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Knowing Your Cost Principles and Cost Accounting Standards…

BID AND PROPOSAL COSTS

(Editor's Note. As part of our continuing series on exploring FAR 31.205 cost principles and cost accounting standards, we have relied on numerous texts for this article especially, Accounting for Government Contracts by Lane Anderson, as well as more recent developments in this area.) disguised names of our client and employees as well as numbers.)

Allowability

Bid and Proposal (B&P) costs are incurred in preparing, submitting and supporting bids and proposals (whether or not they were solicited) on potential government or non-government contracts. Although marketing and sales costs are similar to bid and proposal costs, basic B&P costs are incurred in preparing specific documents whereas selling and marketing costs are more general in nature. Costs incurred in deciding if a bid or a proposal should be prepared, for example, are not considered B&P but marketing.

Since 1997, all bid and proposal costs are allowable if reasonable and allocable to a contract. This is a significant change over rules that limited reimbursement of bid and proposal and independent research and development costs for the prior 30 years. When the government used to impose ceilings on bid and proposal costs distinguishing between B&P and other costs was essential since recovery of other costs were not limited. Though less critical, making distinctions is still important. For example, in General Dynamics *(ASBCA Nos. 15394 and 15858)* the government contended the costs of building a mock-up of a product were improper B&P costs but should be considered development and test expenses. The Board disagreed ruling since the mock-up was needed to display the company's capabilities as well as to develop the products, the costs were properly classified as B&P. This was significant because had the costs not been B&P they would have been considered direct costs of the contract rather than indirect costs resulting in a cost overrun to the contract and hence non-recoverable.

Allocation

Bid and proposal costs should generally be treated as indirect costs unless the contract requires submission of a proposal for subsequent work and authorizes the costs be charged directly to that contract. Individual task orders on ID/IQ contracts frequently contain this stipulation. These are the only conditions under which B&P expenses may be charged directly to a contract and when these conditions are met, only bid and proposal costs covered by the contract clause must be direct charges.

This raises the question about whether all B&P costs incurred on one of these contracts must be charged direct to that contract even when, for example, the task order or contract may limit the amount of reimbursement (e.g. caps on B&P reimbursement). In Boeing (ASBCA 29793) the contractor treated some costs as direct in compliance with contract terms while other related costs were charged indirect. The contractor argued this treatment was appropriate because the costs charged indirect were for efforts above and beyond that required to submit the proposal since they were incurred before the government requested a submittal of a proposal. The Appeals Board rejected these arguments and classified the entire effort as direct costs to the contract but a higher Court *(Boeing Co. v. US, CA FC No 88-1298)* reversed this decision. The Court said the contractor's distinction was appropriate and the treatment of some costs as direct and others as indirect was warranted under the circumstances. The Court concluded the only costs required to be treated as direct in this case were those incurred after the government's go-ahead for preparing the proposal – costs incurred before and after this period were properly treated as indirect.

Many would think these B&P costs would have to be treated either direct or indirect in accordance with CAS 402 (consistency of treating like costs under like circumstances). To prevent such an interpretation in the light of the *Boeing* case, DCAA changed its guidance to auditors to permit direct charging of

the cost of preparing task order price proposals under an ID/IQ contracts as long as such costs are classified as B&P, the contractor's policies provide for direct treatment and the contract terms require the contractor to submit such a bid.

- **CAS Covered Contractors**

Accumulation and allocation of bid and proposal costs are to be the same as IR&D costs. CAS 420, Allocating IR&D/B&P costs provide for similar treatment. The basic unit of accumulation is an individual B&P project or if immaterial in amount, a single account. For example, a contractor may decide to establish a separate account that would accumulate the costs of individual B&P projects whose expected costs are to exceed, say $10,000 while a separate account would be established to accumulate the costs of all other B&P expenses. CAS 420 requires costs allocated to B&P projects be treated as if they were final cost objectives or contracts (although G&A is not allocated) and treated as if they were G&A costs (e.g. allocated on the same base). B&P costs must include all the associated direct and overhead costs just as if they were another contract. The standard requires use of the same base used to allocate G&A costs and B&P costs are routinely included in the G&A pool.

Like IR&D costs, B&P can be accumulated at either the segment or group level. The proper accumulation point is determined by whether the costs benefit only one segment or several within a group. If a B&P project may benefit more than one segment then allocation of these costs must take this into account.

- **Non-CAS Covered Contractors**

FAR 31.205-18(b)(2) provides that non-CAS covered contracts and contracts subject to modified CAS coverage must still meet all provisions of CAS 420 except for CAS section 420.50(e)(2) and 420.50(f)(2) which have to do with allocation of costs between business units. Unlike the more restrictive requirement of CAS 420, the FAR permits use of an allocation base other than the G&A base if (1) the results of using the G&A allocation are "inequitable" and (2) the CO approves another base. The existence of two product lines within a single division having varying requirements for B&P costs would be an example of where another base may be desirable. In practice, we have not seen many circumstances where COs have approved use of another base *(we'd be interested in hearing from others).*

Does Clear Requirements for IR&D Apply to Less Clear B&P Costs?

There is some question by some commentators whether the rules that clearly apply to IR&D costs also apply to B&P expenses. First, DOD FAR Supplement 231.205-18, IR&D and B&P Costs, states these costs must have "potential interest to the Department of Defense" to be allocable to defense contracts. Though they are sufficiently broad to include just about all IR&D effort (we are unaware of any successful challenge) there is some question whether all B&P costs have similar "potential interest." Second, there is some question whether deferred B&P costs are allowable like its IR&D brethren. Offering an opportunity that neither generally accepted accounting procedures or the tax laws provide, the government allows contractors to recover deferred IR&D costs under certain limited circumstances. The FAR 31.205-18 cost principle addressing deferred IR&D costs includes "IR&D" and "B&P" in the title but only IR&D costs are actually referred. Though this raises the question whether deferred B&P costs are allowed, two ASBCA cases *(North Am Rockwell Corp. ASBCA No 13067* and *Channel Splicing Machine Co., ASBCA No 10209)* have supported the conclusion that B&P and IR&D costs should be treated the same.

RECENT TRAVEL AND RELOCATION COST DEVELOPMENTS

(Editor's Note. About once a year we recount some of the more important developments affecting reimbursement of travel and relocation costs. This article is a continuation of our effort to present new changes or decisions likely to affect contractors' travel and relocation expenses. Most of the issues arise in board decisions or issued regulation changes. Though only three parts of the Federal Travel Regulation provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidentals and conditions justifying payment of up to 300% of per diem rates – many contractors choose to follow the FTR either because some contracts call for incorporation of it or auditors and contractors consider it to be the basis for determining "reasonableness.")

Only One Spouse Eligible for Emergency Family Travel

Ms. Sherwood's spouse returned to the US to visit her mother who was seriously ill and after she died,

Ms. Sherwood travelled to the US to attend the funeral after which both returned to Belgium. The agency reimbursed Ms. Sherwood but not her spouse stating relevant regulations allow for emergency visitation travel for only one family member, either the employee or another family member. Ms. Sherwood argued that Joint Travel Regulation 7020 allows for an "EVM" trip to an employee, spouse or domestic partner for an ill family member and another trip for a funeral, allowing two separate trips to be reimbursed. The Board disagreed stating if both travelled when the family member was sick or travelled for the funeral, only one would be entitled to reimbursement. Because she waited to travel that does not allow her to sidestep the one person travel limitation *(CBCA 5231-TRAV)*.

Personal Auto Use Must Not Exceed Cost of Commercial Airlines

On his return trip from temporary travel duty, Kyle was given travel orders to fly back from California to Maryland by commercial airline. Since he bought a car in California, he instead drove back to MD after receiving verbal authority from his travel official submitting his invoice for privately owned vehicle (POV) mileage plus lodging and per diem/incidental expenses. The agency reimbursed Kyle only for the amount of the commercial airline ticket, which was substantially less than his invoice. Citing sections of the FTR, the board sided with the Navy asserting the agency must select the mode of transportation most advantageous to the government and POV use must be to the government's advantage to be authorized where here the Navy determined commercial air was the most advantageous and never determined POV to be advantageous. As to the claim POV was orally authorized, the Board agreed that under urgent circumstances oral authorization can be considered equivalent to written authority, but written authorization must soon follow which did not occur here *(CBCA 5081-TRAV)*.

Entitled to Reimbursement for Travel Despite Late Submission of Invoices

The permanent duty station (PDS) in Convington was changed, temporarily, to Attica after damage. After being told by their temporary ACO they are not eligible for travel costs from their homes to Attica since both offices were in the same county the four employees did not submit requests for travel from March 2011 through June 2014. However, subsequently they did bill and receive payments for the travel and then submitted requests for the earlier period. The agency said they would be open to considering additional documentation and did not dispute the amount of the charges they nonetheless refused reimbursement claiming the relevant travel regulation required submittal of invoices in the same year the costs were incurred and there was no documentation addressing the earlier discussions with the ACO. Though the ACO retired and did not remember the earlier discussion, each of the four employees submitted sworn declarations under penalty of perjury about the discussion with the ACO. The Board sided with the employees ruling sufficient documentation was provided by the declarations and there was no dispute about the amount *(CBCA -5261TRAV)*.

Unneeded Extra Hotel Expenses Arranged in Error Were Reimbursable When Employee Acted Prudently to Fix Error

Mr. Pe traveled to Germany in June through June 12 but an employee responsible for arranging accommodations inadvertently booked a hotel room through June 19th. Prior to his trip, Mr. Pe notified his employer of the mistake and was assured it would be corrected which it was not. The hotel, with a 30-day cancellation policy charged Mr. Pe for the extra seven nights and his agency refused to pay for the extra time, stating there was no provision in the FTR or other legal authority to permit payment of the time not required for official travel. The Board agreed the FTR did not contain specific provisions for the forfeited hotel rooms but stated the regulations provide generally an employee is expected to exercise due care in incurring expenses that a prudent person would exercise when travelling for personal business. Citing many case examples that decided due care was exercised (e.g. no show allowed when government needs changed, safety concerns, administrative error by travel office occurred, erroneous hotel address was provided).the Board ruled the travel arranger had erred and Mr. Pe acted prudently in advising her of the error *(CBCA 5031-TRAV)*.

Househunting Trip From Outside the US to Inside is Unallowable

For his transfer from Bogota, Columbia to San Diego the Army offered to reimburse Robert for a househunting trip for his wife as an incentive for him to accept the transfer. As stated in the FTR, househunting trips are authorized to "facilitate the employee's move" from old to new location and to lower government expenses by reducing the need for temporary housing. However, since the FTR 302.3(a) expressly limits eligibility for this allowance to a transferring employee for whom both the old

and new official stations are located within the US the Army denied the costs. Robert asserted he relied on the travel orders and incurred the expenses with the expectation of being reimbursed but the Board ruled against him stating it has recognized on numerous occasions that erroneous travel orders reflecting mistaken assumptions on the part of authorizing officials cannot obligate the government to expend monies contrary to regulation *(CBCA 5094-RELO).*

Air Force Reasonably Exercised its Discretion in Not Extending One-Year Limit to Sell Old House

Dustin sought reimbursement for real estate expenses after requesting a six-month extension over the one-year limit to sell his house at his old location. The JTR 5908-C.1 allows an employee one year to complete his real estate transaction where it is subject to an extension upon request and provided exigent circumstances prevented the employee from selling his house at the old duty station. The house was put on the market June 5, 2014 and listed for $95,000 where it stayed on the market until Sept. 29, 2014 when Dustin rented it out and stayed off the market until June 16, 2015 when it was relisted at a reduced price of $85,000 and sold and closed on Nov. 20, 2015. The Air Force refused reimbursement asserting "extenuating circumstances" did not prevent Dustin from selling his house during the initial first year but the major factor was his decision to rent it out. The Board sided with the government stating the Air Force reasonably exercised its discretion considering the house was off the market for much of the initial period *(CBCA 5155-RELO).*

Costs for Minor Repairs as a Condition of a Sale are Not Reimbursable

Per an agreement between the buyer and seller, Michael, the seller fixed several items identified in an inspection report such as repairing bathroom leaks, sealing a garage wall and repairing a furnace and billed the government $619 for these fixes. The government rejected these expenses asserting they were unallowable "maintenance" costs while Michael asserted these expenses were required for the sell and constituted "miscellaneous selling expenses." The FTR identifies such expenses as disconnecting and connecting appliances and utilities as well as "environmental testing and property inspection." The Board ruled against Michael stating the expenses were not those within the FTR such as testing or property inspection, required by a lender as a precondition of a sale or disconnecting appliances but the repairs were properly under the category of "maintenance" costs and hence not allowable miscellaneous costs *(CBCA 5332-RELO).*

"Customary" Closing Costs Paid by Seller are Allowable

The government rejected a claim of $9,000 for such items as "Adjustment Origination" and "Title and Lenders Insurance." Thomas submitted a comparative market analysis prepared by his realtor showing it is customary for sellers in his old neighborhood to pay up to 3% of the buyers closing costs. The Board sided with Thomas saying the realtor's analysis was adequate documentation showing such claimed costs were customary citing the FTR saying the seller of a residence is entitled to those costs that are "customarily charged to the seller of a residence in the locality of an old official station" (302-11.200) *(CBCA 5082-RELO).* In separate decisions, other closing costs for a "transfer fee" to a homeowners' association were also reimbursable as "customary expenses" *(CBCA 5015-RELO)* and the same with the buyers loan origination fees and attorney fees *(CBCA 4760-RELO).*

Remaining Period of Unexpired Lease are Reimbursable

Alphonso's family was renting a house for the period Nov. 2014 through Oct 2015 where four months before the termination of the lease he was transferred by the government. The terms of the lease prohibited subletting without the owner's permission and held the leasee responsible for rent under any expired term of the lease. The rent was $1,100 so he owed $4,400 on the remaining lease period and tried to get out of the lease but the owner refused where they negotiated an amount of $2,250. The Board sided with Alphonse ruling the conditions for reimbursement of unexpired lease expenses cited in FTR 302-11-7 were met (e.g. expenses can't be avoided, leasee provided timely notification) and hence allowed reimbursement of the $2,250 amount *(CBCA 5109-RELO).*

Purchase of Capital Assets are Not Reimbursable Moving Expenses

Austin chose to move his household goods himself rather than use the government's bill of lading (GBL). His agency paid for some of his expenses for doing so such as boxes, moving pads and blankets, fuel, etc. but rejected other expenses such as purchase of a trailer, hitch for the trailer and reconfiguring fuel pipe tank to accommodate the hitch. Citing sections of the FTR Austin asserted he was entitled to all his

expenses since they were less than the cost of the GBL while the government maintained they were improper. The Board sided with the government stating the term “expenses” is not as broad as Austin wanted. Expenses are considered to be for goods and services which are consumed or used up for the move not for “capital expenditures” to acquire assets that have a longer life of usefulness where these are not reimbursable. Citing cases that disallowed purchase of clothes bought to replace lost luggage or furniture to make inexpensive long-term quarters more habitable, the board ruled the expenditures were not reimbursable since Austin retained ownership of the assets *(CBCA 5414-RELO)*.

Date of Sale, Not Listing, Determines Allowability of Real Estate Expenses

William sought reimbursement for expenses related to the sale of his house after moving to his new duty station. The government denied $27,000 of his claim asserting he had listed the house with a broker before receiving notification of his transfer despite the fact the house sold after the notification. The government asserted that FTR 302-11.305 prohibited real estate transaction costs before officially being notified of his change in station assignment but the Board disagreed, stating even though the listing with the agent may have been unrelated to his move, the relevant date is when the sale is made, not listed which occurred here after official notification of his transfer *(CBCA 5265-RELO)*.

Financial Hardship is Grounds for Exceeding Time Limit for Home Purchase

Bradley told his agency he needed additional time to purchase a new house at his new duty station since he needed the delay until his spouse found a job and could consider the commute time for her. The agency refused the delay asserting the conditions described by Bradley did not constitute the type of extenuating circumstances that would justify the delay. In his arguments to the Board, Bradley asserted other justification stating the one-year time frame represented a financial hardship due to the delay of his wife finding a job because they did not know what they could afford until she found a job. The Board said that financial hardship represented the type of extenuating circumstance that could justify the delay and turned back the case to the agency for its reconsideration *(CBCA 5510-RELO)*.

No Reimbursement If International Flight Not Booked by US Carrier

American ambassador Makila flew from South Africa to Washington DC on South African Airways (SAA) where the Dept of State denied her claim for airfare of $1,180 asserting her purchase of the ticket did not comply with the Fly America Act (FAA). The FAA requires air travel between a place within the US and outside of the US be restricted to air carriers certified under Section 41102 unless a flight on a US carrier extended travel time by more than six hours or that service be provided under a “code share agreement” which basically provides for a US carrier to lease space on a foreign air carrier. Makila asserted the FAA was not violated because alternative flights by US carriers exceeded the six-hour period, SAA is a code share partner with a US carrier and that it relied on advice from the State Dept. management. The Board sided with the Dept of State asserting (1) that the flight ticket identified SAA, not a US carrier partner, and hence did not comply with FAA (2) the six hour extension applied only to “travel that is scheduled” where here she could have complied with FAA by arranging her flight on SAA to show a US flag carrier partner but did not (3) and that “lack of notice or even erroneous advice” does not change the fact that applicable statutes do not permit reimbursement for tickets issued by non-US flag carriers *(CBCA 5010-TRAV)*.

NEW CASE ADDRESSES PRIME’S RESPONSIBILITIES OF MANAGING ITS SUBCONTRACTORS

(Editor’s Note. The following case deserves greater attention than we could provide in the latest issue of the GCA REPORT since it addresses the hot topic of prime contractors’ responsibilities over its subcontractors. Prime contractors and higher tier subcontractors have long held certain responsibilities for the selection and management of their subcontractors where FAR clauses address such responsibilities and those clauses are flowed down to their subcontractors However, we have been reporting lately on the increasing tendency of DCAA and government agencies to impose more and more responsibility on prime contractors and upper tier subcontractors, whether it is audits of their proposals and invoices received, requiring submission of incurred cost proposals (ICPs) and validation of their direct and indirect costs. The following case will, hopefully put some brakes on those imposed responsibilities.)

DCAA Questions $103 million of Subcontract Costs

In audits of Lockheed Martin's incurred cost proposals (ICPs) DCAA questioned $103 million in subcontract costs for several time and material task orders under two contracts with the Defense Department. Of that amount $19 million was based on receipt of DCAA assist audits from 29 subcontractors based on "audit reports, audit memos or rate agreements" while $84 million was questioned because Lockheed Martin (LM) failed to (1) confirm subcontractor personnel qualifications through a resume review (2) confirm the accuracy of subcontractor invoiced hours through a timesheet review and (3) obtain subcontractor ICPs or contact the government if it was unable to obtain them. With respect to the last point, DCAA asserted no subcontract costs should be allowable without an incurred cost submission from the subcontractors and that several subcontractors had failed to provide the ICPs to LM. DCAA asserted prime contractors were required "to audit their subcontracts or request an audit assistance from the cognizant DCAA office when the subcontractors deny the prime contractor access to their records." As for the $19 million in questioned costs based on its assist audits, DCAA said LM should have accepted the results of the assist audits or at least negotiated access to specific audit results.

DCAA cited two provisions in defense of its questioned costs.

1. FAR 31.201.2, Determining allowability, "A costs is allowable only when the costs comply with the Terms of the Contract."

2. LM was in noncompliance with FAR 42.202, Assignment of Contract Administration which states "the prime contractor is responsible for managing its subcontractors." The failure to substantiate that resumes were in compliance with contract terms and times were reviewed to assure number of hours invoiced were supported justified questioning the costs. Further, the contractor did not provide any records demonstrating it attempted to cause the subcontractors to prepare adequate ICPs or that it requested the government for assistance if the subcontractor refused. DCAA reasoned that the absence of ICPs precluded the prime or DCAA from auditing the subcontract costs claimed. DCAA asserted that a "literal interpretation" of this FAR provision imposes an obligation for the prime contractor "to act on behalf of the government and serve as both the Contracting officer (CO) and the Contracting Administrative Office (ACO) for each subcontract it awards under a government flexibly price contract."

Lockheed Martin's Response

As for the $19 million in questioned costs, LM insisted it could not have gained access to audit reports where many of the subcontractors explicitly do not allow DCAA to disclose results since they contain competitive sensitive details. LM disputed the claim it should have gotten access to the assist audits. It stated its practice was not to collect ICPs since they are often generated at different levels of their organization where they are usually broad and contain proprietary information subcontractors do not want to disclose to LM, a potential competitor. However, it asserted its actions and internal controls are sufficient to preclude questioning its subcontractor costs. For example, it does flow down all applicable contract clauses and advises its subcontractors "of their responsibility to submit all applicable schedules to DCAA." LM stated that throughout the audit, it provided DCAA with its procedures which outline the measures it took to ensure subcontractors provide delivery of all services on time within budget. Further, LM demonstrated its internal controls for ensuring costs are allowable, allocable and reasonable in accordance with contract provisions was evidenced by extensive transaction testing of nearly 70 subcontractor invoices which documented that its subcontracts were awarded competitively, rate billings and contractual rates were verified and there was traceability between subcontractor incurred costs on the LM ledger and its billings to the government. LM said it appears as if DCAA ignored extensive audit evidence provided where their entire justification for questioning the costs was that LM did not produce subcontractor incurred costs claims. Finally, LM asserted there is no requirement in either the FAR or the DCAA Audit Manual for subcontractors to submit ICPs containing sensitive and proprietary business information directly where it is industry practice to make such submissions to the government for audit by DCAA.

DCAA responded to only LM's disagreement that its responsibility to manage its subcontractors included a responsibility to cause its subcontractors to provide it with ICPs and to audit the costs in them. DCAA cited FAR 42.201(a) that enumerated its responsibilities as "including the responsibilities to determine the allowability of costs suspended or disapproved, direct the suspension or disapproval of costs and approve final vouchers" where it concludes based on this section that "therefore, it was the government's intent to require the prime contractor

to act as both a CO and ACO." Notably this section does not involve the receipt or review of ICPs.

The CO issued a final decision based on the audit report, asserting LM failed to "properly maintain oversight of subcontractors" for alleged failure of 46 subcontractors to submit adequate ICPs to LM and LM's failure to audit or request audit assistance from DCAA and demanded payment of the $103 million.

Arguments of the Parties Before the Board

LM's Arguments. The dispute in this case focused on the FAR clause at 42.2. The appeals board addressed the government's assertion that LM breached its contractual duty under FAR 42.202(e)(2) to manage its subcontractors and it breached its contract by invoicing costs that are unallowable under FAR 31.201-2(a)(4) which provides that costs are allowable only when compliant with "...(4) Terms of the contract." LM states there was no breach of contract because the duty to manage subcontractors under FAR 42.202(e)(2) is a regulation dealing only with the government's administration of contracts and is not a term in any of the two contracts or task orders under them. Next, LM asserted that FAR 52.232-7(a), which was not cited by the government, not FAR 31.201-2 establishes the government's payment obligation under the two contracts to pay fixed hourly rates for direct labor where FAR 31.201 is not incorporated into the contract and hence could not have been breached. Finally, the government has failed to allege any causal relationship between the alleged breach and claimed damages where its alleged damages are the amount paid to LM for subcontractor labor but there is no allegation the services were not performed or that they were unacceptable. Rather the Army accepted the benefit of the services performed yet now seeks entitlement for all amounts it paid for the services without saying how the claimed damages resulted from the alleged breach.

The Government's Arguments. The government responded to these assertions saying LM billed the government for unallowable costs because it did not properly manage its subcontracts which is a duty established by FAR 42.202(e)(2). While it admitted that FAR 42.202 was not a contract term it contended "it was the government's intent to require the prime contractor to act both as contracting officer...and ACO." The government repeatedly stated that LM's poor management led it to overbill the government and its claim arises from an "inherent or implied" obligation. As for LM's claim that FAR 42.202(e)(2) does not require a prime to take responsibility for conducting ICP audits of its subcontractors, the government states the specific duties of responsibilities are varied and may include factors such as "how the prime chooses to perform the contract, its relationships with its subcontractors and the performance of those subcontractors." Notably, the government does not explain how or why specific duties it alleges LM did not perform are inherent duties of the prime. The government also argued that FAR 31.201-2 which addresses the "materials" component of T&M contracts also applies because a significant chunk of the questioned costs, including labor costs, were billed under the "materials" or "ODC" part of T&M provisions where those types of costs are covered by that FAR section.

ASBCA Decision

The Board ruled against the government and sided with LM.

1. It rejected the $19 million claim stating the government's position neither offers a "legal theory for its claim of disallowance nor does it provide any allegations of fact." The government said there were some questioned costs identified in assist audits but does not provide "a single actual fact" or an explanation of what grounds the costs were questioned.

2. As for the remaining $84 million, the Board ruled that FAR 42.202 was not incorporated into the contracts so it cannot be the basis for an assertion that the contract was breached.

3. It went on to state even if was incorporated, it did not impose the duties on prime contractors asserted by the government. So, for example, the alleged duty to review resumes or timesheets does not stem from FAR 42.202 but rather from FAR 52.232-7, Payments under T&M contracts. Under that clause there are certain requirements during contract performance such as substantiation of billings by evidence of actual payment, timecards or other approved substantiation at the time of billings or allows for an audit at the CO's request before final payment. The Board distinguishes between duties of the prime during contract performance under FAR 52.232-7 and those under FAR 42 where there are no such requirements. The Board rules the government has presented an invalid legal theory, improperly developed by a DCAA auditor, that the prime had a contractual duty to retain for purposes of incurred cost audits the same documentation that is used to substantiate its billings during the course of performance of the contract.

4. As for LM's alleged duty to cause its subcontractors to submit ICPs directly to LM and request audits from DCAA if subcontractors refuse, such duties are neither found in express terms of the contract nor are they found in FAR Parts 42 or 44.

5. The Board rejects DCAA's assertion that "a literal translation of FAR 42.202 requires the prime to act as both the CO and ACO for each subcontract it awards," where it ruled there is no such requirement under FAR Part 42. Further, there are clear differences in the roles of an ACO and the prime contractor. In examining FAR 42.202(e) the Board said normal contract administration of subcontracts is not the role of the ACO since it is the prime's responsibility to manage its subcontracts where the ACO's roles is usually limited to evaluating the prime's management of subcontracts under FAR Part 44, Subcontracting policies and procedures. FAR Part 44 does focus on the role of the ACO but it is limited – e.g. reviewing and consenting to the award of proposed subcontracts, when a contractor needs to obtain CO consent to a subcontract, etc. However, none of the subcontract clauses imposes any express responsibility on the prime to manage subcontracts after they are awarded. The Board rules that neither FAR Part 42 nor 44 impose any specific responsibilities on LM to manage its subcontracts because they are not incorporated by reference in the two contracts.

CONTRACTORS FACE CHALLENGES WITH THE NEW PAID SICK LEAVE RULES

(Editor's Note. The government has passed a revised rule implementing an executive order of the Obama Administration covering mandatory paid leave benefits for certain contractors. Despite Trump Administration actions to reverse some of Obama's executive orders, there is no actions being taken as of this writing to impact the new sick leave requirements. The following discussion incorporates an analysis made by Jennifer Plitshh and Jeff Bozman of Covington &Burling LLP written in the November 1, 2016 issue of Federal Contracts Report.)

The Labor Department released final regulations implementing Executive Order 13708 establishing mandatory paid sick leave for employees working on federal service, construction and concessions contracts, effective January 2017. The broad coverage of the rules are coextensive with the Service Contract Labor Standards (known as the Service Contracts Act or SCA) and Davis-Bacon Act. The issuance of the EO by the Obama Administration generated significant public comments where the Labor Department fortunately incorporated some changes to the proposed rules in its final rules issued Sept. 30, 2016 *(Fed. Reg. 67598).*

Many of the compliance issues discussed below are not obvious from the text of the rule. The rule is expected to involve several compliance issues and increased costs both from the rule itself (a maximum of seven days per year) and compliance complexity. The new rules will affect contractors already offering paid leave benefits, either through dedicated sick leave policy or part of a broader paid time off policy and those contractors who offer a fringe benefit package under the SCA requirements will need to recalculate the value of those packages after "backing out" the value of the 56 hours of paid sick leave under the EO.

Final DOL Rule Provides Some Relief

Some features of the final rule do ease some of the burden of the original EO. First, the Labor Department removed a provision that would have required successor contractors on contracts to reinstate unused sick leave for employees working on the predecessor contract. However, the preamble to the rule does state this provision may be revisited. Second, the final regulations explicitly state that its provisions do not include contracts that fall outside the scope of the SCA. The DOL declined to extend coverage requirements for paid sick leave on service contracts performed exclusively by bona fide executive, administrative or professional personnel who are not covered by the SCA. Contractors need to bear in mind that this change only affects contracts that are performed exclusively by these exempt "white collar" employee. When a contract is covered by the SCA the sick leave regulations will apply to all personnel working on the contract or in connection with the contract, including the exempt white collar employees.

Potentially Helpful Options for Compliance

Under several contexts, the regulations use a "trade-off' mechanism where contractors can avoid some compliance burdens in exchange for maximizing the amount of paid sick leave offered to covered workers. A trade off policy applies, for example, with respect to white collar employees for whom contractors have no obligations to track hours worked. Under the final rule, employees can calculate paid sick leave by either tracking those employees' actual hours worked or assume the employee works 40 hours

on or in connection with a covered contract in each work week and then give exempt employees the full amount of paid sick leave on that basis.

Trade offs also apply to the contractor's choice for tracking the amount of paid sick leave employees earn. The regulation specifies that an accrual rate of one hour of paid sick leave for each 30 hours worked. Instead of awarding the sick leave on this accrual basis, contractor may elect to front load the full amount of the paid sick leave of 56 hours at the beginning of each year. Doing this, however, may affect the total amount of sick leave an employee may have available for use at any given time. Contractors that award paid sick leave using the accrual method may cap the amount of sick leave available at 56 hours. Contractors that use the front loading method may not do so where their employees may accumulate a large pool of available hours.

For example, an employer using the front loading method may provide 56 hours of paid sick leave at the beginning of Year 1. The employer must then permit the employee to carry over into Year 2 any unused paid sick leave so if no leave is used in Year 1 she would begin Year 2 with 112 hours which is a larger pool of hours than she could accumulate under the accrual method.

The difference between the preamble to the regulation and the language of the text appear to be contradictory, especially for those contractors who have a paid sick leave policy allowing more than 56 hours.. The preamble explains that contractors using the front loading method may cap the carry over to 56 hours, effectively limiting employees to 112 hours. However, the language text clearly prohibits a usage cap for contractors using the front loading method. Contractors are warned to carefully examine their sick leave policies to make sure they do not offer more sick leave than the current regulations require.

Problematic Compliance Requirements

In spite of limiting obligations and offerings of trade off options, the regulation nonetheless require new obligations that increase costs and record keeping. Contractors must update their record keeping systems to track sick leave balances, employees' requests and documentation of "certifications" which employers may require if employees uses three or more days in a row. Contractors must also provide written notification of paid leave balances to each employee at the end of each payroll period or each month, whichever is more frequent.

The new rule also provides challenges to those contractors that include paid sick leave as part of a fringe benefit package for SCA-covered employees. The final rule stresses the principle that paid sick leave benefits cannot be used to meet fringe benefit obligations because the SCA prohibits contractors from claiming credits for benefits that are required by law which applies to these sick leave benefits. So for those contractors that do include sick leave as part of their SCA fringe benefit calculations they must back them out. For example, if a contractor currently includes paid sick leave as one of the benefits in a health and welfare fringe benefit package, it must subtract the value of those benefits from the package, at least to the extent the benefits are coterminous with the 56 hours required by the new rule. After doing so, the contractor will have to replenish the health and welfare benefits package with other equally valuable benefits or offer an equivalent cash payment in lieu of those benefits.

Considering the complexity of this process and the fact the new benefits have substantial value, the Labor Department is publishing a series of frequently asked questions and it plans to publish new health and welfare rates for SCA contractors who receive paid sick leave under the new rule. The new rate is expected to be lower than the current rate but so far they have not been published. At this time it is not clear how extensive these rate changes will be and whether they will change enough to offset the costs associated with the new rule.

ELEMENTS OF AN ADEQUATE COMPENSATION SYSTEM

(Editor's Note. Though executive compensation has been receiving extensive audit scrutiny in recent years (its consistently in the top three areas) auditors are increasingly reviewing non-executive positions where we are seeing significant questioned costs for these positions as well as assertions that contractors' compensation system is inadequate. Audit guidance on contractors' compensation practices has been extensively revised since we last visited this area 15 years ago where areas receiving most revisions are what constitutes an adequate compensation system and how to assess the reasonableness of compensation for various categories of employees. The effect of these changes is to expand the scope of compensation reviews at large contractors and initiate various types of reviews at mid-sized and even smaller contractors. Though we have addressed executive compensation in several prior articles in this one we

address what constitutes an "adequate compensation system," areas of review and what audit steps auditors are instructed to take. We recognize this article will be of interest to other functional areas of your organization (e.g. human resources, project management, business owners, etc.) so feel free to reproduce and distribute it to people you feel will benefit.)

What is an Adequate Compensation System

A compensation system is an inherent part of establishing reasonable compensation in accordance with FAR 31.205-6. In Chapter 5 of the DCAA Contract Audit Manual (DCAM) and its revised audit program (Audit Program for Reviewing and Reporting on Contractor Compensation System and Related Internal Controls), DCAA has elaborated on what it considers an adequate compensation system:

- **Organization Structure**

The contractor's pay administration function should be organized on the basis of a "definitive flow of authority". The contractor should define the lines of authority as well as the duties and responsibilities for administering the pay system and approving changes to cash and non-cash components of compensation. The guidance recognizes the compensation function can be organized very differently depending on the nature of products or services, size of organization, degree of centralization, management attitudes, etc.

- **Management Reviews**

Additions to the DCAM emphasize the need to adequately "monitor" the compensation system. The audit program incorporating this new emphasis stresses Management should conduct compliance reviews to be reasonably assured that (a) qualified employees are working on the compensation system (b) periodic training of these employees are conducted (c) policies and procedures exist and they are consistently followed (d) pay actions are properly authorized and approved and (e) compensation paid to employees is reasonable.

- **Policies and Procedures**

The contractor should have written policies and procedures as opposed to less formal "established custom" to ensure compensation for employees working on government contracts is reasonable. These written policies and procedures should address (a) an established wage and salary structure (b) a system of "internal equity" which includes job analysis, job descriptions and job evaluation (c) a system of "external equity" such as pay policy, relevant market, external pay surveys and market comparisons (d) a description of fringe benefits (e) a system for determining pay increases and promotions and (f) operations of performance procedures. Be aware that bonuses has become a very hot area of audit scrutiny and written policies and procedures need to be carefully crafted. The auditor is instructed to verify policies and procedures exist in these areas.

Recent Emphasis on Areas for Review

The DCAM indicates audits of the compensation system should be conducted at major contractors, non-major contractors "where the system is considered significant" and contractors with substantial firm-fixed price contracts. The evaluation of the compensation system and internal controls will be assessed separately and the results will be used to determine the scope of further review. There have been extensive changes to auditing specific elements of compensation. Covering reasonableness by job class of employees and use of offsets as well as costs of owners, executives and other "high risk" employees in closely held companies are of key importance and guidance includes the following:

- **Executives' Benefits**

The guidance stresses that executives may have enhanced or supplemental benefits not available to the majority of employees and their reasonableness should be evaluated against market surveys or other available data. The prevalence of such plans should also be considered. *(Editor's Note. Though DCAA, especially its dedicated compensation team in the Mid-Atlantic region, readily uses published salary surveys to benchmark "compensation" (e.g. salary and wages, bonuses) we see little benchmarking of supplemental benefits).* So, for example, just because a survey says long term incentive (LTI) pay is 10% of base salary, a 10% LTI plan would not necessarily be reasonable if only a small percentage of participating companies have LTI plans. The guidance also addresses specific types of supplemental benefit plans:

a. *Supplemental executive retirement plans (SERPs).* The guidance puts the burden on the contractor to document the reasonableness of SERPs (sometimes called ERISA excess plans) by using market data. If no measurable market data is provided, the auditor is to benchmark total pension compensation as a percent of base salary. If no data can be obtained, the auditor should question the costs.

b. *Deferred compensation.* This is defined as award given in future accounting period(s) for services rendered in one or more prior accounting periods

before receipt. Examples cited include split-dollar life insurance (a plan giving both the employer and employee an interest in a cash value life insurance on the employee's life) and rabbi trusts (a means to accumulate deferred compensation to usually fund a SERP).

c. Long-term incentive (LTI) plans. These are compensation plans having award periods of two or more years that are typically based on achieving some long-term business goals and are used to retain key executive talent. The guidance reminds auditors that the most common types of LTI plans are based on stock options which are unallowable.

d. Executive severance. Whereas most severance policies are based on years of service executives are awarded severance in excess of normal policies. The guidance warns contractors will often allude to employment contracts as justification for their higher severance but the employment contract does not necessarily support the amount as reasonable. Rather, comparable market surveys or other data benchmarking comparable executives should be used.

In addition auditors are reminded (1) "golden parachute" benefits are expressly unallowable (2) executive pay (salary, bonus and deferred compensation) should be compared to prior years and the auditor should obtain explanations and justification for significant increases, paying particular attention to whether the company's financial performance justifies the increases (3) executive pay components being evaluated should be consistent with that being reflected in surveys, noting that survey data usually combines base pay and cash bonuses and reflects long term incentive pay as a percent of base pay.

- **Non-Executive, Non-Bargaining Unit Employee Compensation**

Section 5-808 provides extensive guidance on how contractors should review pay for non-executives that are not covered by union contracts. Many of the changes are made to incorporate changes in FAR 31.205-6(b) that adds job class of employee to the previous measure of grade level to determine reasonableness of compensation. The guidance addresses the necessary reviews a contractor should take and the steps auditors need to take to ascertain whether they are taking appropriate action. Some of the highlights include:

1. Market comparisons. The company benchmarks wages and salaries of employees by job class or grade level and takes "corrective action" when levels exceed 10% of survey data. Market based pay takes precedence over internal considerations when valuing a job.

2. Management Review. Management reviews for adjusting pay structure including assumptions about inflation, changes in the job market, pay increases and merit increases as well as how reassignments of job additions or reslotting are made.

3. Internal Equity. Internal equity – equal pay for jobs of equal worth and acceptable pay differentials for jobs of unequal worth - is maintained.

4. Job Analysis and Descriptions. The section provides considerable material indicating a contractor should provide adequate job analysis and job descriptions. Job analysis is the process of obtaining relevant information about a job that relates to the nature of work and the level of skills needed. Using the data from job analysis, the contractor also needs to have job descriptions that describe the most important features of a job including duties and responsibilities, level of skill, effort, accountability and working conditions. Use of trained personnel are stressed.

5. Job Evaluation. Alluding to almost limitless ways to evaluate jobs, five methods are identified: (a) ranking (by worth or value) (b) classification (number of grades or levels specified beforehand) (c) slotting (putting new job descriptions into existing ones) (d) factor comparison (key factors such as skills or responsibility are identified and each job benchmarked according to the factors) and (e) point factor (similar to factor comparison but used for exempt jobs).

6. External Equity. Almost three pages of guidance covers general market comparisons and specific use of surveys to determine compensation reasonableness. Actual cash payments of compensation should be benchmarked against the labor market for the same job where practices of firms of the same size, industry, geographic area, primarily non-government work and comparable services are considered. In addition, supply and demand, competition for the skills and internal factors such as ability to pay, business strategy, productivity and skills of current work force are evaluated. The most important factors will vary depending on what is the relative importance in the relevant market.

External pay surveys provide the detailed data regarding market pay levels. The guidance recognizes the validity of private and contractor self-conducted surveys in addition to the traditional public surveys. Guidance indicates these latter two type of surveys

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can be useful by focusing on specific companies contractors must compete with for labor but auditors need to make sure they are reliable and unbiased. *(Editor's Note. If such private surveys provide higher pay results, the compensation team may discard them stating they are an "outlier" or, at best, may add them to their surveys and compute an average for all the surveys.)* Auditors are told that evaluation of choices of pay surveys should consider if (1) the survey provides specific job classification with corresponding job descriptions and duties (2) "maturity-curve" surveys are an acceptable alternative where surveys do not adequately measure professional, scientific or engineering jobs (3) well defined procedures detailing criteria to use (e.g. geographic location, company size, industry type) and (4) weighted average rates by job are provided that also should include minimum/maximum and/or percentile or quartile data.

- **Review of Employee Benefit Programs**

Common benefits include health and life insurance, pensions, worker's compensation, pay for time off, etc. Though each element should not be unreasonable, auditors will focus on the total benefits package. Policies should include (1) identifying contractors' objective in setting the package (2) eligibility requirements for various benefits (3) flexibility in plan coverage (e.g. "cafeteria-style" plans) and (4) the method of financing (e.g. contributory, employee financing). The guidance adds that each element should comply with FAR 31.205-6(m) and the total compensation package including cash compensation and fringe benefits must be reasonable in accordance with FAR 31.205-6(b).

When Deficiencies are Found

When the auditor has determined that there are sufficient internal control deficiencies to preclude an assessment that wages and salaries are reasonable the auditor must take other steps depending on the nature of the deficiencies. When there are system deficiencies that are not severe enough to prevent a demonstration of reasonableness then normal audit steps (e.g. comparison of wage and salary levels against surveys) will be taken to determine independently whether compensation is reasonable. In addition an action plan will be adopted. If the deficiencies are considered serious enough to prevent a demonstration of reasonableness the normal audit steps will not begin and the focus will be put on "fixing" the deficiencies. The contractor will be asked to prepare a time phased corrective action plan. Auditors are instructed to consult with the Administrative Contracting Officer to determine if other steps should be taken (e.g. contract billing withholds).

INDEX

Knowing Your Cost Principles…
BID AND PROPOSAL COSTS 1

RECENT TRAVEL AND RELOCATION
COST DEVELOPMENTS 2

NEW CASE ADDRESSES PRIME'S
RESPONSIBILITIES OF MANAGING ITS
SUBCONTRACTORS 5

CONTRACTORS FACE CHALLENGES WITH
THE NEW PAID SICK LEAVE RULES........ 8
ELEMENTS OF AN ADEQUATE

COMPENSATION SYSTEM 9

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