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Case Study…

DCAA Questions Subcontract Labor Costs and Reallocation of Overhead Costs to G&A

(Editor's Note. We have just completed a consulting engagement that asked us to prepare a response to DCAA's draft audit report asserting that our client inappropriately (1) billed his prime contractor on several T&M subcontracts at his own billing rates rather then the subcontractors' billing rates and (2) shifted some indirect labor costs from the overhead to G&A pool. The following is an edited version of our response where we have disguised the identity of our client and changed the dollar amounts discussed.)

(**FLASH:** We just heard as of this writing that after the exit conference held yesterday with DCAA and the ACO that DCAA has decided to drop all of its findings in the case study below. It shows some significant changes – DCAA and ACOs seem to be open these days to changing DCAA findings when well presented challenges are made.)

Background

Contractor provides IT services to the government where in 2014, most of its work was as subcontractors to two large prime government contractors. Its subcontracts are almost all time-and-material and it uses other subcontractors on T&M task orders. For subcontract labor, Contractor followed its customary practices of billing its prime contractor clients on its T&M contracts at set billing rates based on negotiated rates contained either in its subcontract agreements or "subcontractor billing rates" contained in one of its prime's contract with the government. In accordance with its policies and pertinent FAR provisions, Contractor billed these negotiated rates regardless of whether the individuals were employees of Contractor or subcontractor firms.

Though it strictly adheres to its timekeeping policies when employees distinguish direct from indirect activities, it accounts for employees' indirect time differently. For the remaining indirect costs, indirect employees assign their hours to either overhead or general and administrative pools based on projected estimates made by management at the beginning of the year of the percentage of time they are expected to spend on overhead versus G&A efforts. For example, some employees are considered to be 100% either overhead or G&A while other employees are considered to be 50/50. Management assigns these percentages to all employees working indirect hours and the employees, in turn, use those percentages to distribute their time on timesheets to either G&A or Overhead charge numbers. Contractor believes use of these estimates to assign indirect time is the best method of distinguishing between G&A and Overhead labor where it avoids having employees decide what of their many tasks during a day constitutes overhead or G&A efforts, which is highly prone to inaccuracy. Contractor's practice was followed for many years and DCAA reviewed them in prior year ICP audits.

At the end of the year, in accordance with its Indirect Charge Policy, Contractor creates an adjustment of indirect labor charged to G&A and overhead, again practices reviewed in many prior ICP audits. Since most of its billing rates are fixed on its T&M subcontracts it is concerned that its G&A rates are sufficiently high to bill G&A on its other direct costs. In 2014, Contractor made an adjustment of $300.000 that moved that amount from overhead to G&A. The adjustment represented the amount of time certain employees' time had shifted from an original estimate of 50/50 to 100% G&A based on their primary work effort. For example, Joe Smith's time turned out to be focused primarily on running the operations as a whole and Mary Jones's time turned out to be focused almost exclusively on assisting the CFO, both of which are considered G&A functions.

Also, in its 2014 incurred cost proposal (ICP), Contractor voluntarily reduced its G&A pool by $400,000 because it determined that its actual pool resulted in a G&A rate that it considered was too high to compete with other firms. Though the deduction was otherwise allowable and allocable costs, the voluntary reduction removed this $400,000 from its claimed G&A pool.

DCAA's findings and our response are described below.

Subcontract Labor Billing Rates

- **DCAA Position**

DCAA is questioning $500,000 representing excess costs billed for its subcontractors. The amount represents the difference between what Contractor billed the government for its subcontractors' employees and what they should have billed using the "subcontractor negotiated prices." DCAA cites FAR 52.216-29(c)(1) as the basis of questioning these costs asserting that that FAR clause requires use of only "separate rates for each category of labor to be performed by each subcontractor for each category of labor to be performed by the offeror" where the appropriate way to bill each subcontract "is to bill the subcontract costs at the actual rate incurred by the subcontractor where then Contractor can add its own G&A."

We disagree with DCAA's questioned costs and its interpretation of the FAR

- **Contractor's Practices**

First, the amount of the subcontractors' negotiated prices were the same as the negotiated prices incorporated in both its subcontract agreement and its prime contractor's negotiated subcontractor prices. As the attachment shows (attachments are only referenced, not shown here), there was only one set of contract prices for employees working on its subcontracts and the additional attachment shows that its invoices were consistent with these negotiated billing rates. For another subcontract, Contractor showed the labor prices it charged its prime contractors were consistent with the negotiated subcontract prices contained in its prime contract. These negotiated subcontract prices are also reflected in its invoices shown in another attachment. It should be stressed that there is no verbiage in either documents that indicate different rates should be charged by Contractor's subcontractors.

It should also be stressed that these practices are consistent with what had been Contractor's practice in the past – one set of contract billing prices used by all employees, whether they were Contractor or their subcontractor employees. (We provided several examples over the last 8 years.) If Contractor had wanted other rates to apply to its subcontractor employees, it would have proposed them or the prime contractors or government could have asked for them. Instead, it is and always has been Contractor's practice to use one set of negotiated rates for all employees.

- **Proper Interpretation of FAR 52.216-7**

Though we agree that DCAA's citation of FAR 52.216-7 is the correct FAR provision we disagree with its interpretation of that clause. The current version of FAR 52.216-7 is reflected in changes made to FAR 52.237-3, Payment under Time-and-Material and Labor-Hour Contracts that were presented in the Federal Register dated February 12, 2007 (71 FR 74656). Prior to these 2007 changes there were disputes about whether subcontract labor had to be billed at the subcontractor's actual costs or whether subcontract labor could be billed using the prime contractor's labor rates and the changes were intended to clarify these issues. (We refer to the language in the provisions but it should be understood, as addressed in Contractor's Subcontract Agreement, that references to the "prime" apply to Contractor as the first tier subcontractor and references to "subcontractor" refers to its subcontractors.)

The essence of the final rule is in the following quote, which is repeated throughout the amendment. It "provides that all labor hours that qualify under the labor hour requirements of the contract are to be paid at the labor hour rate specified in the contract. This applies regardless of whether an individual is an employee of the prime contractor, a subcontractor or an affiliate of the prime contractor." This provision is duplicated in whole in several sections of the 2007 amendment.

The amendment to FAR 52,232-7 includes new solicitation provisions where the relevant one is FAR 52.216-29, Time-and-Material/Labor-Hour Proposal Requirements – Noncommercial Item Acquisition with Adequate Price Competition. The amendment states

"offerors may identify the labor rates they are proposing in one of three manners: first, offerors may propose blended rates under which labor hours will be paid at the same rate, regardless of whether the individual performing the labor works for the prime contractor or subcontractor. Second, offerors may offer labor hour rates that include two sets of rates, one set for individuals employed by the offeror and a second set for individuals employed by subcontractors. Third, offerors may offer multiple sets for individuals employed by the offeror and additional sets for each subcontractor for individuals employed by subcontractors."

It should be emphasized that the term "blended rates" does not dictate any particular methods for computing the rate (e.g. no weighted averages) but refers to a single set of rates to be used by multiple contractors. It is a new term intended to meet the goal of have one billing

rate applicable to all employees, whether they be from the prime or subcontractor.

So the question is does DCAA correctly interpret the new provision of FAR 52.216-29 as requiring only "separate rates for each category of labor to be performed by each subcontractor for each category of labor to be performed by the offeror." According to DCAA's statement that leaves only one manner, namely the third "manner." However, the new FAR 52.216-29 provides for three choices not just the third one. As the attachment above shows, there was one set of negotiated rates identified in the subcontract agreement and these rates were used to bill all employees.

G&A Adjustment

- **DCAA Position**

DCAA concluded that Contractor had inappropriately allocated $300,000 plus an additional $120,000 of costs related to fringe benefits of these people to its G&A pool where it then deducted that amount from its G&A pool and added it into the overhead pool. DCAA stated the $420,000 was a difference between the amount it included in its G&A pool and the amount reflected in its books and records. DCAA asserts the difference is a "top line, lump sum adjustment" and states the adjustment was made without "any supporting documentation or justification" and that it was made to "manage" its indirect expense rates."

We disagree with DCAA's conclusions and assertions.

- **Basis of the Adjustment**

The adjustment Contractor made at the end of the year is consistent with its Indirect Charge Policy. Though it did not provide documentation for the change during the auditor's field work, Contractor did subsequently provide a spreadsheet identifying what individuals' hours were changed as well as a narrative explaining the reasons for the changes. These two documents should meet DCAA's request for documenting the basis of the adjustment.

- **Voluntary Deduction of $400,000**

Contractor's voluntarily deduction of its G&A pool for $400,000 was made to offer lower, more competitive G&A rates and lower prices to the government. So, before the reduction was taken, Contractor's claimed allowable G&A pool was $900,000 (we will call that the gross pool) where the deduction resulted in an adjusted pool of claimed costs of $500,000 (we will call that the net pool). The questioned costs of $300,000 (plus burden) should not be deducted from the net G&A pool but should be reduced from the gross pool. To do otherwise is to produce a "double wammy" – a reduction for the amount of the voluntary deduction plus an additional amount for the questioned costs. Offering a voluntary deduction is not uncommon but if questioned costs are asserted it is customary to reduce questioned costs from the gross pool amount. If the questioned amount of $300,000 is added to the deduction of $400,000 the resulting G&A rate would be intolerably low and would require a rescission of the voluntary deduction. We strongly prefer not having to eliminate the deduction because it creates rates that make us competitive and satisfies our clients because they, in turn, offer lower prices the government must pay.

- **No Financial Record Documentation of the Adjustment**

DCAA is saying that the adjustment in question should be reflected in its accounting records and the absence of this indicates the adjustment is inappropriate. This position is contrary to the widely common treatment of costs for government accounting purposes that are different than financial or tax purposes. Adjustments of financial records for government contract reporting are commonly made through "memo" records. These wide-spread practices are common because accounting for financial reporting (i.e. GAAP) and tax purposes often diverge from accounting for government costing purposes. For example, such categories as asset lives, depreciation, capitalization of certain costs, deferred IR&D, cost of money, etc. are commonly treated differently for government accounting purposes and the different treatment rarely results in changing financial records. "Memo" records are substituted. In the case of adjustments to G&A and overhead pools, these distinctions are not important for financial reporting purposes (indirect costs are indirect) and so there would rarely be any documentation of movement between overhead and G&A in the financial records.

- **A Word About "Managing" Indirect Cost Rates**

The audit report indicates that the motive for the adjustment is for Contractor to "manage its indirect cost rates" which for some reason represents a malevolent motive. We believe this assertion is naïve because it does not reflect real world practices of government contractors and unfairly ascribes unsavory motives. Contractors, of course, manage their indirect cost rates which is necessary when the amount of revenue

contractors receive are based on cost build ups. Contractors usually monitor their indirect rates (they are, in fact, required to do so when they have flexible contracts) and often control expenditures so that actual rates are close to what they have been billing to avoid surprises their customers will not like. In general, if indirect rates are too high to be able to compete in the government marketplace contractors need to find ways to reduce those costs while *remaining compliant with the requirements of government accounting rules.* Contractors may, for example, decide to reduce costs by forgoing certain expenditures, find ways to treat otherwise indirect costs as direct or as Contractor did, offer voluntary deductions to one or several indirect cost pools. Conversely, if rates are too low, they may be motivated to take similar actions such as increasing expenditures, forgoing elective deductions, changing their indirect rate structure or even assigning costs from one pool to the other as long as there is no violation of government accounting rules (e.g. inconsistencies with disclosed practices). To assume that all government accounting practices are based purely on cost accounting considerations and not on pricing considerations is naïve.

Know Your Cost Principles…

RELOCATION COSTS

(Editor's Note. We frequently report on cases that address allowability of travel and relocation costs primarily for government employees but we thought is would be a good idea to address relocation costs in the FAR which applies to government contractors. Though we once addressed the issue more than 15 years ago there have been significant changes to this cost principle in that time. The FAR cost principle, which is more detailed than most, sometimes makes costs unallowable that are normally part of relocation packages offered to employees so when preparing company policies these rules should be taken into account. We have relied on a careful reading of the cost principle, our experience as former government auditors, contractor employees and consultants, some of our favorite texts and the DCAA Contract Audit Manual.)

General Rules

FAR 31.205-35 addresses relocation costs. Relocation costs are incurred when a current employee is reassigned or when a new employee is recruited. A permanent reassignment must be for an indefinite time or if a definite time, no less than 12 months. If an employee who is paid otherwise allowable costs resigns within 12 months for reasons under the employee's control, the relocation costs must either be refunded to the government or credited to the account. Costs for mass relocation of personnel are allowable but the costs should be allocated based on the contracts or time periods benefiting from the costs. So, for example, when a facility is closed and employees are transferred to another site, the costs are to be allocated to the cost objectives at the new location.

Relocation costs that are generally allowable include travel costs of the employee and their immediate family and costs of transporting household and personal effects to the new location. Also, the costs of finding a new home are allowable which includes house-hunting trips by employees and their spouses and temporary lodging which cannot exceed 60 days for the employee and 45 days for spouses and dependents.

Unless relocations costs meet the following three criteria they are unallowable:

1. the move must be for the benefit of the employer;

2. reimbursement must be in accordance either with an established policy or with a practice that is consistently followed and designed to motivate employees to relocate promptly and economically; and

3. employee reimbursement may not exceed actual costs, except that a policy may be established to reimburse employees up to $5,000 for certain miscellaneous expenses (discussed below where DCAA offers a "lump sum" exception).

Slightly different requirements exist for relocation of employees who are hired for specific contracts or long term field projects. First, the employment agreement must specifically limit the duration of the employment to the time spent on the specific contract or project. Second, the agreement must provide for the return of the employee to their location before the employment covered by this agreement or to a location of equal or lesser cost.

Specific Requirements

Within certain limits, costs related to disposing of a residence the employee owns at the time of notice of transfer are allowable. Closing costs include (1) brokerage fees (2) legal fees (3) appraisal fees (4) points and (5) finance charges.

Costs of ownership of a vacant former residence that is sold after the employee purchases or leases a new residence are also allowable within limits. These costs include building and grounds maintenance, utilities, taxes, property insurance, mortgage interest and related items. The combined closing and ownership costs

cannot exceed 14 percent of the sales price of the property sold.

Other miscellaneous relocation costs usually considered necessary and reasonable expenses are (1) costs of disconnecting and connecting household appliances (2) automobile registration fees (3) new driver's licenses and use taxes (4) cost of cutting and fitting rugs, draperies and curtains (5) forfeited utility fees and deposits and (6) property insurance for items in transit.

Costs of acquiring a home at a new location are allowable subject to the following and are not expressly unallowable as discussed below. First, the employee must have been a homeowner before relocation. Second, the total costs cannot exceed 5 percent of the purchase price of the new home. Mortgage interest differential payments are also allowable for up to three years provided payments are limited to the difference in the interest rates between the two residences times the current balance of the old mortgage. If the employee transfers again before the three years have passed, the allowable costs are reduced in proportion to the actual relocation period.

Rental differential payments are also allowable. These payments usually arise when a relocated employee retains ownership of a vacated home and rents at the new location. The rented quarters must be comparable to the vacated home. The allowable payment is limited to the actual rental costs less the fair market rental value of the vacated home for three years. The costs of canceling an unexpired lease on vacated premises are also allowable.

Expressly Unallowable Costs

Certain relocation costs are expressly unallowable which means penalties may apply if they are claimed. These include:

1. a loss on the sale of a residence
2. mortgage principle payments on the old residence
3. payments for job counseling and placement assistance for spouses and dependents who were not contractor employees at the old location
4. costs incident to furnishing loans to employees or arranging for below-market mortgage loans.

Payments for employee income or social security taxes incident to reimbursed relocation costs (so-called tax gross-ups) used to be expressly unallowable but now they are allowable.

DCAA has become, in general, quite expansive in determining what unallowable costs are expressly unallowable. Other costs we see it claim as expressly unallowable include unallowable brokers' fees and commissions, litigation costs, real and personal property insurance, mortgage life insurance, owner's title policy insurance when such insurance was not carried by the employee on the former residence.

DCAA Audit Guidance

Chapter 7-1004 of the Defense Contract Audit Manual (DCAM) addresses employee relocations costs. In addition to merely reflecting the FAR, one can reasonably assert the points emphasized in DCAM actually adds elements to the cost principle. We recommend your human resources and project manager personnel become familiar with this section when considering policies, employee agreements and relocation plans. The guidance contains eight sections summarized below:

7-1004. A relatively recent amendment to the DCAM to implement new language to FAR 31.205-35(a)(5) was a memorandum to regional directors that provides that three types of relocation costs may be reimbursed on a "lump sum basis in lieu of actual costs:" (1) costs of finding a new home (2) costs of travelling to the new home and (3) costs of temporary lodging. Rather than paying actual expenses, contractors can estimate the costs of these three types of costs and arrange payment where there is no ceiling but the estimate should identify all the relevant cost elements such as airfare, lodging, meals, etc. The lump sum amount is to be estimated before employees actually incur the costs where subsequent adjustments to the lump sum to reflect actual costs is prohibited.

7-1004.1. General. This section states FAR 31.205-35 addresses relocation costs and applies to costs incident to permanent changes of duty assignments of not less than 12 months. It identifies eight type of costs that are usually associated with relocation costs – (1) travel and transportation of household goods (2) advanced trips to find a permanent residence (3) closing costs incidental to sale of prior residence (4) miscellaneous expenses such as cancelling a lease or disconnecting and reinstalling appliances (5) acquiring a new house (6) continuing mortgage interest at the old residence (7) interest differential between the old and new mortgage and rental differential where relocated employee retains ownership of a vacated house in the old locations and rents at the new location and (8) other miscellaneous expenses. Travel costs associated with relocation should

be considered allowable per diem costs in accordance with FAR 31.205-46, travel costs.

7-1004.2. Conditions for allowability. This section focuses on the meaning of the 12 month threshold period. Relocation must involve a permanent change of duty assignment or for an indefinite period as long as more than 12 months are expected. The auditor should question relocation costs "in excess of constructive temporary duty assignment costs" if the contractor should have known at the time of assignment it would not have continued for a period of 12 months or more.

Failure to fulfill a permanent change of duty requires the contractor to refund or credit the cost charged to the government. The auditor is told to encourage contractors to include recapture provisions in their relocation agreements with employees and that this provision should be monitored by the auditor to assure the contractor adequately collects refunds from employees and these refunds are credited to the government.

The guidance states the recapture rule is not applicable to new employees who are (1) hired specifically for long term (at least 12 months) field projects or contract assignments (2) entitled to a return relocation under the terms of their employment contract and (3) not permanent employees and are released from employment upon completion of their assignment. All three conditions are required to meet the recapture waiver.

7-1004.3. Applicability of Joint Travel Regulations (JTR). JTR per diem rates for lodging, meals and incidentals are to apply to employees traveling on official business which includes house-hunting trips and travel to new duty stations. Be aware that most separate government travel regulations have been consolidated into the JTR.

7-1004.4. Employee assignments not considered relocations. Certain duty assignments, principally overseas locations, often include "location allowances." These "location advances" are considered inducements to work at these locations and should be considered additions to normal wages and salaries covered by FAR 31.205-6, "compensation for personal services" and not relocation costs. Also, costs of travel to overseas locations should be considered travel not relocation if dependents are not permitted and the expenses do not include costs of transporting household goods. Under these circumstances, the move is considered a temporary rather than permanent change of duty station.

7-1004.5. Unallowable relocation costs. The guidance reflects the type of costs in FAR 31.205-35(c) identified above. The section does state the contractors should not be compelled to refund or credit relocation costs for less than 12 months of relocation when the termination of employment was due to illness, disabling injury or death.

7-1004.6. Mass relocations. The guidance alludes to FAR 31.205-35(e) that states both reasonableness and allocation questions may arise over large scale or mass relocations and stresses that when an advanced agreement is not in place FAR 31.2 should be used by the auditor to determine reasonableness and allocation of costs. When the auditor learns of impending mass relocation costs they are told to report the matter to the cognizant ACO and recommend an advanced agreement be prepared for allowability of costs that addresses (1) the appropriate segment where the costs should be allocated (2) length of time over which the costs are to be amortized and (3) eligible employees.

7-1004.7. State and local transfer tax. When a state or local government imposes a tax on the sale of a home by law, the guidance in FAR 31.205-35(a)(3) allows the costs. However, if an agreement to pay the tax is not imposed on the seller (i.e. employee) by law but is agreed to in order to help make the sell or other reasons, the tax is not considered a legitimate closing cost and is to be questioned by the auditor.

Though we frequently report on CBCA cases involving allowability of relocation costs for individuals usually employed by the government, there have been some cases settled by the ASBCA applicable to government contractors. For example: reimbursement is prohibited when employees resign within 12 months from the date of hire but are allowable if they are discharged *(Page Communications Eng'rs, ASBCA No. 15076)*; "settling-in allowance" (SIA) paid to employees relocated overseas were miscellaneous relocation costs subject to the $1,000 lump sum (now $5,000) limit and are not to be treated as compensation subject to FAR 31.205-6 *(Lockheed Martin, ASBCA No. 51452)* and; the cost principle precluded reimbursement of relocation costs for employees terminated and then rehired because charging such costs to the "losing" rather than the "gaining" organization was a deviation from the contractor's established policy *(Telecomputing Services, ASBCA No. 10644)*.

MAXIMIZING RECOVERY FROM DELAYS

(Editor's Note. We have been encountering many complaints lately from subscribers and clients that the government has been delaying their contract performance and it is wreaking havoc on the profitability of their work. Knowledge of when a contractor can recover costs associated with delays and how to present a claim to get the most recovery is a critical antidote to a contract experiencing various delays. There have been several clause changes and cases since we last wrote about this issue so we decided to revisit it here. We still appreciate the insights of an article written by Rand Allen and Phil Harrington of the law firm of Wiley Rein & Fielding LLP published in the now defunct Government Contract Audit Report back in 2002 and we reference more recent cases and, regulations.)

For delays or disrupted performance, the government has created three clauses that permit it to order a contractor to stop or suspend contract performance. In return for this right, the three clauses create a corresponding obligation on the government to compensate the contractor for the interference. Entitlement to compensation is not automatic, putting the burden of proof on the contractor to demonstrate it suffered compensable harm as a result of the government-ordered delay. The proof requirements and elements of compensation vary depending on which clause the government issues to delay the work.

Relevant Regulations

- **Suspension of Work, FAR 52.242-14**

Of the three clauses that permit the government to interfere with government work, the Suspension of Work clause is the least generous and places the most obligations on the contractor. This clause is most commonly invoked in construction and architect-engineering services contracts but we have seen it in many others. The clause puts forth several hurdles before a contractor can recover the extra costs incurred by a government-directed delay:

1. *The government caused the delay.* This precondition can be a result of an act or a failure to act.

2. *The government caused not just a delay but the delay was for "an unreasonable period of time."* There is no clear standard what is considered reasonable or unreasonable – under one circumstance even one to 10 hours have been held to be unreasonable in one case while under another, a delay of 12 days was considered reasonable.

3. *The delay must not be attributable to the contractor's fault or negligence.* Court rulings have provided numerous examples of when a contractor was not entitled to compensation such as if the contractor could not perform the work required, the contractor did not furnish material the government required to permit work to proceed, or refused to cooperate with the government.

4. *Must put government on notice within 20 days.* The terms of the clause prohibit recovery for government-ordered delays "for any costs incurred more than 20 days before the contractor shall have notified the contracting officer in writing of the act or failure to act." Contrary to what some believe, this does not require the contractor to file a claim within this 20-day window but rather to put the CO on notice of a triggering act or failure to act within the 20 days period.

5. *The final steps for recovery of costs involves the filing of a claim.* Though the clause requires a claim filed "as soon as practical after the termination of the suspension, delay or interference" it also states such a claim can be considered directly if it is submitted "not later than the date of final payment under the contract." Thus under normal circumstances, timeliness of filing a claim should not be a bar to recovery.

6. *No profit.* An allowance for profit in any amount cannot be part of a contractor's claim under this clause no matter how long the delay. Many commentators have expressed the belief this clause eliminates an essential element of contractors' bargain with the government – a fair return on extra costs.

- **Protest After Award, FAR 52.233-3**

It is not unusual to receive a contract only to learn that a losing competitor has protested the award to the GAO. If a protest is filed the government agency is required to suspend contract performance and may issue an order to stop all work and take reasonable steps to minimize costs allocable to the contract. After the GAO issues a decision on the protest the agency either cancels the stop work order or lets it expire which permits the contractor to resume performance or terminates the work covered by the order. In either event, the clause allows the contractor to recover the costs it incurred during the stop work period. In contrast to the Suspension of Work clause, there is no requirement to show the government-caused delay extended for an unreasonable period of time. Also, the delayed contractor is entitled to receive profit on the costs it incurred.

The contractor is not required to stop *all* costs that may be allocable to the contract but rather to take prudent steps to *minimize* these costs. Thus in some circumstances it may be less costly to the government for a contract to continue to incur costs at some reduced level of activity than to stop completely and incur, for example, relocation and severance costs.

In some contracts the government is supposed to issue a Notice to Proceed (NTP) before the contractor can begin performance. Some agencies have attempted to escape their obligations under this clause by not issuing a NTP. Courts have ruled this is not a successful tactic stating that withholding a NTP subsequent to a protest should be treated as if it were a stop order under this clause.

Even if the clause is not included in a solicitation or ensuing contract, court ruling have held it is covered by the "Christian Doctrine" which makes the clause a part of the contract by operation of law. The "Christian Doctrine" provides that certain clauses are considered a part of the contract whether or not it is actually referenced or included in the contract when those clauses "express a significant or deeply ingrained strand of public procurement policy."

- **Stop-Work Order, FAR 52.242-15**

The stop work order clause permits the government "to stop all, or any part, of the work called for by this contract for a period of 90 days after the order is delivered to the contractor, and for any further period to which the parties may agree." The provisions of this clause are essentially the same as those under the Protest After Award (FAR 52.233-3) discussed above. Under this clause a contractor is:

- Not required to show the period of delay was unreasonable
- Entitled to recover profit on the costs incurred as a result of the delay
- Not required to stop all allocable costs, only to minimize them
- Entitled to an equitable adjustment on its contract.

In addition, at the end of the 90 day period the CO must either cancel the stop-work order or terminate the work covered by the order. If the stop work order is cancelled or the period expires the contractor is to resume work and the CO is required to make an equitable adjustment in the delivery schedule or contract price or both.

Recovering Costs and Profit

- **Procedures**

As we have discussed the government has the right to suspend or stop contract performance and the agency must compensate the contractor for additional costs it incurred as a result of the delay as well as profit in the case of the last two clauses discussed above.

The burden falls on the contractor to demonstrate how much it is entitled to. The first step the contractor should take is to immediately begin to identify the delay-related costs. It should establish a separate accounting charge number to identify and record the extra costs attributable to the government's action and inform its employees of this separate charge number. We cannot count the number of times a fair equitable adjustment eluded a contractor because this initial step was not taken on a timely basis. This tracking of costs should proceed regardless of the duration of the government-caused delay.

- **Elements of Recovery**

In considering what specific elements of costs are allowable, boards and courts have stated that the rules applicable to equitable adjustments under change orders should apply. All assertions below are based either on board cases or DCAA guidelines which we will avoid citing here (feel free to contact us if you would like a citation). Under these rules, the basic pricing formula has been held as "the difference between what it would have reasonably cost to perform the work as originally required and what it reasonably cost to perform the work as changed." The courts have generally held the purpose of the equitable adjustment is to make the contractor whole. Put another way, once the contractor establishes the government interruptions caused a contractor to incur additional costs, the contractor is entitled to recoup those additional costs.

Generally a contractor should be expected to recover the following types of costs in equitable adjustments from the government caused delay:

Stand-by labor and related overhead. The costs of personnel who became idle as a result of the stopped/suspended work should be separately identified and the labor costs and associated burdens should be recoverable.

Retention of personnel. The cost of retaining key personnel that may become unavailable if they do not remain with the contractor as a result of the stopped/suspended work is allowable.

Severance payments. Such payments that are incurred because of the delay are recoverable.

Recruiting costs to replace staff. If the work stoppage or delay occurs at the beginning of the contract, personnel recruited for the contract often take other employment requiring additional costs to recruit replacement labor.

Idle and underutilized equipment and facilities. The cost of any equipment or facility that would have been used on this contract which became idle as a result of the stopped/suspended work can be recovered.

Demobilization and remobilization. These costs may be recovered if they are due to the delayed work.

Material and labor escalation costs. The costs of performance should be escalated to account for any inflation impacts resulting from slippage in performance period.

Loss of efficiency. If the contract contemplated lower prices due to efficiency or learning effects the impact of any loss of efficiency or learning resulting from the interruption should be recovered.

Unabsorbed overhead. A disruption in contract performance results in an interruption in the absorption of overhead costs on the contract thereby causing other ongoing contracts to absorb more overhead costs. This unabsorbed overhead is a routine cost on equitable adjustments and the so-called "Eichleay formula" is the only method to compute this adjustment. We have discussed the Eichleay formula in prior articles (do a key word search at our website).

Increased subcontractor costs. Any subcontractors impacted by the stopped/suspended work have the same rights to an equitable adjustment as the prime contractor. These subcontractor claims should be included as part of the equitable adjustment request.

Profit on costs incurred. Profit is allowed on the equitable adjustment if the stop work was ordered under either FAR 52.233-3 or 52.242.15.

REA Preparation Costs. The costs of preparing, submitting and negotiating the request for equitable adjustment are allowable costs of the stopped/suspended work claim. Once the REA becomes a claim then the associated costs of pursuing the claim (usually legal and consulting costs) are not allowable under the equitable adjustment claim.

It should be noted many cases have ruled that "ascertaining all costs of an equitable adjustment is not an exact science." As long as it appropriately segregates its delay-related costs and provides a reasonable estimation of its damages the contractor should not hesitate to include such costs in its request for equitable adjustment. Of course, you can likely expect an audit of your REA if it is significant.

Oldie But Goodie…

FINANCIAL ACCOUNTING

Though we focus on contract cost and pricing requirements rather than financial and taxes, we are often asked about financial accounting issues unique to government contractors. Since many of our subscribers are in accounting and financial positions we decided to address some of the financial accounting issues government contractors commonly face. Last issue we discussed the completed contract and percentage-of-completion methods while in this issue we will discuss some financial reporting requirements under generally accepted accounting principles (GAAP) that are particularly relevant to contractors. In the next issue, we will touch on some tax issues. For these three articles, we are particularly indebted to the Mathew Bender text, "Accounting for Government Contracts" edited by Lane Anderson.)

Revenue

Revenue recognition is a key accounting concern and under the percentage-of-completion method, revenue must be estimated. Such estimates are particularly complicated for government contractors because of change orders, options and additions, claims and terminations and government-furnished materials.

- **Change Orders**

Changes to a contract are common and when such changes result in a contract cost adjustment revenues and costs should reflect only adjustments agreed to by both parties (unapproved or changes in dispute should be treated as claims discussed below). The accounting principles are as follows:

a. Costs under change orders should usually be included in contract costs during the period incurred.

b. Costs that will be recovered through an adjustment in price can be accounted for in two ways: either defer the costs to the period when the price adjustment is made or charge the costs when incurred but recognize revenue only to the extent of costs incurred.

c. If the contract price adjustment exceeds the costs incurred under a change order, the contractor should recognize the additional revenues and the costs in the period in which the revenue becomes reasonably determinable.

Before revenue from a price adjustment can be recognized the contractor must assess the timing and probability of recovery. In determining whether recovery is probable three conditions should be ascertained: (1) whether the government has confirmed the basis for the price adjustment (2) the adequacy of supporting documentation and cost records and (3) the historical experience in negotiating similar adjustments.

- **Options and Additions**

An exercised option or addition to an existing contract can be combined with the original contract, treated as a separate one or treated as a change order to the original contract (Note a FASB change was issued in 2014 on this issue.) Combining into the initial contract can occur when the change order does not generate significantly more revenue from the original contract and the products or services are similar. They are treated as separate contracts if (1) the product or service differs significantly from the product or service of the original or (2) the price of the new product or service is negotiated without regard to the original contract and involves different economic assumptions or (3) the product or service is similar but the contract price and "anticipated contract relationship" are significantly different. If options or additions do not meet either the conditions for combining with the original contract or treating it as a separate contract then they are to be treated as change orders to the original contract as discussed above.

- **Claims and Terminations**

Revenue should be recorded only to the extent the costs are incurred and only if there is a high probability the claim will result in additional revenue. Because of uncertainties in resolving claims the most practical approach is to recognize additional revenue only when received or awarded. Otherwise, revenue from claims may be recognized to the extent costs have been incurred and (1) entitlement is established, often obtained through obtaining a legal opinion (2) additional costs were incurred as a result of unforeseen circumstances and not as a result of contract deficiencies (3) the claimed costs are identifiable or otherwise determinable and are reasonable for the work performed and (4) support for the claim is objective and reliable and not based merely on management intuition. Under a T of C, income effects are realized when the termination value (e.g. costs recoverable under FAR 31.205-42) can be reasonably identified and estimated. Revenue including negotiated profit from the termination should reflect the probable recovery amount and associated costs should be expensed.

- **Government-Furnished Materials**

Often when the government provides materials, the value of them is not considered a cost, is not included in the contract price and is not booked by the contractor. If a contractor is at risk for the material, however, the value of the materials should be included in the contract price, reflected as both revenue and cost. The contractor is "at risk" when (1) it is responsible for the nature, type, characteristics or specifications of the material (2) if it purchases as an agent of the government and (3) is responsible for the ultimate acceptability of the performance of the materials.

Costs

Whereas cost is of paramount concern for government contract accounting, recognition of income is key for financial reporting purposes. Consequently, GAAP rules covering costs of government contractors are primarily oriented to accuracy in reporting earned revenue and income, particularly for percentage-or-completion contracts.

At any time during the life of a contract, total estimated contract costs consist of costs incurred to date plus estimated costs to complete. Contract costs must be identified, estimated and accumulated with a reasonable degree of accuracy to assure proper income measurement.

Contract costs are accumulated in the same manner as inventory costs. Like inventory costs, contract costs are recognized in the income statement only as the related contract revenues are recognized. Contract costs include all direct and indirect costs identified with a contract. Costs not clearly related to a contract or are unallowable are treated as period costs and expensed as incurred.

Though recognition of income depends upon the accounting method used (percentage-of-completion or completed-contract) contract costs are accounted for in the same manner under both methods. They are allocated and accumulated in the same way but like revenue, they are recognized at different times for financial reporting purposes.

Since revenue and income on percentage-of-completion contracts are generated based on estimates of costs, the AICPA seeks to prevent manipulating income by providing the following guidelines for estimating costs:

1. "Systematic and consistent procedures" need to be used for periodically comparing actual and estimated costs.
2. All significant elements of costs should be identified
3. Estimates to complete should include the same elements of costs that are included in actual accumulated costs and expected price increases should be reflected.
4. The effects of future wage and price escalations should be taken into account. Escalation rates should not be a blanket overall amount but the escalation rate(s) should cover labor, material and indirect costs based on consideration of history and other pertinent data.
5. Estimates to complete should be reviewed "periodically" and revised as appropriate to reflect new information.

Earned Income

Under the completed-contract method, earned income is simply the difference between contract revenue and contract cost when the contract is completed (or significantly completed). Under the percentage-of-completion method, computation of estimated earned revenue involves estimating the revenues earned to date and the costs related to that revenue. The AICPA recognizes two acceptable approaches for estimating earned revenues and matching costs.

Approach 1. Earned revenue to date is computed by multiplying total estimated contract revenue by the percentage of completion. Any excess of the total amount over amounts recognized in prior periods is the revenue for the current period. The cost of the earned revenue is computed the same way – multiplying total estimated costs by the percentage of completion and recording as costs of the period the excess of this amount over costs recognized in prior periods. Any difference between actual costs incurred and costs of earned revenue are reported on the balance sheet as a current asset or liability.

Approach 2. Earned revenue is the amount of gross profit earned on a contract during the period plus the costs incurred during the period. Costs of earned revenue for the period equals the costs incurred during the period (the costs incurred may exclude the costs of materials purchased but not yet used and the cost for subcontract work yet to be performed). Gross profit is computed by multiplying the total estimated gross profit on the contract by the percentage of completion. The excess over the amount recognized in prior periods is the gross profit earned in the current period..

Anticipated Losses

Whether the completed or percentage-of-completion method is used, losses should be recognized in the period they are discovered. Normally the loss is reported in the income statement as an addition to contract costs rather than as a reduction in contract revenue.

Contractors often attempt to defer recognition of contract losses. One approach is to spread the losses over the period remaining in the life of the contract. Another approach is to defer the loss in the hopes of recovering it through obtaining future or follow-on contracts or the customer anticipating exercise of options. Neither approach is acceptable under GAAP.

Guidelines for Financial Statement Presentation

- **Balance Sheet Presentation**

Common asset and liabilities relatively unique to government contractors include:

Assets
- Accounts receivable on contracts (including retentions)
- Unbilled contract receivables
- Cost in excess of billings and estimated earnings
- Other deferred contract costs
- Equipment and tooling specifically purchases for an individual or group of contracts

Liabilities
- Accounts payable on contracts (including retentions)
- Accrued contract costs
- Billings in excess of cost and estimated earnings
- Advanced payments on contracts

Some words about a few of these.

Receivables. If receivables from government contracts are significant or if billed or unbilled government receivables are material, GAAP requires they be disclosed separately either in the balance sheet or a footnote. Unbilled amounts occur when revenues, though appropriately recorded, cannot be billed yet (e.g. contract terms not

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determined, unit prices not established) but will be billed later. Some contractors prefer to label unbilled receivables as "accrued" which is permissible under GAAP. Few companies disclose unbilled receivables on the face of the balance sheet and choose rather to (1) treat them as billed or (2) disclose them in a footnote.

Retention. Retention amounts (holdbacks of a percentage of billing) should be disclosed on a balance sheet or in a note. Though most companies do not disclose them in a way for the reader to identify them, they are usually included as a part of unbilled receivables. For example, a note might say "receivables include approximately $ X billed to customers but not paid pursuant to retainage provisions in the contract."

Inventories. The accumulated costs of contracts in process are reported according to the type of contract and accounting method used. Under the completed-contract method, costs are considered inventory with the usual title "contracts in process." Under percentage-of-completion method the costs are generally classified as billed (or unbilled) receivables.

Costs incurred under cost-type contracts are usually reimbursable so they are billed as incurred. For fixed-price contracts contractors receive payment as work progresses or units are delivered. The usual balance sheet description for accumulated costs under completed-contract method is "Contracts in progress" while under percentage-of-completion method, the balance sheet description is typically "costs incurred under U.S. government contracts less amounts applied to units delivered and unapplied progress payments."

- **Income Statement Presentation**

The income statement of a government contractor is basically the same as that for any other business. Revenues and expenses are usually not segregated between government and other commercial business. There are some unique circumstances to government contractors that may affect either comparability or future operations and therefore may need detailed disclosure. These might include (1) abnormal contract price adjustments (2) provisions for a substantial loss (3) recognition of significant incentive income (4) material changes in contract estimates (5) claims activity that can significantly affect revenue or losses and (6) big problems in performance that can materially affect future operations.

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GCA DIGEST P.O. Box 1235 Alamo, CA 94507 (tel) 925-362-0712 (fax) 925-362-0806 Email: gcaconsult@earthlink.net
website: www.govcontractassoc.com
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