GCA REPORT

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NEW DEVELOPMENTS

Two FAR Changes Promise to Entice Primes to Treat Subcontractors More Fairly; Changes to Measuring the 50 Percent Rule for Small Business Participation

A couple of FAR changes are providing strong incentives for prime contractors to treat their subcontractors more fairly. One of the rule changes, issued by the GSA, DOD and NASA July 14 will require prime contractors to make "good faith" efforts to use its small business subcontractors while the contract is in place to the same degree it relied on the small businesses in preparing its bid. If it can't the prime needs to explain to the CO why it can't. This "good faith" rule will attempt to ensure that if they were promised 30 percent of the work the prime will no longer get away with providing only 15 percent. Another change to the FAR will no longer allow primes to get away with prohibiting subcontractors from discussing matters with an agency CO. Now subcontractors who are concerned about the amount of work they have received from the prime or whether they have been paid in full can now complain directly to the federal agency representative.

In a separate action a rule on the "limitation on subcontracting" has been changed. Under the old rule, the small business prime contractor is required to perform at least 50 percent of the work under a set-aside contract. No longer. In a new rule touted to expand opportunities for small businesses to win set aside contracts, the relevant inquiry now becomes not what percentage of work is performed by the prime but rather what percentage of government payments go to all "similarly situated" small businesses combined which can include both the prime small businesses and all other first tier subcontractors who are small businesses. Work not performed by employees of the small business prime or first tier subcontract but by, say, large businesses or second or lower tier subcontractors cannot count toward the 50 percent number *(Fed. Reg. 34243).*

DOD Finalizes Anti-Counterfeit Rule

The Defense Department has finalized the proposed rule on Detection and Avoidance of Counterfeit Electronic Parts which will allow contractors and subcontractors to obtain electronic parts only from approved suppliers and who must establish systems to detect and avoid counterfeit parts. The DOD removed the term "trusted supplier" and added "contractor approved suppliers" which include (1) original manufacturers of the part (2) their authorized suppliers or (3) suppliers that obtain such parts exclusively from the original manufacturer or authorized suppliers. In limited circumstances, contractors may obtain parts from other sources, subject to notification to the CO after adequate inspection, testing and authentification. Contractors are required to establish counterfeit detection and avoidance systems where the systems must include risk based procedures for training personnel, inspecting electronic parts, maintaining traceability, quaranteeing counterfeit parts, keeping current on counterfeit trends and screening Government Industry Data Exchange Program. The rule applies to both noncommercial and commercial items, is not limited to large companies and applies to small businesses also. Upper tier subcontractors must include the substance of the new clause in subcontracts for electronic parts or assemblies containing electronic parts. Most commentators confirm the rule is quite burdensome but say the effort is outweighed by the dangers of fake parts and possibility of disaster (*Fed. Reg. 50635).*

Proposal Would Modify Commercial Item Pricing

The Defense Department is planning to modify its pricing data requirements for commercial items to determine whether pricing is reasonable. The proposed rule would allow prior commercial item determinations to serve as a determination of subsequent procurements. It would also require COs to consider evidence provided by an offeror of recent purchase prices paid by the government for the same or similar commercial items when establishing price reasonableness. The proposal would remove the definition of "market based pricing" which has been the prescribed method of determining the appropriate cost when there is a lack of competition. The new rule will also provide additional guidance concerning determinations of whether an item is commercial and the appropriate amount and type of other than certified cost or pricing information a CO

must require an offeror to submit in order to determine its proposed prices for commercial items are fair and reasonable *(Fed Reg. Aug. 11, 2016).*

New Contract-Related Interest Rate Set for Second Half of 2016

The Treasury Secretary has set a rate of 1 7/8% for the period June through December 2016. The new rate is a decrease from the 2.5% rate applicable to the first six months of 2016. The Secretary of the Treasury semiannually establishes an interest rate that is then applied for several government contract-related purposes. Among other things, the rates apply to (1) what a contractor must pay the government under the "Interest" clause at FAR 52.232-17 and (2) what the government must pay a contractor on either a claim decided in its favor under the Contract Disputes Act or payment delays under the Prompt Payment Act. The rate also applies to cost of money calculations under Cost Accounting Standards 414 and 417 as well as FAR 31.205-10 and when a discount factor is used to calculate the present value of future payments (e.g. deferred compensation).

The GSA's New Electronic Reporting Rule is Being Praised

The General Services Administration is introducing the new Transactional Data Reporting (TDR) rule which will eliminate certain requirements and add contractor requirements to electronically report various types of procurement data such as prices paid for items and the quantity, part numbers and product descriptions of all purchases made through GSA contract vehicles. The collected information is supposed to help contracting officers "make smarter purchasing decisions." The GSA plans to introduce the TDR clause to its Federal Supply Schedules in phases beginning with a pilot for certain schedules and Special Item Numbers. If adopted by contractors, they will no longer be subject to existing Commercial Sales Practice (CSP) and Price Reduction clauses (PRC). The CSP clause mandates that contractors disclose the discounts vendors offer to commercial customers for similar products and services while the PRC monitors contractors' pricing over the life of its contracts and gives the government the same price reductions that contractors give to certain commercial customers. The TDR is being praised for the elimination of the two burdensome clauses but is being criticized for the extensive electronic reporting of sales data required, some of which the government already has *(Fed. Reg. 41104).*

Announcements and Advice on New Contracting Opportunities

In a recent request for information sent only to Seaport-e holders the Navy is asking for feedback that would help it develop its recompete vehicle. The recompete will be the Navy's primary vehicle in the 2020s for acquiring support services such as engineering, financial management and program management. The new Seaport contract will replace the predecessor contracts Seaport and Seaport-E on which the Navy has obligated $50 billion since 2001. The new Seaport contract will be one of four major governmentwide contracts that agencies will use to acquire virtually all professional services requirements over the next 10 years. The three other professional services multiple-award contracts are the Army's future $37.5 billion Responsive Strategic Sourcing for Services (RS3), expected to be awarded in October; the General Services Administration's $60 billion One Acquisition Solution for Integrated Services (OASIS) and the GSA's Professional Services Schedule (PSS) which has an unlimited ceiling.

The Defense Department signed a memorandum of understanding indicating it will procure complex professional services through the GSA OASIS and OASIS Small Business contract vehicles. The OASIS vehicles provide access to commercial and noncommercial services including financial, engineering, logistics, program management, management consulting and scientific services. GSA noted that OASIS is designed to span multiple professional services disciplines and include contract-type flexibility at the task order level.

The Defense Department Information Analysis Center has announced plans to merge three multiple award contracts (MACs) into one $28 billion mega-MAC to be awarded Oct 2018. The three awards to be consolidated are Technical Area Tasks (TATs) – the $3 billion Defense Systems (DS TAT), $900 million Home Defense (HD TAT) and $45 billion Cyber Security and Information Systems (CS TAT). The new MAC will be used to buy a wide range of studies, complex analysis, engineering and technical services that generate scientific and technical information. Though the interim bridge period will benefit incumbent contractors in the near term the new IAC mega-MAC will leave some incumbents out of competition. The new MAC will award at least 14 contracts across three pools – 10 contracts in Pool 1 for large companies, 4 contracts in Pool 2 for small companies and Pool 3 has not yet been determined.

In a slide show offered by the Army Aug. 12, four existing small business opportunities were revealed,

including two for over $1 billion. First, is the 10 year $8 billion Special Operations Forces Global Logistics Support Service (SDFGLSS) which 35 percent of the contract's work in the US is to be subcontracted to small businesses. Second, is the $2 billion Special Operations Forces information Technology Enterprise Contract ll (SITEC ll) which will be using the GSA's Alliant contract rather than a unique contract vehicle. Also, a $150 million 8(a) set aside Exercise Support Contract and a $45 million single award small business set-aside for the Global Research and Assessment Program.

An analyst, Daniel Snyder, is offering advice on how bidders on Alliant 2 should maximize their scores. Competition is expected to be stiff where new small-business joint ventures will have a chance to bid and they will be able to use prior experience of each partner though they will not be able to get the full additional 7,500 points that are awarded to teams that have worked together. They are offering advice to be in the top 60 scorers for Alliant 2 unrestricted or top 80 scorers on Alliant 2 Small Business. Though scoring the full 83,100 points is considered to be impossible successful scores for the Alliant 2 unrestricted is considered to be 59,000 points while 47,000 points are needed for the Alliant 2 small business. Rather than getting caught up in scores bidders are encouraged to focus on past performance and experience, leading edge technologies and systems, certifications and clearances that include evidence that adequate accounting and purchasing systems are in place.

Fair Pay Order May Encourage Early Settlements

We are seeing considerable commentary that the government may use President Obama;s Fair Pay and Safety Workplaces executive order as a way to get early settlements with employers during audits and investigations. Under both guidelines and proposed rules employers bidding on federal contracts worth more than $500,000 would have to disclose whether they previously violated any of 14 federal labor and employment laws and their state counterparts where serious or repeated violations might make them ineligible to receive federal contracts and must be considered in making determinations of responsibility. The EO will change the risk calculus of companies considering whether to settle claims brought against it where current risk includes such factors as risk of an adverse ruling, monetary range of verdicts and penalties, costs and burdens of investigations and potential bad press. In a move to ensure labor law violations are accurate, the National Labor Relations Board is preparing to report labor law violations to a federal database to comply with the executive order *(Memo OM 16-23)*.

SBA Expands Mentor-Protégé Program

The Small Business Administration has announced July 25 in a final rule that it is expanding the mentor-protégé program government-wide to include all small businesses. Currently protégé status is reserved only for 8(a) firms. The SBA says that over 2,000 firms will become active in the programs where they can be in line to win $2 billion a year. For mentors and protégés, the advantage of the arrangement provides several competitive advantages such as expanding capabilities, resources and experience and makes mentor-protégé joint venture arrangements eligible for set aside procurements.

DCAA Revises Guidance on Auditing Low Risk Incurred Cost Proposals

The Defense Contract Audit Agency has issued revised policy for selecting low risk ICPs worth less than $250 million for audits over earlier sampling guidelines. The changes reduce the number of ICPs to be audited, particularly those with less than $5 million of auditable dollar value (ADV). Proposals with less than $5 million ADV, including those already awaiting audit will be audited only if the field audit office documents significant risk requiring an audit and obtains approval from the regional audit manager. However, the guidance does permit field offices to perform an audit on specific direct costs on a specific contract if risk is identified and there is no potential impact on indirect cost rates *(MRD 16-PPD-006(R)*.

DCAA Revises ICP Adequacy Guidance

DCAA issued revised guidance to its auditors stressing the need to have an advanced agreement (bilateral written agreement) allowing a contractor to use a blended compensation cap to compute its G&A rate as opposed to computing a G&A rate using different compensation rates or computing different G&A rates for contracts before and after the current comp rate (see the last GCA DIGEST issue for a discussion on the background and instructions on how to compute blended rates.) *(MRD 16-PSP-005(R)*.

Government Departments Increase Fraud Penalties to Adjust for Inflation.

Civil penalties to a minimum of $10,781 and a maximum of $21,563 per claim for the Defense Department have been raised from a penalty range of $5,500 to $11,000 *(Fed. Reg. 42491)*. The Departments of Veterans Affairs and Housing and Urban Development each issued interim final rules increasing maximum civil penalties

under the Program Fraud Civil remedies Act (PFCRA) *(Fed. Reg. 38931)*. The VA increased its penalty for false loan guaranty certifications from $10,000 to $21,563 and fraudulent claims from $5,500 to $10,781. The Dept. of Commerce *(Fed. Reg. 36454)* and the Small Business Administration *(Fed. Reg. 31489)* increased their claims by the same amount. HUD increased its false claims penalties from $8,500 to $10,781. Dept. of State *(Fed. Reg. 36991)* raised its PFCRA penalties from $5,000 with a maximum total of $150,000 to $10,781 per claim for a maximum amount of $322,442.

CASES/DECISIONS

High Court Rules on Implied Certification

In what has been the most anticipated US Supreme Court decision affecting government contractors in many years, the Supreme Court has ruled in a unanimous opinion that the implied certification principle is valid. However, the Court's explanation of the scope of the theory leaves considerable amount of discretion in trial courts to determine when it should be applied. The dispute involved a patient who died while getting treatment from a mental health clinic that received reimbursement through Medicaid. A qui tam action claimed the clinic sought payments even though it failed to comply with staff license requirements. Though the first court dismissed the claims the first circuit court reinstated them ruling the clinic knowingly misrepresented compliance with a material condition for payment when it submitted its claim. Universal petitioned the Supreme Court asking if the implied certification theory of liability is viable under the False Claims Act (FCA) and if a false claim can proceed if a violated rule or statute was not expressly identified as a condition for payment.

Traditionally, a liability under the False Claims Act occurs when a claim is factually false (e.g. invoicing the government for goods or services that were never delivered). Though lower courts have varied in their interpretation of the theory, the implied certification theory holds that when a contractor submits a claim for payment it is impliedly stating it is not in violation of any statutory, regulatory or contract requirement. Since government contracts contain a myriad of such requirements this could lead to widespread liability under the FCA that could make government contracting an extremely hazardous endeavor. The Court modified this broad interpretation of the theory by stating three prerequisites for application of the theory: (1) a specific representation about the goods or services provided and (2) a knowing failure to disclose its noncompliance with some statutory, regulatory or contractual requirement that is (3) material. The Court's opinion, written by Judge Clarence Thomas, held that the implied certification theory can be a basis for FCA liability if a defendant submits a claim for payment that "does not merely request payment but also makes specific representations about the goods and services provided" and the "failure to disclose noncompliance with material statutory, regulatory or contract provisions makes those representations half truths." These "half truths" are actionable as misrepresentations regardless of whether they are designated as conditions of payment. This notion of "half truths" is considered to be an expansion of the theory established by several lower circuit courts while the requirement of "materiality" and need to demonstrate intent is considered to be a limitation of the theory. Many commentators stress the court did not provide clear guidance on the meaning of these limitations which will result in a field day for lawsuits attempting to decipher their meaning *(Universal Health Svcs Inc. v United States ex rel Escobar, No. 15-7)*.

Supreme Court Upholds Rule of Two Requirement on Task Orders

In a 2012 task order solicitation for emergency services at VA hospitals under a federal supply schedule (FSS) contract, the Dept. of Veterans Affairs awarded the order to a non-veteran owned firm. Kingdomware protested the award arguing the VA violated federal law by failing to evaluate whether two veteran owned small businesses (VOSBs) could perform the work. The VA rebutted the protest saying the so-called rule of two provision was only a tool to meet VOSB contracting goals and if these goals were met, which they were, the requirement was not mandatory. The VA also argued that the rule applies to "contracts" where "orders" are not considered to be contracts. In a unanimous opinion the Supreme Court ruled that the VA must consider whether two VOSBs can perform a proposed contract before issuing a solicitation. Though lower courts ruled there was no mandatory set-aside requirements if the VA had met its statutory VOSB goals, the Court reversed this saying if a "rule of two" analysis leads to a reasonable expectation that two such businesses would submit offers and that the award can be made at a fair and reasonable price the acquisition must be reserved for VOSBs. In a ruling expected to have wide application, the Court also rejected the VA's argument that the rule of two provision should not apply to "orders" under "pre-existing federal supply contracts" because the orders are not "contracts." The Court ruled FSS orders are "contracts" under the normal meaning of the term. The Court stated whereas a FSS gives the government the option it does not require the government to make a purchase or expend funds while the order does, making

a new contract to buy *(Kingdomware Techs. Inc. vs U.S., 136 Ct.)*

Subcontractor Entitled to Post Termination Audit Related Costs

DCCH's subcontract was terminated following a partial termination of the prime contract. Before the termination, there were several years of open incurred cost audits where after the termination, DCCH continued to provide liaison support for the audits. In its termination settlement proposal, which was sponsored by the prime contractor, DCCH included the labor costs to service the audits where the contracting officer denied the claim reasoning the costs were unallowable because (1) the costs DCCH incurred were "standby" costs to "continue the viability and operations of DCCH" after the termination (2) it is unreasonable for a contractor or subcontractor to expect to be in a better position than had the contract run its normal course and (3) the claimed costs are not supported by "accounting data and other information sufficient for review" by the government. DCCH disagreed with all assertions arguing (1) though it could not discontinue all costs it terminated most of its employees where it maintained a reduced workforce to close out its subcontracts and support the audits of its indirect cost rates asserting had the government closed out the years on a more timely basis it would have discontinued all operations and put all documents into storage (2) if the subcontract had run its normal course the costs would have been allowable and allocable to the subcontract and (3) DCCH had made all of its accounting data available and asserted the government's "real" complaint was that DCCH refused to copy all its documents for the auditor asserting nothing in its subcontract required copying voluminous records that are otherwise available for review and inspection. The Board sided with DCCH on all counts and ruled it was entitled to its post termination costs though the amount was left open until the audits determining final indirect cost rates were completed *(Group Health Inc., CBCA 3407)*. *(Editor's Note. Comments we have seen on this case indicate it represents a major victory for contractors because the implications go far beyond termination settlement costs but apply to costs following contract performance that are related to the administrative clauses of the contract (e.g. FAR 52.216-7).*

Firm Fixed Price Contractor Not Entitled to Contract Price Adjustment For Increased Fuel Costs

(Editor's Note. The following should be a good reminder for contractors to cover themselves as much as possible for unforeseen costs under fixed price contracts and subcontracts.)

In its proposal for a firm fixed price base operations contract DG21 relied on a fuel estimate of historical rates the Navy charged its contractors "for informational purposes only." The proposal provided for an equitable adjustment (REA) to the contract price if fuel costs exceeded 10 percent of historical rates but that it would not escalate the amount of costs over the life of the contract. During the pre-award phase the Navy asked DG21 about its proposal and said since the solicitation was firm fixed price DG21 "assumed the risk of consumption and/or rate changes." The Navy also questioned DG21's decision not to include an escalation clause and accordingly asked for clarification and confirmation of its intentions regarding rates changes. In revising its proposal, DG21 did not change its cost estimates or add an escalation factor and, in fact, removed the provision calling for an equitable adjustment if fuel prices changed 10 percent. During performance the price of fuel doubled over the Navy's historical rate and DG21 first requested the Navy cap the fuel rates it charged and when the Navy refused it submitted an REA asserting it was a "change" under FAR 52.243-4 which the Navy also rejected. The Court sided with the Navy affirming there was no contract change citing the contract that said DG21 would purchase the fuel "at the prevailing rate at the time of purchase." The Board observed that the essence of a firm fixed price contract is that the firm, not the government, assumes the risk of unexpected costs and if it wanted to protect itself from rising fuel costs it could have " bargained for such protection" *(DG21 LLC v Mabus 819 F.3d)*.

Contractor's Detrimental Reliance on Defective Appeal Notice Can Suspend 90 Day Appeal Period

(Editor's Note. The following case sheds light on opportunities that may be available for inexperienced contractors.)

DCAA issued a notice to disallow $22,000 of labor costs APS inappropriately billed for its subcontract labor costs using the prime contractor's billing rates. The CO issued a letter April 28 disallowing the costs where the letter neither said it was a final CO decision nor provided APS a statement of its appeal rights. The same day APS sent a letter to the CO asking him to reconsider his position where on May 21 the CO denied APS's request where the letter again did not mention it was a final decision nor identified appeal rights. In March of the next year, APS appealed to the ASBCA where the government asserted the Board did not have jurisdiction since the 90 day appeal period had been exceeded. The same day APS replied saying it was unfair after it had spent five years following instructions of DCAA and the ACO to collect

funds owed, repeatedly providing the same information to numerous departments and without informing him that he should, could or needed to file with the ASBCA, not knowing that it even existed until, "at wits end I stumbled upon your information on the internet." The Board sided with APS citing *Decker and Co. vs West* saying that detrimental reliance on a defective CO decision will stall (its called toll) the 90 day appeal period. The Board found that APS was misled by the CO's failure to inform APS of its appeal rights because it was unfamiliar with the contract dispute process and the ASBCA in particular. The Board also rejected the government contentions that (1) APS should have searched the internet or obtained consulting/legal help or (2) the Contract Dispute clause at FAR 52.233-1 advised APS of its appeal right stating Decker required "due diligence requirements on unknowledgeable contractors" and the clause refers to "appeal" but does not state by whom or when the appeal needs to be filed *(Access Pers. Svcs., ASBCA 59900).*

NEW/SMALL CONTRACTORS

Shifting Certain G&A Costs to Overhead

(Editors Note. We have occasionally addressed in the past which costs can or should be charged to what indirect cost pools. We were recently contacted by a subscriber, through our "Ask the Experts" feature available to subscribers, if we had any articles that could address their desire to lower their G&A and increase their overhead rates by reassigning certain costs. The following is an edited version of what we sent to them which we believe should be helpful to others.)

Contractors quite commonly find themselves in positions where they would like to alter the magnitude of costs included in their various indirect cost pools to achieve their cost and pricing objectives. For example, one may want to shift costs to overhead to maximize recovery on direct labor or to lower their other rates because they are facing strict ceilings on their contracts; others may want to reassign costs to G&A to increase recovery on material, subcontracts or other direct costs or their other rates may be perceived to be too high.

Here we will address how certain costs in one pool may properly be reallocated to another pool. Our client had an established practice of two indirect cost rates – overhead applied on a direct labor dollar base and general and administrative (G&A) costs applied on a total cost base – and was not interested in considering an alternative indirect rate structure. They asked us to examine some of its G&A costs and tell them if some of the costs could properly be reallocated to overhead because it considered its G&A rate excessive while its overhead rate was on the low side.

Practices for what costs are included in overhead versus G&A vary widely by contractors and you have a great deal of flexibility even if you are CAS covered *(they are not).* The basic requirement is to have a reasonable rationale for your practices and follow the practice consistently. It is also a good idea to have your practices in writing (this is mandatory if you are CAS covered). Though disputes may arise and auditors may become aggressive in attempting to minimize allocable costs to government work, it is not up to the auditor to tell a contractor how to treat a cost - rather their job is to evaluate the reasonableness of the contractor's decision and ensure the practice is followed consistently.

As to your request for me to examine what costs can be reassigned from G&A to overhead the general criteria is that overhead costs are considered expenses in support of two or more projects while G&A is considered costs for operating the company as a whole. Contractors commonly follow the above criteria for overhead and then consider G&A as "everything else." Many costs that you are charging to G&A such as contract administration, marketing, IR&D, legal expenses and accounting may properly be considered overhead.

Contract Administration. Your contracts administration expenses consist of three people's salary who are involved in administering contracts as well as purchasing primarily direct materials and supplies. These tasks are closer to supporting projects and can easily be considered overhead.

Marketing and Sales. Marketing and sales are usually considered to be effort to expand the business base and hence are quite properly G&A. However, my examination of the types of activities that you charge to marketing indicates the majority of expenses should be charged to other accounts which can then be assigned to overhead. For example, much of the time not charged direct by normally direct employees are identified as "sales and marketing" when they are really kind of idle time. Though "sales and marketing" seem somehow more productive than idle time, idle time is usually not considered unallowable and would more properly be assigned to overhead. Or, for example, non-direct time spent with the client need not always be considered "sales and marketing" even though the effort hopefully results in expanded work on a contract. The nature of this effort is usually discussions of either technical matters or various administrative matters where such costs can plausibly be charged to overhead.

Independent Research and Development. IR&D is also commonly a G&A cost but many of the "IR&D" efforts you classify can be considered support of existing contracts (e.g. designing new technical solutions applicable to current jobs) and hence overhead. I have included a detailed account of the activities you charge to IR&D and identified which ones can be considered overhead and what is clearly G&A IR&D costs (not included here).

Legal Fees. Many of the legal fees you incur can be properly assigned to overhead when they support projects (e.g. employee issues, opinions related to contracts, suits resulting from contract work, etc.) while those legal costs in support of the company as a whole (e.g. support of Board work, finance related, etc.) are charged to G&A. It is quite common for contractors to erroneously assume that the same categories of costs must always be charged to the same pool. Stemming from CAS 402, the criteria for consistent treatment is "costs incurred for the same purpose in like circumstances" need to be charged either direct or indirect. There is no requirement to charge indirect costs to the same pool. Further, one can argue that legal costs related to administering contracts are not "like circumstances" to legal expenses for corporate board work.

Accounting. Many accounting costs are chargeable to overhead - it is common, for example, to include senior finance and accounting personnel in G&A (e.g. CFO, corporate controller, corporate audits) while all other accounting expenses are included in overhead, reasoning they primarily support contract work including employees.

Of course reassignment of the personnel costs from G&A to overhead discussed above would also entail a corresponding shift of fringe benefits, taxes as well as a proportionate share of "Other Operating Expenses" (primarily facilities and utilities related expenses). Be advised these changes would normally be considered accounting changes and hence subject to rules for them.

QUESTIONS & ANSWERS

Q. When our company is profitable, we distribute bonuses to several classes of employees. DCAA has disallowed all of our bonuses claiming they are an unallowable distribution of profits citing FAR 31.205-6(a). What do you think?

A. Under most circumstances, DCAA is wrong here. It is quite common to establish the "pool" of bonuses to be dependent on the amount of profit and to make profitability a condition for distributing bonuses but this does not mean these payments are a distribution of profits. You will need to educate the auditor about the nature of the bonuses paid and most likely clarify in your written bonus procedures such factors as the conditions for distributing bonuses (e.g. whether the company can afford it, based on services provided), how the bonuses are calculated and explicitly state they are not a distribution of profit. When educating the auditor, you should allude to Section 6-414.4*e* of the DCAA Contract Audit Manual that warns auditors against assuming bonuses paid, particularly in closely held companies, are a distribution of profits.

Q. We were given a contract to produce about 1,000 units of a critical component on missiles. The government recently terminated half of the units and I am not sure whether to submit a partial termination settlement proposal or a request for an equitable adjustment to the contract price. What alternative will give our firm the greatest recovery?

A. It largely depends on whether the contract was terminated after producing a lot of the items or shortly after contract award. If, for example, your 1,000 unit contract was priced at $1,000 per unit and you produced 500 units yet already incurred the majority of costs (say $750,000) including engineering, ramp up, inefficiencies, etc. you would likely be better off submitting a termination settlement proposal where many of the upfront costs and all the costs incurred for the 500 terminated units could be recouped (see our detailed article in the GCA DIGEST, "Maximizing Your Termination Settlement Proposal". Use our key word function). If the partial termination occurred soon after award, a request for a price adjustment on the remaining items would likely yield more. This is because it is unreasonable to expect unit costs to be the same when the contract has been cut in half (e.g. absorption of fixed overhead) whereas the termination settlement would likely be modest.

Alternatively, you may want to consider preparing *both* a partial termination for convenience proposal to recoup the costs associated with the terminated portion of the contract *and* a request for an equitable adjustment to recover the additional unit costs associated with the reduction of units. Of course, we recommend conducting an analysis of all options discussed and comparing the results. Feel free to get some consulting help – its usually fully reimbursable by the government.

Q. We laid off several direct and overhead employees recently and gave them severance payments in accordance with our normal company policies. Since they had unique skills and the remaining employees were not sufficient to cover all the work, we used some of them to work on

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specific projects with definite time lines. We use the term "variable employees" for these individuals where they do not receive most fringe benefits (we pay payroll taxes) and they are paid on an hourly basis. Recently, DCAA told us they are considering disallowing the severance payments since they were hired back as "employees." What do you think?

A. We are seeing auditors questioning the severance payments made to individuals who are brought back on an "as needed" basis to work on specific projects. Since the IRS has very specific criteria for categorizing "independent subcontractors" (e.g. separate business, minimal supervision, etc.) many of the ex-employees brought back do not qualify for this term and, instead, are being called "variable employees", "temporary employees", etc. Though FAR 31.205-6(g) provides that most severance costs are allowable (e.g. reasonable, consistent with company policies, etc.) FAR 31.205-6(g)(i) provides two conditions when the severance costs would be unallowable: if the terminated employees were (1) hired back on the basis of "continued employment at another facility, subsidiary, affiliate or parent company" or (2) hired by a "replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment." DCAA is likely to allude to this section as a basis to challenge the severance payments – after all, "variable" and "temporary employees" sound like employees and payment of payroll taxes smell like "employees."

One of the best challenges that comes to mind is to assert their new relationship with the company is not one of "continued employment." Unlike regular employees, they do not receive fringe benefits (or, at least, minimal), are paid hourly rather than a salary, paid only when they work, do not accumulate seniority, work only on specific, defined projects, work less time than employees, etc. In addition, you can assert the "variable employees" are, in effect, subcontractors. If you choose to stress this point, make sure you demonstrate they are treated like subcontractors for costing purposes (e.g. normal fringe benefit and overhead rates applied to employees are not applied to them, only indirect costs applied to subcontractors are used, etc.).

Q. We are negotiating a multi-year cost type subcontract and the prime contractor is insistent that we provide a ceiling on our overhead and G&A rate. Is this common and if so, can you suggest any ways to protect ourselves?

A. It is becoming quite common for the government to require prime contractors to cap their indirect cost rates to minimize cost overruns and surprises and we are also seeing numerous prime contractors taking the same action with their subcontractors. If you cannot negotiate your way out of the caps, the following represent a few conditions that may lessen the sting:

1. Provide that overruns and underruns in any indirect rate be allowed to offset the other.

2. Ensure the caps apply on a cumulative basis so that overruns in one year may be offset against underruns in other years.

3. Make sure the caps do not apply to terminations for convenience and even claims. Since the method of calculating indirect rates differ under these circumstances (e.g. some indirect costs are direct), your firm should be entitled to recover actual indirect expenses calculated in accordance with the relevant cost principles.

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