GCA DIGEST

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Case Study…

IS A SALES COMMISION ALLOWABLE

(Editor's Note. We continue our long time policy of addressing "real world" issues we face in our consulting practice. The following article is a highly edited memo we wrote for a client who asked us to prepare a position paper on whether a sales commission it paid to one of its employees would be considered an allowable cost. We find the memo very relevant to many contractors and it also illustrates sound proactive actions taken by our client. We have disguised names of our client and employees as well as numbers.)

Introduction

Contractor has established a practice of paying one of its employees a "sales commission" on revenue he is responsible for generating for the company. The employee, Jim Smith, has a network of contacts in the government and Contractor has decided the sales commission is an important incentive for him to help bring in business. Contractor is concerned the sales commission may be considered unallowable and has asked us to provide an opinion on the allowability of the expense.

Background

Jim Smith was hired in 2009 where discussions between Jim and Contractor began in 2013 to provide an incentive "sales commission" bonus to him on certain target awarded contracts. A written addendum to his employment agreement was completed and signed by Jim and Contractor representatives in late 2013 that stated he "will receive incentive pay in the amount of 1.25% of the revenue of future contracts. This incentive is to be awarded as a performance bonus related to Mr. Smith's role in developing new business for the company. Specific targets for new business acquisition will be agreed upon in advance. The bonus will apply to those targets and not to new business which may not be considered related to Mr. Smith's efforts." An additional addendum to his employment agreement dated May 2014 identified a specific target, X-Ray Deflector, to which the bonus would apply and reiterated that the bonus would be distributed over the contract duration where the estimated amount was $7 Million with a corresponding amount of $87,500.

The commissions paid to Jim as of this writing were $27,000 (2014), $42,000 (2015) and $4,200 (2016). Jim's salary (excluding the bonus) during this period as VP of Marketing was $90,000 (2014), $97,000 (2015) and $107,000 (2016). Company annual revenue for 2014-2015 was approximately $15 million, projected to be the same in 2016.

Analysis

The expense in question may be evaluated in three ways: (1) as a sales commission expense (2) an incentive bonus and (3) an element of overall compensation. The varied ways of applying these three conceptions means the government can use any criterion associated with these three elements to question the costs. So, for example, even if the costs can be supported by FAR provisions addressing sales expenses, costs can still be questioned by provisions addressing incentive pay or excessive compensation. I will consider all three perspectives.

Selling Expense

FAR 31.205-38, Selling costs addresses selling expenses. Section (c) states:

Notwithstanding any other provision of this subsection, seller' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for purposes of securing business.

As for DCAA's position, the DCAA Contract Audit Manual in Chapter 7-1306.3(a)(3) alludes to FAR 31.205-38(c) as the governing FAR provision. It states that "contingent fees" for soliciting or obtaining Government contracts are considered contrary to public policy because they may lead to improper influence.

"However, an exception is provided for contingent compensation arrangements with bona fide employees or bona fide agencies." As defined in FAR 3.401, a bona fide employee is considered as one who does not exert "improper influence" to obtain government contracts. *(We occasionally see DCAA disallow these fees referring to the first part of the quote – "contingent fees" – forgetting the "exception" part.)*

We asked other members of our firm to comment on our position. Though most comments were no different one idea did surface – the bonus should not be considered an indirect cost but rather might need to be allocated to the one contract Jim was responsible for bringing in.

- **Opinion**

In my opinion, if we represent the costs in question as "sales commissions" which is reasonable, then those costs are allowable. The costs meet the FAR 31.205-38(c) provision for allowability. First, the costs are explicitly addressed under the terms "commissions" and "percentages." Secondly, there is no question that Jim is a bona fide employee, which is confirmed by both my examination of the employee agreement documents and discussions with the company. Hence, the commission paid to Jim, a bona fide employee, meets the condition of the FAR provision.

As for the question of whether the sales commission should be an indirect cost or a direct cost of the contract there would seem to be some flexibility on that issue. If it is the policy of the company to charge all sales commissions indirect then the cost we are considering here should be indirect. Even under this circumstance, it could be possible to charge it as a direct cost to the contract if it represents costs that could be considered an "unlike cost" or one incurred under "unlike circumstances" than those for indirect costing. For example, if all other sales commissions are immaterial in amount or are incurred by operations personnel while Jim's efforts are considered different because he is a marketing executive or are material in amount then you could have a basis to charge the cost direct. We should discuss your preferences and make sure the bonus policy and practices are consistent.

Incentive Expense

In addition to the costs paid to Jim being considered selling commissions, they also can be reasonably considered as bonuses and incentive compensation.

FAR 31.205-6, Compensation for personal services, Section (f), Bonuses and incentive compensation states:

(1) Bonuses and incentive compensation are allowable provided the -

(i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and employees before the services are rendered or pursuant to an established plan or policy followed by the contractor or consistently as to imply, in effect, an agreement to make such payment;

So the question is whether there is an agreement in place between Contractor and Jim. The two addendums referenced above to the Employment Agreement between Contractor and Jim clearly provide for an incentive bonus to be paid on future contracts where the specific contract is explicitly identified in the other addendum. The dates of discussions of the bonus and dates signed on both addendums clearly indicate an agreement between the contractor and employee was in place before any payments were made.

As for DCAA's position, they have issued guidance from time to time, sometimes detailed, to its auditors to ensure an agreement, entered into in good faith, exists or an established policy exists. They will commonly ask for any written policies addressing incentive bonuses, proof that an agreement between the company and employee exists, and examine employee handbooks, board minutes, communications between the company and employee, etc.. Though the FAR clearly states an agreement or an established plan/policy should exist (no requirement for it to be in writing) I have seen DCAA auditors inappropriately question bonuses costs because an agreement **and** policy did not exist or that a **written** policy does not exist. Despite these "creative" actions by auditors occurring, they would be clearly wrong.

Our colleagues agreed with our position but emphasized that it is very common for auditors to assert that the bonus was not paid pursuant to an agreement entered into before the services were performed. One of them drew our attention to a court case that found there would be a right to the bonus if there was a reasonable expectation the bonus would be paid *(Boeing Aerospace Ops, Inc., ASBA No 46274).*

- **Opinion**

The expense in question clearly meets the conditions of FAR 31.205-6(f). The earned incentive payment is a result of an agreement between Jim and Contractor. That agreement provides both that a bonus will be paid on business generated by Jim and it also explicitly identifies a prospective contract to which the bonus will apply. The agreement was arrived at during discussions

with Jim which occurred before effort even began and was formally approved before a contract was awarded and at least a year before any bonus was paid. In addition, based on our colleague's comment, I would say the discussions about the bonus clearly provided an expectation of the right to receive the bonus.

Reasonableness of Compensation

Though the government could challenge the costs in question as either an unallowable selling expense or bonus, it has a third way to "bite the apple." If the bonus costs, added to three other components of compensation – salary/wages, deferred compensation or company contributions to a defined benefit pension plan – were considered "excessive" then part of that compensation can be questioned.

FAR 31.205-6 addresses several elements of compensation. Usually, each year the government establishes a compensation ceiling. For example, prior to June 24, 2014 the compensation cap was $952,036 while after that date to the current period the cap is $487,000. Prior to 2015, the cap applied only to the five highest paid executives while after 2015, it applied to all employees. There is an important limitation to these caps – they apply only to large companies, usually with over $50 million in revenue. The government seeks to apply lower caps to smaller companies, usually using 2-4 national compensation surveys arriving at average caps for different positions when they conduct a compensation review. The caps vary, largely dependent on the revenue of the company – higher revenues justify higher compensation caps.

DCAA provides highly detailed guidance on how to arrive at what it considers reasonable compensation levels for both senior executive and other employees. It is supposed to consider numerous factors such as revenue, location, industry, etc. as well as position titles, education levels, etc. when arriving at what is calls reasonable compensation levels for employees it is benchmarking.

- **Opinion**

I believe Jim's total compensation would very likely not be considered excessive. Jim's total compensation as a VP of Marketing - $117,000 in 2014 and $139,000 in 2015 are clearly below the 50 percentile level for that position for comparable companies with revenue at $15 million. An examination of Salary.com, Mercer national survey and a private survey benchmarking compensation in Contractor's industry all showed results for the VP Marketing position significantly higher than Jim's compensation. I would conclude his compensation levels would not strike an auditor as "high risk" that is, excessive. It is only once a high risk assessment is made that they may ask DCAAs compensation team in Philadelphia to conduct an analysis. Based on my experience, a company with $15 million in revenue employing a "VP of Marketing" would not raise concern unless it exceeded, say $150,000. The amount paid to Jim would not appear to be potentially unreasonable and hence I would expect no further review.

Conclusion

Whether the payments made to Jim are characterized as a "sales commissions," "bonus or incentive compensation" or an element of total compensation they would not reasonably be considered unallowable. FAR provisions addressing (1) sales commissions allow for the payment to bona fide employees (2) bonuses or incentive compensation provisions allow for the payment since it is clear there is an agreement between Contractor and Jim existed prior to any payments and (3) total compensation for Jim's position would not be considered excessive, generating a compensation review by DCAA.

11 TIPS FOR GETTING OUT OF A CRISIS

(Editor's Note. One of the popular features of our newsletters is our efforts to highlight current thinking about sound business practices and how their implementation affects government contractors. In prior articles we have addressed pricing considerations and what practices make sense when the economy is challenged. As companies face challenging times several articles we have seen address what companies should do when they are facing a crisis or tailspin. Here we have selected a couple of articles addressing prescriptions on what to do when a company is in distress and how they might impact government contractors specifically. The insights about business practices come from both Doug Yakola, a McKinsey and Co. partner writing in the March 2014 edition McKinsey Quarterly and another article by Chris Zook, a partner of Bain & Company writing in the June 2016 edition of the Harvard Business Review. The discussion about the implications for government contractors comes from our own consulting practices where many clients have or are facing many of the recommendations we discuss.)

Mr. Yakola likens the difficulty of seeing the early signs of distress to boiled frogs – the frogs do not notice the gradual warming of the water until it's too late. He has heard many regrets by managers, sometimes where they have underestimated their situation by looking at the

wrong data, or sought illusory quick fixes seeking short term returns while neglecting the company's long term health. The authors offer several general comments and together eleven specific recommendations.

The specific insights for getting started on turning themselves around include:.

1. Focus on cash. A successful turnaround comes down to one thing – a focus on cash and cash returns. Are activities generating or burning cash, which investments are generating or burning cash? Mr. Yakola asks us to consider running a hardware store. Asking fundamental questions like is there enough cash to pay the utility bill or pay for that pallet of paint to arrive next week or how much cash can I make by investing in a new delivery truck. Many times management is focused on more complex metrics like earnings before tax and interest (EBIT) or return on investment that excludes major uses of cash, Failing to pay attention to cash can make net present value calculations of investment decisions look deceptive where, for example, returns at year two or jump ups at year five look the same where you can find yourself with little cash to run the business if you're waiting for year 5 proceeds to happen.

Implications for Contractors. Erroneous focus on non-cash metrics can take your eyes off the target. Cash measurements should be the primary focus where numerous reports generated by accounting may be deceptive. Bonuses and other forms of compensation that are not related to generating more cash should maybe be deemphasized or even eliminated.

2. Build traction for change with quick wins. Under turnaround circumstances there is a tendency for managers to put their focus and resources into 3-4 big bets. This can be high risk because big bets often take lots of time and effort where they may not pay off. For example, you may decide to change suppliers and sources from a low cost country hoping for a 30 percent cut in direct material costs. However, you may realize after six months the material did not meet your needs where you spent a lot of time, interrupted your production and probably burnt a lot of cash. In addition to the big bets companies should focus on getting a series of quick wins to gain traction. These quick wins often involve cutting costs where, for example, stopping some services or introducing more stringent travel policies. In any given company, a fifth of employees are fully supportive of efforts where you'll want to spend your time with them rather than on the fifth who are underachievers and resist change. Rather, you want to change the 60 percent who tend to be fence sitters where they are generally more tuned to action, not just talk. If they see changes then 80 percent of the company will be behind change but if they don't see wins, they will likely be negative.

Implications. Attention to quick actions that help turnaround performance requires a critical analysis of so called "giveaways" like discounts, free delivery, added services, etc. Elimination or reduction of some can help cut costs or looking for ways to keep them but be paid for them should be closely examined. Requests for equitable adjustments on initial prices or deals to get more awards on other or current jobs should be looked at carefully. Quick wins might mean going after awards that were previously not sought.

3. Throw out your old incentive plans. Stable companies often have complex incentive plans that do not relate to needed actions of distressed companies but rather focus on safety, financial, operational or personal development goals. Current incentive plans are often so complex that most employees and managers don't even know the basis for them – "someone will tell me at the end of the year" is common. In a turnaround, companies need to take the lessons of private equity firms and throw out the old plans. Instead managers need to have incentives tied specifically on what they want to accomplish. For example, if you need $10 million of additional revenue from pricing then your sales and proposal staff need to have incentive plans in place. If you need $150 million from better procurement practices then your procurement chief and staff needs meet-or-beat targets and to be incentivized. Be willing to forgo bonus payments for those who do not achieve 100 percent of their targets and payout handsomely for those who do.

Implications. Signs of distress should be the time to closely evaluate your compensation and incentive compensation practices. Fast revisions should be implemented to be reflected in proposals for new work, provisional billing rates and revisions to billings. Written policies need to be revised to reflect the new practices. All the changes should be consistent with FAR 31.205-6 detailed elements and new DCAA guidance in how to review compensation and bonuses.

4. Replace a top team member – or two. Mr. Yakola states his experience indicates successful turnarounds need changing at least one or two top-team members. It is not about eliminating "bad" managers – very few are incompetent but it's a reality that managers should take ownership for the decline. More often than not, top managers are incapable of shifting their mind-set to make the fundamental changes to the philosophy and actions they have believed in for a long time. Whether they realize it or not, they often block needed change because they are bent on defending what they believe is

true. Removing senior people also sends the necessary signal that changes are needed. Mr. Zook states that needed personnel changes needs to occur quickly. Though a gradual change may be appealing because it's less disruptive, you will lose valuable time and new employees brought in may begin to absorb the old lessons.

Implications. This should be the time to review compensation levels for senior people. Compensation paid to replacements should not duplicate what was paid to the people leaving, whose compensation levels were determined in years of plenty and long seniority. Compensation surveys that auditors value should be used to determine compensation levels and compensation at these levels can be justified by the surveys. In addition to considering the four elements of compensation – salary, bonus, deferred compensation and defined benefit payments – other forms such as various fringe benefits and relocation packages should be considered as ways to reduce salaries and shift some of these costs from direct to indirect. In addition, severance and retainer policies as well as written agreements with laid off executives should either be reviewed or prepared to ensure payments will be allowed so as to be consistent with company written procedures and agreements.

5. Find and retain talented people. Beyond the leadership team there are types of people that are critical for success of the company. First, there are those with long time institutional knowledge. They may not be top performers but they know all the ins and outs of the company and are vital in understanding potential changes on the business. These people know about prior mistakes and usually know the clients well to know what needs to be done to win awards, generate more revenue under existing contracts or avoid problems with auditors and contracting personnel that caused problems in the past. These people may be disgruntled and unhappy with the company's performance but they are needed to identify uncomfortable truths. Second, are the people who are at the next level in the organization. In the author's experience the people who eventually have the best impact on the company are not the ones sitting at the table at the beginning but the one two or three levels down who are waiting for an opportunity. They can be highly energized by being a part of something bigger than themselves such as saving a company. Money and bonuses are not always the key component.

Implications. Identify the key personnel who have the institutional knowledge to help the company. Also, become aware of those further down the chain who have insight into what went wrong and what can be done to improve things. These people need not necessarily be slotted into high executive positions but can remain in their positions where respectful appreciation of their value can go a long way. This is a good opportunity to evaluate the structure of the company – distress situations often stem from excessive layers of management and bureaucracy, impediments to getting things done.

6. New ways of doing business. The author points to a case study, Total Renal Care who brought in a new CEO after losing $60 million that year. The management team was immediately replaced, he began referring to the company as a "village" to emphasize that everyone had a stake and abolished titles internally. He convened town hall meetings with local staff and organized regulation regional meetings.

Implications. Extensive reorganization and ways of communications will be critical for a turnaround. Whereas reorganization efforts to improve economies and efficiencies are allowable they should be clearly distinguished from unallowable organization costs. New policies should address these distinctions and costs should clearly identify the allowable costs. Also, communications like business meals and conferences throughout the company will likely be increased to spread the messages. Policies addressing these costs, recognizing recent developments that not only disallow some of these costs but also impose penalties, should be carefully established.

7. Focus on stripping away complexity and then focus on "the core of the core." A turnaround usually involves a top down analysis by leaders to find noncore assets to shed, businesses to sell, activities to eliminate and product lines to simplify. Mr. Zook emphases the need to "shrink to grow." He uses the example of Lego where after successful growth over decades it diverted cash from its profitable toy brick business into an array of other businesses that were virtual failures and then focused on streamlining the brick business eliminating 50% of rarely used components. These lessons have been repeated for many companies such as IBM, Apple and Schwab,

Implications. Conduct an analysis to identify the core product and services the company offers. Such an analysis should determine what items offered to the government can provide the lowest price and highest quality. Simplification of operations should be a key criteria for changes. For example, subcontracting or teaming arrangements can be made to outsource non-core products and services where firms can begin earning extra points for utilizing firms that qualify for small business set aside work which is likely to be highly valued by the next administration. In addition,

the indirect rate structure may need to be revised. For example, use of more subcontractors may mean loading up G&A rates to maximize cost recovery or adopting a subcontractor handling rate to minimize such costs.

8. Invest hugely in a new capability. Distressed companies have a lot to fix but seldom have all the tools needed. They usually find they are missing at least one capability that is crucial for adopting their business model to new conditions. For example, Leica cameras were once the most profitable camera around, originating the first lightweight camera with superior lens becoming the favored brand of great photographers and high end photo stores. However, when digital photography arrived, it did not soon adapt and the decline of the high end photo stores and rise of the internet and discount camera retailers sunk its distinctive characteristics. When its new investor came in 2006, it utilized its unique assets – brand, image quality, lens expertise and reputation with great photographers to obtain new capabilities to revamp its product line.

Implications. An assessment of new capabilities to be developed will need to be made. From a costing perspective, creative use of independent research and development dollars and acquisition of R&D awards will require a thorough knowledge of IR&D costing rules (several recent cases and audit guidance have resulted in many changes) and pricing of R&D work will need to be considered where even unprofitable arrangements may be of benefit to expand important capabilities. Also, additional marketing efforts will be needed where their accounting treatment and impact on G&A must be weighed..

In addition to the eight insights above both authors offer more general observations.

9. Throw away your perceptions of what a company in distress is. There is really no clear definition of what a company in distress is. Mr. Takola offers 25 different signs of potential distress where the problem is rarely just one or two but usually is a result of several interacting together. Some of these distress signs include: (a) working capital/liquidity (e.g. declining free cash flow, revolver drawdowns, increased AR and AP aging) (b) profitability and industry outlook (e.g. shrinking profit margins, deteriorating industry fundamentals, reduced capital investment) (c) financial (e.g. declining stock prices, bank or bond prices, not meeting debt covenants, accounting restatements) and (d) employees (e.g. large or unplanned workforce reductions, management turnover).

Implications. There is probably a need to conduct a "mock" financial capability review similar to what you can expect from DCAA. The government conducts reviews periodically as a matter of course and is required to focus on them if there are indications of financial distress. Negative financial metrics will need to be highlighted and fixed before a government audit is conducted. Other sources of cash needs to be identified (e.g. working capital loans, stretching vendor payments).

10. Force yourself to criticize your own plans. To avoid stress review your business plans. Either when you are creating them at the beginning of the year or at the start of a three year cycle, build in some trigger points such as "if we haven't gotten the 12 things done by this date we will step back and decide if we are going down the right path." These trigger points should be oriented to both operational and market performance as well as basic financial and cash flow measurements. Compare your results with competitors and the rest of the industry. If you are not moving with the rest of the industry or outpacing them then consider whether your plans are obsolete. Also take a look at past cycles to identify any trends.

Implications. A trend analysis will be useful. When preparing budgets or forecasts used for provisional billing rates or forward pricing rates, place triggers points in those documents. These trigger points can be used as justification for altering projected indirect rates. For example, lower sales forecasts will result in higher G&A rates. This is a good time to carefully review the financial performance of on-going contracts as well as forecasted new ones. Profit projections on fixed price contracts should lead to ideas for cost cutting and projections on cost type contracts should lead to alterations in direct and indirect costs. Also, this should be a time to aggressively look at opportunities for additional revenue from existing contracts and need to be compensated for "freebies" provided to clients

11. Create a great change story. Companies in distress need to create a change story that everyone can understand, that creates some urgency. For example, a mining company was profitable, managed a decent margin and was cash positive but the commodity price was dropping and there was worry the company would generate enough cash to drive the capital investments needs of the business. The change story created was "yes we are profitable but the point of profitability is to generate enough cash to expand, grow and maintain operations. If we can't we are headed for a slow decline where equipment breaks down and lower production becomes the new reality." If you can't tell this story in a paragraph, in a way that means something to the average person on the front line then people won't get on board. A company where employees want to stay for

their career (and maybe employ their kids) such a story is crucial to get them on board to spur actions.

Implications. These communications during distress times are when compensation and operational changes can best be accepted. Compensation levels, bonuses, fringe benefits and other benefits and operations efficiencies probably all need to be tightened up. Policies addressing these issues will also need to be revised to withstand audits.

Know Your Cost Principles…

LEGAL COSTS

(Editors Note. Changes to the FAR, recent cases, expert discussions and increased audit scrutiny of legal costs have made a revisit of this cost principle essential. We have updated prior articles on this and added more case law and experts' perspectives mostly from Karen Manos' "Government Contract Costs and Pricing.")

General Rules

The FAR identifies five general conditions that must be met for costs to be allowable: (1) reasonableness (2) allocability (3) standards promulgated by the CAS Board, if applicable, as well as generally accepted accounting principles (4) terms of the contract and (5) limitations in the FAR. Allowability of specific FAR-related costs are addressed in Section 31.205 where there is a laundry list of costs. FAR 31.204(d) notes that the FAR 31.205 section does not cover every element of cost where the failure to do so does not necessary imply the cost is allowable or unallowable. Rather the determination of allowability should be based on the principles in FAR 31.2 and the treatment of similar or related selected items.

Legal Proceedings

Far 31.205-47 addresses costs related to "legal proceedings." The purpose of this principle is to describe in some detail the various circumstances in which legal proceedings – particularly those between a contractor and the government – are allowable. The basic prohibitions are spelled out in section (b) where additional details of unallowability are contained in section (f).

The unallowability of costs contained in 31.205-47 is triggered by certain proceedings where the definition includes an "investigation." The prohibition applies only to costs of certain proceedings and investigations "for violation of …law or regulation by the contractor." Normally the government would not investigate a matter that did not include a violation of law or regulation so the investigation triggers the investigation as long as it relates to certain types of matters. It should be noted that not all investigations do relate to violation of law where, for example, a contracting officer might investigate instances of corporate espionage that nonetheless does not rise to a level of violating the Procurement Integrity Act. In such cases, the cost of responding to that investigation (as opposed to anther formal investigation) would be allowable.

Though 31.205-47 does not expressly state that it applies to settlement costs or payments it is understood to do so. Settlement payments are allowable to the extent any other legal costs are allowable. However, it should be noted that allocability of settlement costs is a separate matter where such costs may either be direct or indirect.

Other FAR Provisions

In addition to 31.205-47 there are three additional cost principles that have a bearing on allowability of legal proceedings costs.

1. FAR 31.205-15, Fines, penalties and mischarging costs. Costs of fines and penalties resulting from a violation of or failure to comply with Federal, State, Local or foreign laws are unallowable unless they were a result of complying with specific terms and conditions of the contract or written instructions from the CO. In addition to actual fines and penalties, costs that are "similar" or "related" to them are also unallowable. The Courts have refined the conditions for when a penalty is unallowable where, for example, a legislature must have intended for penalties to be applied *(Ingalls Shipbuilding Inv. V Dalton, 119 f.3d 972)* or fines and penalties are imposed because there has been a false or improper recording of costs caused by alteration or destruction of records.

2. FAR 31.205-30, Patent costs makes certain types of patent costs unallowable. Contrary to popular belief, general counseling services related to patent matters such as advice on patent laws, regulations, clauses and employee agreements are allowable. Some types of these allowable costs are expressly identified such as preparing invention disclosures, reports and other documents, costs of searching the art needed for disclosures and costs of filing and prosecution of a US patent where title or royalty-free license is to be conveyed to the government. However, except for these general counseling services, all other costs related to patents are unallowable unless they are required by a government contract. FAR 31.205-47 separately makes

patent infringement litigation of any kind unallowable unless it was provided for in the government contract.

3. FAR 31.205-33, Professional and consultant services costs addresses whether outside professional or consultant services are reasonable (we intend to address these costs in the near future). Note even though such costs would be otherwise allowable, the cost principles addressing legal proceedings and patent costs impose additional conditions of allowability for these costs.

FAR 31.205-47

This cost principle is by far the most comprehensive FAR provision addressing legal proceedings costs. Section (b) (1-3) provides that costs of proceedings brought by the federal government or by a state, local or foreign government or by a qui tam relator under the False Claims Act (FCA) are unallowable if the result is (1) conviction in a criminal proceeding (2) in civil or administrative proceedings, a finding of civil liability involving fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct (3) suspension or debarment (4) rescission or voiding of the contract or (5) termination of the contract for default. Under section (b)(4), disposition of the matter by consent or settlement if the proceedings "could have led" to any of these outcomes also makes the costs unallowable. Costs are unallowable if the case is lost. If the case is settled, the determination of allowability depends on who brought the case. If the case was brought by the government then allowability turns on whether the parties' settlement agreement provided for allowability. If the case was brought by a qui tam relator or a third party then allowability of the costs turns on whether the relator or plaintiff had very little likelihood of success on the merits.

Section (f) provides a list of legal proceedings where the incurred costs in connections with the following are unallowable:

1. Defense of a government claim or appeal or the prosecution of claims or appeals against the government.

2. Organization, reorganization or resisting mergers or acquisitions.

3. Defense of antitrust suits.

4. Defense of suits brought by the contractor's employees or ex-employees under Section 2 of the Major Fraud Act where the contractor settles or is found liable.

5. Legal, accounting and consulting services or other associated costs related to certain disputes between contractors such as (a) teaming arrangements, joint ventures or similar arrangements of shared benefits (b) dual sourcing, coproduction or similar arrangements except they were incurred as requirements of the contract or written instructions of the CO.

6. Patent infringement litigation unless required under the contract.

7. Representing or assisting others where there is no legal obligation to do so and the person or entity was convicted of violation of a law or regulation or found liable in a civil or administrative proceeding.

8. Connection with a protest.

The FAR 31.205-47 cost principle was significantly revised with passage of the Major Fraud Act of 1989. Though the two seeks consistency, Ms. Menos points out that the FAR cost principle exceeds the scope of the Act in three ways: First, the statute but not the FAR is limited to "covered contracts" (i.e. those in excess of $100,000 that are other than fixed price). Second, the statute covers proceedings brought by the United States or a State whereas the cost principle applies to proceedings brought by federal, state, local or foreign governments. Third, the statute is limited to wrongdoing by contractors where the courts have stated the cost principle applies to wrongdoing "by the contractor (including its agents and employees)."

Selected Issues

- **80% Rule**

There is a lot of confusion of when the so-called 80% rule applies where for certain proceedings the contractor is entitled to recovering only 80% of its expenses. The FAR presumes that a government's criminal proceedings or civil actions for fraud or similar misconduct has at least some validity. If a government (federal, state, local or foreign) brings an action for violation of a law or regulation that can result in a criminal conviction or civil judgment for fraud or similar misconduct or in a final decision to suspend or debar, terminate the contract for default or rescind the contract and the contractor prevails in the litigation section (c)(3) provides that contractor may treat no more than 80% of the proceedings costs as allowable. This provision also applies when a CO determines (after a settlement) that a qui tam relator in a suit where the government does not intervene had very little likelihood of success. Also whenever the US government agrees to a settlement to allow legal costs

only 80% of those costs are allowable. However, when the contractor loses or where the matter is settled by consent or compromise (unless the settlement agreement provides otherwise) none of the costs are allowable.

Most experts we have opined that for all other proceedings (e.g. by a private party other than a qui tam relator) the 80% rule "probably does not apply." Though some have argued the rule "may" apply elsewhere there is nothing in FAR 31.205-47 to suggest an extension of the 80% rule applies beyond actions initiated by the government or qui tam relator where the consensus opinion is "the rule likely does not apply to proceedings by a private party other than a qui tam relator." Also, all costs brought by a state, local or foreign government may be allowable if the costs were incurred as a direct result of a specific term or condition of a federal contract or in compliance with a CO's direction.

- **Reasonableness**

There is an ongoing dispute between DCAA's tendency to challenge legal fees as unreasonable when it believes the costs would not have been incurred but for some prior wrongdoing while the courts have argued that it is reasonable and prudent for a company to defend lawsuits brought by third parties. In Hirsh Tyler Company *(ASBCA No. 20962)* the Board held that legal costs incurred in an unsuccessful defense of an employee discrimination lawsuit were allowable because the costs were reasonable in amount and did not fall within any category of costs prescribed by the cost principle. The Board rejected the government's claim the costs were by their nature unreasonable because the contractor was found to have violated the Civil Rights Act stating a prudent businessman would incur legal expenses to defend a litigation and such expenses are "of a type generally recognized as ordinary and necessary" for the business.

- **Direct vs Indirect Costs**

Legal fees are generally treated as indirect costs and included in the G&A pool because they are considered to benefit the company as a whole (or overhead when legal costs relate to support of multiple projects such as environmental or personnel issues). However, several cases have held that when legal or accounting costs are incurred specifically for and can be identified specifically with one contract the costs must be allocated to that contract. For example, costs of defending against a protest of the award of a contract was ruled to be directly chargeable to that contract *(Jana Inc. ASBCA 32447)* and costs of litigating a claim under a purchase order were directly chargeable to that purchase order *(FMC, Corp., ASBCA 30130)*. Many cases have ruled such costs are not recoverable under fixed price contracts unless there was a constructive change because practically speaking such costs are not ordinarily included in the price of the contract. However, such costs are reimbursable under flexible contracts.

- **Claims and Appeals**

Legal, accounting and consulting costs incurred in connection with the performance or administration of a contract are generally allowable if reasonable and not contingent upon recovery from the government. This is based on the strong policy preference of encouraging resolution of claims through negotiation rather than litigation. On the other hand, costs incurred in connection with the prosecution of claims against the government are unallowable. Whether a cost is an allowable contract administration or an unallowable costs of defending against or prosecuting a claim or appeal depends on what the purpose was for. There is a "strong legal presumption" that costs incurred before a CDA claim is submitted are allowable *(Bill Strong, 49 F.3d at 1550)*. However, because only costs associated with prosecution or defense of a claim or appeal are unallowable, costs even after a CDA claim is submitted may still be allowable if incurred for the genuine purpose of materially furthering the negotiation process.

- **Similar or Related Costs**

Several cases have established that even when 31.205-47 does not explicitly address a situation, if a case addresses "similar" or "related" costs then those costs may be disallowed. As an example of a "similar" situation, the Court disallowed legal fees and settlement expenses in a case where Caldera employees brought a suit alleging they had been retaliated against for refusing to participate in a fraud against the government. In determining the allowability of these costs, the Court "established a simple principle – that the costs of unsuccessfully defending a private suit charging wrongdoing are not allowable if the "similar" costs would be disallowed under the FAR" which is the case here *(Caldera v Northrop Worldwide Aircraft Systems, 192F.3d962)*.

The Courts have applied the "similar" arguments even when the issues involve a citizen suit alleging violation of the Clean Water Act (CWA) where it ruled the costs were "similar" to costs deemed unallowable under 31.205-47(b). Though the underlying suit was not brought by the government, the Court ruled the citizens acted like a "private attorney general" where also the penalties for violation of the CWA were paid to the government not the citizens who brought the case *(Southwest Marine v US, 535 F.3d 1012)*.

Oldie but Goodie…

FEDERAL INCOME TAXES

(Editor's Note. The following is the third and final article addressing financial accounting issues of interest to most of our subscribers who are involved in the accounting functions of their company. For all three articles we have relied both on our experiences as CFOs and controllers and the excellent Mathew Bender text "Accounting for Government Contracts," edited by Lane Anderson.)

The method of accounting selected for tax purposes usually has a big impact. The general rule is that taxable income should be computed using the same method used for keeping contractors' books. The purpose of this requirement is to enable the Internal Revenue auditors to examine the contractor's books and records directly to find support for the numbers on the tax return. Different methods may be used if the contractor's books and records are kept consistently with their tax method in which case the books need to be adjusted to prepare financial statements.

Under the cash method, items of gross income are recognized only upon actual or constructive receipt while deductions for expenses are taken only when actual payment is made. The cash method has the advantage of allowing contractors to control income and deductions by timing receipts and payment. Unfortunately, many government contractors cannot use it because (1) books and records need to follow the accrual not cash method to be consistent with generally accepted accounting principles (GAAP) (2) when contractors have inventory, the accrual method needs to be used and (3) the Tax Reform Act of 1986 requires regular corporations (not S corporations), partnerships with regular corporations as partners and tax shelters to use the accrual method. Exceptions (cash method is allowed) are for qualified personal service corporations (i.e. consulting, law and accounting) and entities having less than $5 million in the prior three years.

Under the accrual method, income and deductions are recognized in accordance with an "all events" test. When all the events necessary to fix the right to income or establish the existence of a liability have occurred and the amounts can be determined with reasonable accuracy income or expenses are recognized. Treatment of loss contracts under the accrual method depends on the "all events" test and any contract losses are recognized as deductions taken that exceed income recognized.

Long Term Contracts

Whether the cash or accrual method is used, IRC Section 460 provides for special treatments for long term contracts (see the 2Q16 issue of the GCA DIGEST for a discussion of financial accounting treatment of long term contracts). The statute defines a long term contract as "any contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable year in which such contract is entered into." Note the definition is not that the contract must take over a year to complete but simply the contract must begin and end in different taxable years. For manufacturing contracts there is one other requirement – items produced must be unique and of a type not usually carried in the contractor's finished goods inventory or else items that are not normally completed in 12 months or less.

Recent changes to the tax laws allow for the completed contract method only under very limited circumstances - general construction contracts estimated to be completed within two years from commencement as long as annual gross receipts did not exceed $10 million over the three preceding tax years or home construction contracts if at least 80 percent of the total contract costs relate to buildings containing four or fewer dwellings.

Otherwise the percentage-of-completion method is used where income or loss on long-term contracts are based on annual evaluations of the cumulative progress made on the contracts. Income or loss is recognized over the life of the contract. Early recognition of income before actual completion of the contract is usually disadvantageous for tax purposes since it means the contractor must pay taxes on income sooner. Of course, it can be advantageous if the income can be used to offset losses on other contracts or the calculated loss can offset income on other contracts.

The gross income to be recognized for tax purposes in any taxable year under the percentage-of-completion method equals the estimated percentage of completion of the contract times the gross contract price (unreduced for any retainages, holdbacks or payment considerations). The percentage of completion of the contract is determined by comparing costs allocated to the contract that are incurred before the end of the tax year with the estimated total contract costs. Taxes rule changes in 1989 allows taxpayers to elect non-recognition of any income in the first year on a long-term contract if less than 10 percent of the total contract costs have been incurred.

Though gross income is estimated and recognized over the life of the contract, expenses can be deducted only in the taxable year they are incurred under either the accrual or cash method. In addition some expenses are disallowed such as material and supplies on hand at year's end, deductive costs associated with guarantees, warranties and maintenance and service contracts.

Look-Back Method

Rather than revise estimates to complete when estimates of total contract costs change, the government now allows a new method called the look back method. Now actual contract price and costs, rather than revised estimates on contract price and costs, may be used on all years prior to completion year and any additional tax or tax refund that would have been due in the earlier years is subject to an interest payment by the taxpayer or government at the prevailing government rate for overpayments.

As an illustration: assume $200,000 was incurred the first year of a $1 million contract expected to have a cost of $800,000 then $250,000 ($200,000/$800,000 or 25% on $1 million) was declared as income. If actually costs are $600,000 then $333,333 of income should have been claimed the first year ($200,000/$600,000 or 33% of $1 million). Then the contractor would owe interest on the higher income of $83,333 ($333,000-$250,000) for the first year as well as any other years the income was understated.

Recent changes have lessened the impact: (1) for partnerships and S corporations the look back method does not apply to contracts that are completed within two years and the contract gross price either does not exceed the lesser of $1 million or 1 percent of the contractor's average gross receipts for the past three tax years or (2) the taxpayer may elect not to apply the look-back method if the income (loss) reported each year of the long-term contract period is within 10% of the recomputed income for each year or the total reported income for the entire completed contract is within 10% of the recomputed income.

Allocation of Costs

The amount of expenses claimed on long term contracts depends on the accounting method used to allocate costs. Direct costs defined in IRC Section 451 defines direct material and labor costs. Direct material includes material that is an integral part of the contract as well as materials consumed in the ordinary course of completing the items. Direct labor includes regular pay, overtime, vacation and holiday pay, sick leave, overtime payroll taxes and unemployment insurance. Indirect costs rules are similar to those encountered by government contracts and are considered those "incident to and necessary for" performance of the contract. Certain costs are required to be included such as indirect labor, rework, research, indirect materials, rent and repair. Other costs are optional such as marketing, interest, G&A expenses, income taxes and interest. Indirect costs should be allocated to long term contracts using either (1) a specific identification method that would use a separate set of accounts or (2) burden rates based on computed ratios of direct and indirect costs. For those firms using the completed cost method, less costs are allowed to be allocated as indirect costs resulting in fewer current deductions.

Special Income Recognition Problems

- **Retentions, Advance Payments and Progress Payments**

Retentions (amounts withheld by the government pending final acceptance) are generally not included in income until the contractor has a right to them under the accrual method. Under the cash method, there is no recognized income until actual receipt. For long term contracts, recognition rules discussed above apply. *Progress payments and advanced payments* are most common on long term contracts. It is to the contractor's advantage to use the percent-of-completion method so that income recognition does not have to be triggered upon the mere receipt of those payments.

- **Research and Development Deductions**

IRC Section 174 govern research and development (R&D) expenditures. Qualifying R&D are those R&D cost commonly used in the experimental or laboratory sense (e.g. new product development) where examples include cost of developing or improving an item, process, technique, formula or invention or obtaining a patent and both in-house and purchased costs qualify.

One of two options for deducting R&D costs can be used: (1) deduct R&D expenditures as they are paid or incurred (depending whether a contractor uses the cash or accrual method) or (2) defer the costs and amortize them over a period not less than 60 months, beginning with the first month the taxpayer benefits from the expenditure (e.g. sells the first units of the item). The first method reduces current tax liability while the second is advantageous if the contractor is not in a taxable position or expects to be in a higher one later. Either option must be identified on a tax return and is

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binding on future taxable years. It is, of course, possible to have different amortization periods for different R&D projects.

Changes to the tax laws provide that R&D expense incurred in a tax year be reduced by the amount of the R&D tax credit (discussed below).

- **Research and Development Credit**

A credit is available at the rate of 20 percent of the excess of qualified research expenses for a taxable year over a base amount as well as for 20 percent of certain basic research payments. Certain types of research are excluded form entitlement such as research related to style or cosmetics, beginning of commercial production, the social sciences or arts and research funded by another contractor. Other than for basic research, only the increased level of research activities generates the credit. The base amount is determined by multiplying the taxpayer's fixed-base percentage by the average annual gross receipts of the taxpayer for the prior four years. Example:

	Qualified Research Expense	Receipts
20X1	$100,000	$1,500,000
20X2	150,000	1,000,000
20X3	200,000	2,500,000
20X4	250,000	2,000,000
20X5	300,000	3,000,000
Total	1,000,000	10,000,000

Fixed Rate Percentage = $1,000,000 divided by $10,000,000 = 10%

If the average annual gross receipts for the last four tax years is $2,500,000 the base amount is $250,000 ($2,500,000 times 10%). If the next years qualified R&D expenditure is $350,000 the incremental credit is $20,000 (20% X {$350,000 - $250,000}). Any unused amount may be carried back one year or forward 20 years.

In addition the taxpayer is eligible for a 20 percent research credit for basic research payment that is considered funding research for the advancement of scientific knowledge without a specific commercial objective. To qualify, it (1) must be paid in cash under a written agreement by a regular corporation (S corporations do not qualify) and (2) must be performed or controlled by a qualified outside organization (e.g. university, nonprofit scientific research organization).

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