cases. One acceptable measure is to compare the length of time the contract was performed before it was terminated with the original forecasted period of performance.

Another method is to identify the extent to which the work was completed prior to termination. This method is most easily applied where work status can be

measured objectively. For example, in one case where the government awarded a commercial service contract to thin trees on 98 acres of land within a 90 day period, the board ruled the number of acres completed prior to termination could be used to measure percentage of completion (divide acres completed by 98 acres).

In another case the board rejected the government method based on the ratio of number of crew hours estimated by number of actual hours worked prior to termination stating the estimated hours were only that –estimates – and hence there was no basis under a fixed price contract to restrict recovery to this measure. In that case, the board relied on witness testimony to measure percentage of work completed.

In another case, the court decided to calculate the proportion of work performed prior to termination subtracted from the original contract price the anticipated price of the terminated work.

Considering the challenge of determining the percentage of work performed under a terminated commercial item contract where there is not the benefit of cost information, the authors indicate they have seen many instances of where the percentage of work performed was estimated by engineers or project managers. Though typically subjective, these estimates are often the best information available to the parties.

It is quite common for auditors to ask for cost information for commercial item contracts stating it is necessary to determine the percentage of work performed prior to termination. However, many contractors have accounting systems that do not comply with government accounting rules where, for example, failure to identify and properly treat FAR Part 31 unallowable costs where then the auditor may report the contractor does not have a compliant accounting system which can hurt them in the future. The authors urge contractors to resist providing cost information.

- **Recovery of Reasonable Charges**

Recovery of reasonable charges by a terminated commercial item contractor is defined as "settlement costs or costs reasonably incurred in anticipation of contractor performance provided such costs are not adequately reflected as a percentage of work performed and provided such costs could not have been reasonably avoided." This provision has been interpreted broadly where such charges are not limited to costs incurred subsequent to the T of C or to settlement costs. The reasonable charges provision allows contractors to recover costs incurred in anticipation of performing the contract as well as costs incurred prior to the termination provided, of course, that such costs are not reflected in the percentage of completion computation.

Fixed Price Contracts

Though the most important points involve what costs are allowable termination costs, which we will address in the next issue, there are two points that commonly occur: assertion the contract was in a loss position and when can a total cost basis be used.

- **Loss Ratio**

Assessing whether the contract was in a profit or loss position when the fixed price contract was terminated is important since a determination that the contract would have been completed at a loss precludes the contractor from applying any profit and will result in a reduction of the settlement to reflect the indicated rate of loss. From a practical point of view, if the final cost of estimate at completion (EAC) at the time of termination is in a loss position this EAC will be used to compute the loss ratio.

- **Total Cost Basis**

On fixed price contracts there are two formats that can be used on the TSP: total cost basis and inventory basis (which is preferred). The total cost basis is the only basis for which the FAR required the contractor to include all its costs from contract inception through termination in its TSP. However, the total cost basis can be used in only four situations: (1) if production has not commenced where the accumulated costs represent only planning, preproduction or other "get ready" costs (2) unit costs for work in process and finished products cannot be established under the contractor's accounting system (3) the contract does not specify unit prices or (4) the termination is complete and involves a letter contract. The second condition is the most common basis to justify use of the total cost approach. If the total cost basis is desired, the contractor (or subcontractor) needs to notify the termination contracting officer promptly after T of C they do not have the accounting system to accumulate the costs of particular items that are in inventory, including work in process, in great detail where even if the system could establish unit costs it could only be done at great expense.

T&M Contracts

Since labor charges are based on "fixed" prices contractors mistakenly assume T&M contracts are fixed price. When this occurs they may use Standard Form (SF) 1435, Settlement Proposal (Inventory Basis) or SF 1436, Settlement Proposal (Total Cost Basis) when

they should use SF 1437, Settlement Proposal for Cost-Reimbursement Type Contracts. T&M TSPs should be treated as cost-reimbursable contracts with one twist – the cost of labor should be based on multiplying number of labor hours by the contract price established for each labor category. The advantage for T&M contracts is that the termination clause for such contracts allows a terminated contractor with a T&M contract to continue to submit invoices for six months after termination where if there are unpaid invoices or settlement costs to be recovered, these amounts can be addressed through submittal of invoices or a TSP. If there are no more costs or costs have been invoiced then a TSP is not required and the contract can be closed out using normal closeout procedures.

Issues Common to All Contract Types

In addition to what costs to include in a TSP there are a few issues common to all types of terminated contracts

- **Partial Payment Applications**

Terminated contractor and subcontractors have the ability to submit partial payment requests to maintain cash flow to cover expenses and pay termination settlement expenses of its subcontractors. Partial payments are discretionary with the government but when authorized contractors may be reimbursed for (a) up to 100% of contract price (less undelivered acceptable items) (b) up to 100% of subcontractor settlements approved by the government and paid by the prime contractor (c) up to 90% for work-in-process which may include raw materials, purchased parts supplies and direct labor (d) up to 90% of "other allowable costs" including settlement costs and indirect costs and (e) up to 100% of partial payment made to lower-tier subcontractors.

A complicated factor is the interpretation of what "90%" means. Sometimes it is considered up to 90% of total contract price while another position is it is made up of 90% of costs unpaid as of the effective T of C date.

- **Subcontracts With Affiliated Business Units**

Whereas it is common for affiliated businesses to issue intracompany work orders (IWO) rather than more formal subcontracts, it is important for all contractors to document requirements where undocumented or improperly documents IWOs can result in disallowance of costs associated with IWOs. To avoid such problems, the best practice when issuing IWOs is to make sure the prime contractor flows down to its affiliate the same FAR clauses it would typically flow down to its subcontractors.

In addition, make sure the affiliate follows its own cost accounting requirements as opposed to using the prime's practices where a case upheld DCAA's questioning costs because it did not follow its disclosed practices. Also be careful not to compound profit in its transfer pricing where charging fees twice on the same contract is prohibited.

- **On-Going Work on Fully Terminated Contracts**

It is important for terminated contractors to develop a structure of accounts or charge codes for recording post termination charges. For performance prior to termination contractors commonly have a work breakdown structure or other system of charge codes where those costs will have no relevance to termination activities undertaken after termination. It is also necessary to accumulate costs into different categories or account codes to correctly apply indirect cost rates (some normal indirect costs may be considered direct for post termination work) as well as computing fees.

- **Percentage of Completion**

To maximize fee recovery, the contractor needs to develop a well-supported analysis of the percentage of completion of contract work. It is usually best to assign a person who is very familiar with the contract and can perform a technical evaluation as soon as possible after the T of C. The goal will be to determine the percentage of completion of the contractor's work as well as the work of lower-tier subcontracts and supplies. Of particular importance is to review the engineering and technical work performed prior to termination keeping in mind that most difficult work required by the contract is work scheduled early in the contract period.

For those contractors employing an earned value management system (EVMS) the monthly cost performance reports that are typical of such systems may provide relevant project status information.

Other General Recommendations

- **Seek Fair Compensation**

Though we will address specific costs in the next DIGEST issue, the FAR provides for an overriding opportunity to be reimbursed "fairly." The cost principles are not to be applied strictly in determining allowability but are applied "subject to" the general principle that a contract whose contract is terminated for convenience is entitled to "fair compensation". This overriding principle states "a settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a

reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at a fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement" (FAR 49.201(a)). The strategies we discuss below for maximizing your claim is based on this "fair compensation" principle. Despite a long history, this principle is commonly overlooked by auditors, contracting officials and even contractors. If disallowance of a cost would be unfair you should claim it even if it is not allowable under one of the cost principles. Whatever form you are using (e.g. SF 1435 or 1436), you should take an aggressive approach and include a narrative that explains why a claimed cost is necessary to provide fair compensation.

- **Avoid Loss Adjustments**

If a contract is performed at a loss (i.e. it would have been completed at an amount in excess of the contract price), the contractor is not entitled to profit and termination costs are subject to a downward adjustment for the percentage of loss. This can be avoided by (1) submitting an equitable adjustment claim that will increase the price of the contract and hence avoid the loss or (2) avoid submission of information that auditors can use to infer a loss (e.g. estimate-to-complete for the terminated portion of the contract, verbal assent to a loss, etc.).

- **Avoid Government Second Guessing**

It is quite common for contracting officers and auditors to disallow costs (e.g. subcontracting decisions, lease arrangements, personnel decisions) alleging they would have performed the contract in a different manner. Case decisions (e.g. Aeronica Mfg. Corp., ASBCA 3844) have held contractors are allowed great discretion in performing their contract and unless there is a clear abuse of discretion, the choice along with its resulting costs are to be considered reasonable. The FAR also has long held that a cost is reasonable if it passes the prudent person test.

- **Reject Impractical Proof Requirement**

Though a fixed price contractor is not required to document its costs of performance, COs and auditors commonly attempt to disallow costs that do not have the type of documentation required under a cost-type contract. Both FAR 49.201(a) and numerous decisions (e.g. Algonac Mfg. Co., ASBCA 10534) have established a "liberal approach" of proving costs under a terminated fixed price contract. Though it has the burden to prove its termination costs are "more than mere speculation" use of estimates that have a reasonable basis in fact have been held to be sufficient when accounting records are unavailable due to no fault of the contractor. The burden of proof, however, is higher for settlement expenses and other costs incurred after a contract is terminated. As long as you incurred the expense and provide a reasonable factual basis to substantiate the amount, disallowance for lack of proof is improper.

- **Charge Indirect Costs Directly**

After a termination, the contractor is often left in a position where normal treatment of indirect costs result in unfair compensation (i.e. absence of direct costs prevents application of an indirect cost rate to recoup indirect costs). Numerous Boards of Appeals decisions have routinely permitted normal indirect costs to be charged direct for termination purposes (e.g. Agronautics, ASBCA 21512) These costs include: supervisory personnel, freight charges, factory supplies, equipment repairs, small tools, travel, telephone and other office expenses, engineering labor, quality assurance, purchasing, office labor and the company president. This different treatment of similar costs has been held not to violate CAS 402 (consistency of like costs under like circumstances) because costs of terminated contracts are not considered to be incurred "in like circumstances". Of course, these costs charged direct should be removed from an indirect cost pool(s) to avoid "double counting".

- **Obtain Professional Help**

Terminations often involve very complex legal and accounting problems where professional help can usually result in greater recovery. Expense should not be a concern since reasonable fees are allowable as settlement costs.

STRATEGY BEYOND SCALE

(*Editor's Note. We have received favorable feedback on articles we have written on strategic business issues raised by leading business thinkers and noting how those insights affect government contractors. In this article we address a topic by Bain Consulting how companies who are not necessarily large scale competitors in their industry nonetheless achieve superior profit results. Though the Bain study focuses on commercial companies competing in the global economy we find there are significant lessons for our government contractor clients and subscribers. The following is based on a 2015 study by Bain Consulting authored by Nicolas Block, Jame Hadley, Ouriel Lancry and Jenny Lundqvist where implications for contractors we describe are ours alone.*)

The article asks whether large scale is essential for competitive success or whether other factors should be considered. Bain analyzed 315 companies across 45 markets worldwide. Their analysis showed that the scale leader was also the economic leader in 60% of the cases. This is not surprising, says the Study, since companies focused on building scale benefit by spreading costs across the widest base, wield the most market influence and benefit the most from accumulated experience. On closer inspection, Bain found that creating exceptional value does not rely on scale alone. Finding that 80% of the economic profit in each industry was concentrated in the hands of just one or two players, Bain found that 40% of the economic leaders were not scale leaders at all.

- **Implications for Contractors**

1. *Learning curve*. The learning curve (or alternatively, the experience curve) refers to the proven tendency for unit costs to decrease a certain percentage for each doubling of production. The decrease is due to increasing experience that allows companies to become more efficient as their manufacturing and services grow in volume. Analysts can calculate from historical cost records a percentage decrease in unit costs a company has experienced (typically, 5% to 20%). It is commonly used by sophisticated companies to, for example, establish pricing on initial products or services based on anticipated volumes in the future and is often used to determine strategies to become, for example, a low price-high volume producer or a high priced-lower volume competitor. Auditors frequently use the technique (we remember taking a one week course when we were DCAA auditors) by computing a learning curve percentage and using it to evaluate the accuracy of proposed prices on government contracts. So, large scale companies should be "farther down the learning curve" where their proposed prices should be low compared to small scale companies allowing a higher proposed price for less price sensitive contracts. The higher prices can be defended by computing prices higher up the learning curve.

2. *G&A rates*. Higher scale government contractors might ordinarily show a lower general administrative (G&A) rate by computing G&A costs using a high total cost input base because of their high volume of work. Lower scale competitors are faced with the option to adjust their G&A cost rates: if they want to show lower G&A rates then they may need to lower the pool of costs by, for example, charging some of these costs direct (see the article above); if their proposed contract is less price sensitive, they may want to offer a significantly higher G&A rate by, for example, using a value added base (no direct material or subcontract costs) or maximize costs in the G&A pool.

Thinking Beyond Scale

The Bain study's finding is the best performing companies achieve their success by focusing their resources and augmenting the power of scale by using an array of assets and capabilities that surpass their competitors. Across the industries studied the authors found the winners focus on four critical attributes:

1. Valuable assets. Strong proprietary assets can often trump the benefits of scale by improving costs or boosting a company's ability to offer premium products or services. Leading pharmaceutical companies, for example, win by developing the best patent portfolios in the right categories or success in the oil and gas industry depends on bringing the most attractive new fields into production rather than their scale.

2. Superior capabilities. Unlocking those assets or realizing the benefits of scale requires strong capabilities. If you are Exxon Mobil or Shell the ability to pump the most oil at the lowest costs is hard to beat. But strong capabilities can turn smaller companies into economic leaders. Progress Insurance has been able to outperform the scale leader by using better underwriting algorithms to select the best customers and price risk them effectively.

3. The most attractive customers. Every market has a group of customers that are more lucrative than others. The companies that attract them command the highest margins. These customer groups are stickier and not as price sensitive and they cost less to serve. For example, Verizon's superior network gives it the highest average revenue per person among major U.S. telecom providers.

4. Benefits of scope. When Proctor & Gamble shares advertising, chemical and packaging costs across a diverse family of brands it benefits from wider scope than its rivals, both in terms of products and geographies. Apple generates greater "premiumness" for its customers by building an ecosystem of software, devices, content, storage and retail capabilities. Creatign scope and remaining focused is not easy where companies need to choose their opportunities carefully. Competing in related markets is no substitute for creating fundamental strength in each correctly defined market.

- **Implications for Contractors**

1. *Obtaining valuable assets and capabilities*. A smaller, more nimble company have opportunities to expand its asset base. Proliferation of mergers and

acquisitions and teaming arrangements show evidence that more companies are expanding their asset bases and capabilities while similar actions are precluded by government regulations. Recent expansion of mentor/protégé opportunities for all small business as opposed to just 8(a) firms provide more opportunities to utilize others' assets. Going after research and development opportunities (e.g. SBIR) that seek small businesses and contracts where organizational conflict of interests preclude larger scale companies offer opportunity that is not available to large scale companies.

2. *Contract types*. Following the concept that greater risk requires higher prices, going after lower risk contracts (cost type as opposed to fixed price) provides opportunities to offer lower prices on cost reimbursable or time and material contracts. Even fixed price contracts can be relatively low risk if predictability of costs are clear.

3. *Profitable customers*. Excellent relationships with niche agencies or individual buyers allow for opportunities to provide high margin work. Add-on work that falls within the scope of existing contracts is usually quite profitable since it is commonly sole source or minimally competitive Establishing commercial item eligibility early will allow using commercial item pricing on existing or related contracts. Using GSA schedule or other MAS schedules should allow for profitable provision of products and services.

4. *Segmentation analysis provides maximum pricing flexibility*. Multiple government awards (or even multiple task awards within single contracts) allow considerable flexibility in pricing strategies. Highly competitive awards imply low cost pricing while less competitive awards allow maximum pricing. Government accounting rules provide a great deal of flexibility. Many of our previous articles have addressed ways to accomplish pricing objectives where contract prices are based on cost build up estimates. For example, different facilities and locations may imply different indirect rates (e.g. geographic, on site/off site rates). Various overhead rates at one facility can be used for different types of contracts (e.g. highly support-related versus commodity like services). Different categories of labor provide opportunities for varied costs such as full time employees earning maximum fringe benefits versus temporary employees earning little fringe benefits or purchased labor providing no benefits.

Challenger Strategies

Companies achieve superior economic leadership by linking these four elements together into an ambitious strategy that explicitly targets higher performance. For example, Continental Tire captures three times more profit than its global scale leader Bridgestone by setting up a network of manufacturing plants in low-cost countries which gives it a cost base its competitors cannot match where it has developed a world-class set of capabilities in running these plants. It has also adapted its product mix to the most lucrative of customers and it has expanded its scope selectively to provide other automotive systems and components where it can bundle products and create a distinctive partnership with its customers. Whereas building scale through, for example, M&A could be an option it may want to adopt, so far it has invested in leapfrog technology, lower-cost processes and better models to reach its customers quickly which has proven more valuable.

How can a company best marshall its resources when challenging scale leaders? They should make bold, forceful choices about what path to take, commit to their choice and invest aggressively as far and fast as possible. Most challengers have three strategies to choose from:

1. The hitchhike strategy. Though large incumbents have scale advantages they are usually married to the rules they have set. Challengers have opportunities to hitch onto an existing market and win using differentiated capabilities and learning systems to create more value. In smartphones, for example, Samsung hitchhiked on Apple's iPhone strategy and pricing where it used its strong network relationships and its go-to-market capabilities were used to carve out a place where now it is the industry scale leader and low-cost producer.

2. The highjack strategy. Though hitchhiking may be easy if the scale leader lets you get away with it, aggressive challengers can also highjack the industry profit pool by winning over the best customers or by introducing something new that creates additional demand in this lucrative group. For example, BMW pulled off this strategy in the global automotive market by developing a premium brand and gradually extending it into other corners of the car business – from city cars to SUVs and super cars. Borealis followed a similar path in plastics by focusing on the highest value polyolefin markets, such as wire and cable applications and high press gas pipe.

3. Disruption. The ultimate death blow is for a challenger to render the leader's scale advantage obsolete by changing the rules of the game. Amazon wreaked havoc on the big-box retail segment with internet retailing, and Southwest Airlines showed how to make money in air travel with a low-cost, no-frills service strategy. Digitalization is opening opportunities for disruption in many industries. Witness Netflix who first used mailed

DVDs to disrupt Blockbuster's brick and mortar model and then disrupted itself by streaming. What is clear is that disruption is more than just innovation – its requires breaking the existing rules to build economic leadership

- **Implication for Contractors**

The three strategies described that allow smaller scale companies to reap superior results are certainly relevant to government contractors. For example:

1. *Hitchhike strategy*. Recent contracting trends are allowing smaller contractors to win work that was dominated by large scale companies. The trend toward small business preferences and preferences within the small business category (e.g. veteran owned, women owned, HUBZone firms) provide unique opportunities for smaller companies to prevail. Increasing trends such as unbundling large contracts, more small business set-asides and mentor-protégé arrangements provide wedges into work long dominated by large companies. Expansion of teaming arrangements and small business joint ventures are increasingly providing capabilities to provide the same products and services large companies dominated.

2. *Highjack strategy*. The same trends described above allow smaller companies to become aggressive challengers by finding niches long dominated by larger companies. For example, small contracts for nuclear engineering allow small companies to enter into that niche and expand by providing additional engineering services.

3. *Disruption strategy*. Smaller companies with unique technology can win niche contracts (e.g. subcontracts, SBIRs) and leverage those capabilities by winning larger contracts. Unique technologies in clean up services allow a small contract or subcontract to evolve into larger environmental clean up contracts.

Raising the Bar for Leaders

The paradox of leadership is the largest companies often fail to take advantage of their leadership position. Many market leaders can become complacent and settled into their position where the strongest are significantly focused on what to do with their leadership position. They set for themselves the ambition of aggressively taking full advantage of their scale and augmenting it with other attributes. The industry leaders typically follow at least one of the following paths:

1. Play by the rules. Industry incumbents have the unique opportunity to extend their leadership by sticking to established rules of the game and executing better than anyone else. Though it may sound easy, the company must maximize its scale by developing capabilities that allow it to reduce cost and build quality faster than its competitors. For example, Intel, the semiconductor leader set the rules of the game early on in the chip industry and has rarely strayed from them. Others have often threatened but Intel has stayed ahead by moving rapidly down the learning curve to introduce a more powerful chip every 18 months.

2. Bend the rules. Playing by the rules may be fine but sometimes they need to be bended, even by quite a lot. That can mean using core strengths to generate more opportunities such as when Starbucks created an international brand and standardized a carefully designed coffee drinking experience that transformed a local drinking experience and generated huge profits. Or, for example, Spain's Telephonia bent the rules by rolling out both mobile and fixed-line service allowing it to provide a bundle no one else could match.

3. Break the rules. This is clearly the most difficult because most leaders are heavily invested in winning with the current rules. However, sometimes leading companies can use their size and clout to reshape the rules to their advantage. For example, DeBerrs changed the model of the diamond business from a supply-based source to a more demand-driven strategy tapping into hidden assets rooted in the company's unique relationship with its customers and its strong brand. Or IBM used its scale, deep customer relationships and technical expertise to move from hardware producer to high margin provider of software and services.

- **Implications for Contractors**

Though we have been addressing strategies for small companies to beat scale competitors to achieve greater economic results advantages of scale companies are still difficult to beat, especially when they follow the right path. The strategies the authors describe are very relevant to scale government contractors.

1. *Play by the rules*. Keeping highly profitable contracts by all means can make the difference between continued success or sudden failure. Scale companies can leverage their experience to find solutions newer contractors will only slowly find. Talking about experience, continued path down the learning curve can provide lower unit prices and hence beat any competitor on price where its low unit price structure will provide far more profits than any less experienced competitor can generate.

2. *Bend the rules*. The scale companies in one area can leverage these skills to enter new but related markets. For example, one large engineering firm we worked with who provided extensive engineering services in DOE

facilities used their skills to move into the maintenance and operations (M&O) field at these same facilities after they had worked so hard to win the confidence of its management.

3. *Break the rules.* The size and clout of such large hardware companies as Boeing and Lockheed allowed them to provide an expanding group of services to the government where they could use their relationships, high past performance ratings and hard won accounting and contract compliance to win new contracts that smaller companies simply could not provide.

RAYTHEON CASE ON PENALTIES FOR EXPRESSLY UNALLOWABLE COSTS GENERATES COMMENTARY AND GUIDELINES

(Editors Note. Imposition of penalties for claiming expressly unallowable costs is becoming a highly prevalent practice since several inspector general reports have criticized the Defense Department for not doing so. The issue is what are expressly unallowable costs where prior decisions have been spare so government auditors are tending to find them under every rock while contractors seek to limit the definition only to exceptional cases. The recent case addressing what is an "expressly unallowable cost" we reported on in the July/August issue of the GCA REPORT has generated considerable comments from contractor representatives. Much of the commentary we have read on the case, Raytheon Co., ASBCA Nos 57576 includes quite technical legal analyses but one we found in the September 2015 issue of the CPA Report written by Karen Manos is probably the most clear yet generated. Her overall conclusion is the case rejected the overbroad interpretation of "expressly unallowable" costs that are advanced by DCAA and DCMA and instead substitutes the plain language of FAR and its cost principles.)

Contractors that include "expressly unallowable costs" in their indirect costs (overhead and G&A) expose themselves to penalties equal to the amount of the unallowable costs or in some instances to twice that amount, plus interest on any part of the unallowable costs that was reimbursed plus other "administrative, civil, criminal penalties imposed by law." In the case of Raytheon, the government had claimed $11.2 million in unallowable costs where on top of this they sought penalties and interest totaling $20 million. The appeal arose out of a corporate administrative officer's final decision asserting a claim for increased costs paid as a result of Raytheon's alleged noncompliance with CAS 405. The decision stated Raytheon did not withdraw from its cost submissions a proportionate amount of bonuses and incentive compensation (BAIC) for employees engaged in expressly unallowable activities under FAR 31.205-1, public relations and advertising costs; FAR 31.205-22, lobbying and politcal activities; FAR 31.205-27, organization costs; and FAR 31.205-47, costs related to legal and other proceedings.

FAR 31.205-1. The Appeals Board rules that BAIC is not expressly unallowable under three of the four cost principles cited above. The Board began by noting that "an 'expressly unallowable cost', by the plain terms of the definition, must be an item of cost or a type of cost that is specifically named and stated and unallowable by law, regulation or contract." The Board found that BAIC cost is an item or type of cost but is not specifically named and stated as unallowable under FAR 31.205-1. Although portions of "salary" and "fringe benefits" are stated to be unallowable, BAIC is neither a salary nor fringe benefit where salary is fixed compensation typically paid on a monthly or biweekly basis where BAIC is not fixed compensation. In addressing FAR 31.205-6, compensation for personal services, that section identifies "salary" and "bonuses" in different places. Similarly, it found BAIC is not a fringe benefit because it "is not an allowance or service" as fringe benefits are defined in FAR 31.205-6(m)(1) and bonuses and fringe benefits are addressed in separate sections of 31.205-6. Finally, the Board determined that BAIC is not even unallowable, let alone expressly unallowable under FAR 31.205-1 because framers of the cost principle used the words "salaries" and "fringe benefits" rather than the broader term "compensation." Interestingly, though one can assert the BAIC costs may be unallowable as a "directly associated cost of the unallowable salary cost" it left open the issue because it found a material factual dispute as to whether the BAIC costs were "generated solely as a result" of the unallowable salary costs and "would not have been incurred had the other cost not been incurred."

FAR 31.205-22. The ASBCA found that FAR 31.205-22 makes unallowable costs "associated with" certain lobbying and political activity but neither BAIC cost nor "compensation" are costs specially named and stated to be unallowable nor are such costs "identified to be unallowable in any direct or unmistakable terms." Though the ASBCA found the BAIC costs are not *expressly* unallowable they are nonetheless unallowable. The Board's reasoning is "it is self-evident that a basic element of a contractor's lobbying costs is the compensation paid to those who perform the lobbying activities." Such compensation is reasonably "associated" with lobbying activities.

FAR 31.205-27. The Board applied the same logic for this cost principle as it used for the lobbying cost principle. FAR 31.205-27 does make unallowable those costs "in connection with certain organization-type activity" but since neither BAIC cost nor compensation cost is specifically named as unallowable the ASBCA rules that compensation of employees engaging in organization activity are not expressly unallowable. However, like lobbying efforts, the Board found Raytheon's BAIC costs that are attributable to organization activities are unallowable under 31.205-27.

FAR 31.205-47. Unlike the three other cost principles, the Board found that BAIC costs are expressly unallowable for employees engaged in legal and other activities covered by FAR 31.205-47. That is because the statute uses very broad language that specifically names and makes unallowable employee compensation. Specifically, Statute U.S.C.A #2324 includes in the definition of "Costs" of unallowable legal proceedings "the pay of directors, officers and employees of the contractor for time devoted" to such activities where as FAR 31.205-47 more generally disallows "costs of employees, officers and directors." The Board concluded the costs are specifically named and stated to be unallowable and hence they are both unallowable and expressly unallowable.

Lessons in Challenging Assertions of Expressly Unallowable Costs

In the past, assertions of equitable estoppel could often prevent the government from disallowing costs it had previously allowed. That defense is far less useful these days since a condition for equitable estoppel is to prove "affirmative misconduct by the government" which is very hard to prove However, an alternative defense against disallowing costs that were previously allowed is the "retroactive disallowance principle." Though Raytheon put forth the arguments, the ASBCA left open the issue. The Board stated though the principle can be used to bar recovery of government claims, it stated its application is largely fact dependent where here there are factual disputes whether or not the government, with knowledge, had consistently approved the BAIC and TSR metric.

In addition, Ms. Manos asserts the case should help contractors challenge assertions of expressly unallowable. She states the case makes clear that the fundamental premise of DCAA guidance is "completely wrong." She quotes sections of DCAA guidance on what makes a cost principles' costs expressly unallowable if "(1) it states in direct terms that the costs are unallowable or leaves little room for difference of opinion as to whether the cost meets the allowability criteria and it identifies the specific cost or type of cost in a way that leaves little room for interpretation." She concludes that contrary to DCAA's erroneous interpretation, a cost is expressly unallowable only if it is specifically named and stated to be unallowable. Pointing to another hurdle that must be met, she states in addition to the requirement to assess penalties, the government must also show it was unreasonable under all circumstances for a person in the contractor's position to conclude the costs were allowable which is part of DCAA's guidance.

Know Your Cost Principals and Cost Accounting Standards…

ENVIRONMENTAL COSTS

(Editor's Note. The recent withdrawal of a proposed FAR rule on environmental costs has left many contractors confused on allowability and allocability of environmental remediation costs. The proposed rule was intended to clarify some of the outstanding issues and with its withdrawal we are left with a kind of regulatory void where contractors and the Government must fall back on applying existing cost principles, cost allocation rules and DCAA guidance. Contractors should be particularly aware of certain regulatory "landmines" where allowability of costs may be questioned. Though there has not been any detailed discussion lately, the best source we are aware of is in an article in the National Contract Management Association's "Contract Costs" article written by Margaret L. Rumbaugh.)

Primary Environmental Statutes

Before we explore allowbilitry and allocability issues we believe there are three primary environmental statutes that government contractors should be aware of:

1. National Environmental Policy Act (NEPA). The Act imposes environmental responsibilities on all federal government agencies. It requires agencies to consider environmental factors when engaging in federal actions that may affect the environment such as research and development programs, cleanup work, and award of federal contracts and grants. The Act requires agencies to establish procedures to ensure decisions take environmental factors into account and has agencies prepare environmental impact statements evaluating alternatives to this action.

2. Resource Conservation and Recovery Act (RCRA). RCRA address environmental problems created from disposing hazardous wastes. The Act delegates to the Environmental Protection Agency the responsibility of establishing criteria for identifying hazardous waste

and the EPA, in turn, has created extensive regulations implementing RCRA. The EPA has set standards for the storage, treatment and disposal of waste material and for the land disposal of hazardous wastes and numerous requirements covering record keeping, reporting, labels and container have been set.

The EPA prioritizes waste spills and establishes a National Priorities List (PNL). Once a site is placed on the PNL, the EPA identifies individuals and businesses that may be financially responsible for investigation and cleanup of the site. Any person or company previously or currently involved at the site may be held responsible. This liability applies without regard to the entity's conduct at the site. A company may be liable even if it did not violate any existing law while working at the site.

RCRA allows for three types of enforcement actions--administrative, civil and criminal. Administrative includes issuance of compliance orders and/or penalties up to $25,000 per day. Civil actions are formal lawsuits that may result in temporary or permanent injunctions and/or penalties up to $25,000 per day per violation. Criminal actions can result in penalties up to $50,000 per day and/or imprisonment up to five years. If a violation is committed knowingly, the violator is subject to a penalty up to $250,000 for individuals and $1 million for organizations while offenders can be imprisoned up to 15 years.

3. Comprehensive Environmental Response Compensation and Liability Act (CERCLA). The Act, better known as "Superfund", regulates hazardous-waste releases and any Government actions are financed through a Superfund tax imposed on chemical and the petroleum industry. Though it has a trust fund to pay for hazardous waste emergencies and for site removal when it cannot be determined who is responsible for the waste problem, it specifies financial liability:

a. Sovereign immunity is no defense so federal Government as an owner of a government-owned, contractor operated (GOCO) facility can be liable along with the operatior.

b. Liability is strict, joint and several with regard to cleanup costs--liability can apply to any potentially responsible person. A party may be responsible for all cleanup costs even if it contributed to a small amount of the contamination.

c. If a company has gone out of business, the EPA may try to create another responsible party. Costs can include short term removal, long term remedial action, necessary response costs incurred by another, damages to federal or state resources including assessing injury and interest on damages.

Compliance

Under several versions of the proposed FAR rule that was eliminated, preventive and compliance costs were generally allowable whereas remediation costs to correct past environmental damage was considered unallowable unless certain requirements were met. Now, no cost principle specifically addresses allowability of clean-up costs. The presumption is that all clean-up costs are an ordinary business expense and hence allowable as an indirect cost provided it is reasonable, allocable and compliant with cost accounting standards and not inconsistent with contract terms and FAR Part 31 cost principles. Recovery as a direct cost is dependent on contract costs where direct costs can be demonstrated (e.g. the materials that must be remediated were used solely in the performance of the contract).

DCAA's Position

In its Contract Audit Manual, the Defense Contract Audit Agency states "environmental costs are normal costs of doing business and are generally allowable if reasonable and allocable" (7-1920.1). Costs are considered on a case-by-case basis and DCAA generally applies a high standard of what is "reasonable". It requires the contractor conduct business prudently and acts promptly to minimize damage. Though environmental costs are considered a normal business expense, not all environmental costs are allowable. DCAA distinguishes between costs to prevent environmental contamination (usually always allowable) and costs to clean up prior contamination, If the latter is caused by the contractor, DCAA will generally take the position it is unallowable.

Contract Clauses

Some contract clauses have been used as sources for disallowing environmental costs.

1. Permits and Responsibilities clause (FAR 52.236-7) is often invoked to preclude reimbursement on fixed price contracts. The clause, included in such contracts, specifies (a) the contractor must comply with all applicable federal, state and local ordinances and (b) the costs must be included in the cost of the contract. Successful defenses generally must prove the agency was at fault (e.g. refusing to allow a contractor to test a fuel-storage tank being modified).

2. Clean Air and Water clause (52-223-2) requires the contractor to (a) comply with the monitoring and

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reporting requirements of the two statutes and (b) use its "best efforts" to comply with the clean air and water standards.

FAR Cost Principles

There are specific cost principles that can often be used to prevent cost recovery:

1. Bad Debts (FAR 31.205-3). Bad debts, which include estimated losses arising from uncollectible claims are unallowable. DCAA questions that allowable costs should be limited to the contractor's share of clean-up costs based on the actual percentage of contamination attributable to it. If the contractor cannot collect from other potentially responsible parties (PRPs), DCAA considers these uncollectible amounts as bad debts and hence unallowable. The Department of Defense has ruled such costs that a contractor pays to a PRP under CERCLA is allowable.

2. Contingencies (FAR 31.205-7). The cost principle distinguishes between contingencies that arise from presently known conditions (allowable) and unknown conditions (unallowable). Because many cleanup liabilities are often difficult to quantify, the Government can site this principle to prevent recovery. These costs should be disclosed separately and an advance agreement should be negotiated.

3. Fines and Penalties (FAR 31.205-15). Fines and penalties resulting from violation of or failure to comply with federal, state, local and foreign laws are generally held to be unallowable.

4. Taxes (FAR 31.205-41(b)). The Superfund tax, though originally considered as unallowable, is now considered allowable as a matter of policy. Other environmental related taxes should be scrutinized.

5. Cost of Legal Proceedings (FAR 31.201-47). Costs incurred in connection with a proceeding brought by federal, state, local or foreign governments for violation of or failure to comply with laws or regulations are not allowable if the result is a criminal conviction, certain civil/administrative findings, debarment or suspension, or certain consent decrees.

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