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GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

(Editor's Note. We were very happy to see that the accounting firm, Grant Thorton, has resumed publishing its Annual Government Contractor Industry Survey that benchmarks both federal services and supply federal contractors. The latest survey is for 2015 and provides a variety of very useful financial and contracting information. You can find the complete survey now at their website rather than paying the $1,000 fee we used to pay.)

Company Profile

48% of the surveyed companies are classified as large and 52% as small where 15% had sales less than $10M, 33% between $11M-50M, 36% between $51M-150M and 16% over $150M. 66% of surveyed companies sell professional services – consulting, IT, research, engineering, general business services, science and technology, training and education, other services - while 18% sell products and 16% receive their revenue from pass through transactions. Most said their primary customer is the federal government. 40% of their revenue came from the Defense Department, 34% from other federal agencies, 8% came from state and local government and 18% was commercial. The survey shows government business trends are lower where 42% of respondents had increased revenue over the prior year (36% in 2013, over 50% the prior three years), 21% had no significant change while 37% had reductions (compared to 38% in 2013 and an average of 25% the prior three years). Revenue from GSA or other IDIQ contracts increased for 45% of respondents, decreased 14% and 41% saw no change. Revenue from cost reimbursable contracts was 34% (down from 40-46% the prior 5 years), 33% from time and material contracts and 33% from fixed price contracts (up from 20% the last five years). We are seeing a shift upward in expected revenue growth over the next 18 months where 69% of surveyed company said they expect to see increases coming from federal prime contracts, 57% are expecting increases in federal government subcontract work while 20% expect increases from state and local government and 31% from the commercial sector.

Employee Trends

59% of respondents report an increase in number of employees (significant increase), 15% report a decrease (significant decrease) and 26% report no change. Wage increases ranged from 0 to 9% where the median response was 2%.

Indirect Headcount Breakdown

12.5% of total headcount is represented by management and support functions. There is an overall downward trend over the last several years which is attributed to more outsourcing of support services such as HR, legal, internal audit, contract compliance as well as some larger contracts allow for direct billing of normal indirect support costs. The breakdown of certain functions are finance and accounting (2.9%), contract and procurement administration (1.7%), sales and marketing (2.1%) and other indirect (5.8Government Contracts

Feet. Though fees were not tracked this year, the results for prior periods are pretty consistent from year to year where average negotiated fees for cost type contracts was 6-7%, T&M contracts had an average of 8-9% while firm fixed contracts had 9-10%. It should be noted that these negotiated profit rates are computed after deducting unallowable costs and before income taxes so actual profit rates are lower than negotiated rates.

Proposal Win Rates. Surveyed companies stated their win rate on non-sole source proposals was 35% and jumped 75% when they were the incumbent which was significantly higher than prior years. Win rates when either a special business unit or joint ventures were created was 64%, again higher than prior years.

Bid and Proposal costs as a Percent of Revenue. 15% reported less than 1%, 52% 1-2% while 33% reported greater amounts.

Claims and Terminations. Identifying out of scope work, whether it comes from an easy to recognize direct change or sometimes difficult to recognize constructive changes, provides an important opportunity to receive additional entitled revenue. 33% of the respondents said their procedures for recognizing out of scope work are very effective, 44% said somewhat effective and 23% said not

effective. 78% of respondents said the government requests out-of-scope work either occasionally or frequently without issuing contract mods. 23% of respondents who have performed out-of-scope work indicate they have filed either requests for price adjustments and/or claims indicating the majority of firms are performing out-of-scope work without compensation. The authors assert this high level partially explains the lower profit levels discussed below. As for terminations for convenience the survey found that 23% of all respondents had a contract terminated for convenience in recent times where 24% submitted a settlement proposal while 76% did not. As for partial terminations, where an increase in contract price is usually justified due to allocating fixed or semi-fixed costs over a smaller base, 18% of those experiencing a partial termination actually negotiated a price adjustment on continuing work while 82% did not.

Contractor Business Systems. The survey notes recent changes to contractors either fully or modified CAS covered are now subject to audits of six business systems (cost accounting, EVMS, estimating, purchasing, material management and accounting and property management) where future surveys will focus on results of these audits. For now, the survey found that 30% of respondents had already undergone at least one of these audits and that 29% said they had made improvements to their business systems in order to comply with these new rules. 71% of the respondents said they have undergone an accounting system audit.

Financial and Cost Statistics

Profit. Contrary to common public perceptions, government contracting does not generate abnormally high profits where the survey defines it as profit before interest and taxes as a percent of revenue. Profit rates appear to be plunging compared with prior years where 7% reported no profit, 45% reported 1-5% profit, 39% reported 6-10%, 7% had 10-15% and 2% had profit over 15%.

Indirect Cost Rate Trends. Indirect cost rates are increasing at 26% of companies while 42% are decreasing.

Fringe Benefit Rates. Fringe benefit pools consist of payroll taxes, paid time off, health benefits and retirement benefits (some include bonuses while others do not). Fringe benefit rates as a percentage of total labor averaged 37% when bonuses were included and 36% when excluded which is an increase from last year.

Overhead Rates. These costs are considered to be in support of direct staff working directly on contracts and hence are normally allocated as a percentage of direct labor costs. Some companies include fringe benefits associated with direct labor in the direct labor base while others do not – the result when they do is to lower overhead rates. Average overhead rates are as follows: (a) on-site direct labor (on-site means performed at company sites) - 77% compared to 84% in 2013 (b) on site direct labor and fringes – 36% compared to 43% in 2013 (c) off-site direct labor – 49% as opposed to 38% in 2013 last year (off-site is lower because facility related costs are normally borne by the customer at their facilities) (d) off-site direct labor and fringes – 20% compared to 21% last year. When companies used multiple overhead rates logic used for them were location (53%), labor function (15%), customer (24%) and products versus services (8%).

G&A Rates. The survey states that general and administrative rates are typically those incurred at the headquarters and include executives, accounting and finance, legal, contract administration, human resources and sales and marketing as well as IR&D and bid and proposal costs. G&A costs are most often allocated to contracts on total cost input (direct operating costs, overhead, material, subcontracts) or a value added base that generally includes all the above costs except material and/or subcontracts. Average G&A rates under a total cost input base was 13% (12% in 2013) while those using a value added cost input was 17% (15.4% in 2013).

Material handling and subcontract administration costs. 29% of surveyed companies used a material handling and or subcontract administration rate as a burden chargeable on direct material and subcontract costs (higher than previous years). The survey notes that in service industries a handling rate is established in conjunction with use of a value added G&A base to reduce burden applied to pass-through subcontract and material costs. Average material handling rate was 3.0 and subcontract handling rate was 3.0%.

Labor multipliers. Multipliers, a term commonly found in the commercial world, are fully loaded labor multipliers used to price out work and are derived by dividing total burdened labor cost by base labor cost. The average labor multiplier was 2.3 for on-site work and 1.8 for off-site work. Almost all respondents expressed a belief their labor multipliers were competitive with their industry. It should be pointed out that the labor multipliers are overall averages where many companies commonly use different multipliers for different markets.

Uncompensated overtime. (Editor's Note. Uncompensated overtime refers to hours worked exceeding the normal 40 hour work week by those salaried employees exempt from the Fair Labor Standards Act.) 63% of respondents said their employees work uncompensated overtime (UOT) while 37% said no. 82% of the companies working UOT use total time reporting while the other 18% report

only 40 hours per week. 75% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 25% use a "standard/variance method" that charges an hourly standard rate and then credits an indirect cost pool for the difference between labor costs charged to projects.

Charging Subcontractor hours on T&M contracts. We have frequently reported on new regulations that provide that subcontract labor can be charged at fixed rates provided in the prime contract as opposed to the older way of simply billing subcontractor costs plus applicable prime indirect rates. 89% of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract or subcontract (substantial increase) while 11% bill on a cost reimbursable basis (i.e. as an ODC). This change has led to a different audit focus from merely auditing hours charged to ensuring labor skills being billed meet contract requirements where 73%of respondents state their procedures for properly assigning employees to labor categories are effective while 27% state they are either somewhat effective or not at all.

Medical Expenses. Despite widespread concerns about health care cost increases, most contractors have apparently not made any changes to health coverage. In response to questions asking what percent of health benefits are paid by the company the survey results were: 5% reported the company pays for less than half, 12% pays 51-60%, 20% pay 61-70%. 36% pay 71-80%, 9% pay 81-90% and 18% pay 91-100%. With respect to health costs as a percentage of labor costs, the median range is 7.1-8% compared to 9.1-10% last year. 17% of respondents incurred health costs less than 4% of labor costs (significant increase over most five years), 12% between 4.1-5%, 4% between 5.1-6%, 7% between 6.1-7%, 13% between 7.1-8%, 5% between 8.1-9%, 12% between 9.1-10% and 39% over 10% of labor costs. As for effects of the Affordable Health Care Act, 46% of respondents said health care costs had increased significantly while 54% reported no major change

Dealing with the Government

The Defense Contract Audit Agency, because of their Defense Department contracts or contracts with other agencies that use the audit agency, audits most of the contractors in the survey. Regarding the respondents' opinions of DCAA audits, 57% say auditors' opinions are substantiated with appropriate references and 43% are arbitrary and not substantiated while 67% of auditors are open-minded and receptive to contractor rebuttals (substantial increase) and 33% say auditors are inflexible and are rarely receptive. Contracting officers receive lower ratings where 51% of their opinions are considered substantiated with references and 49% are arbitrary while 55% are open-minded and receptive and 45% are not. When asked if their relationship with DCAA has changed, 71% said it had stayed the same, 19% reported the relationship had worsened (compared to 2% in 2013) while 10% said it had improved. In an effort to measure the quality of relationships with ACOs and DCAA, the survey found 45% of respondents resolve issues efficiently where the remaining 55% say the government was inefficient where 38% say they believe DCAA is the primary cause for delays of resolving issues while 17% believe it is the ACO. The most frequent types of costs questioned by DCAA are executive compensation (21%), consultant costs (11%), incentive compensation (21%), labor charging (10%) and indirect cost allocations (10%). Most frequently cited violations of cost accounting standards, which has substantially dropped, were CAS 403, home office expenses (1%) and CAS 405, Unallowable costs (3%, compared to 4% last year). Costs questioned as a percent of revenue were less than 1% of revenue (72%), 1% of revenue (13%), 2% of revenue (7%), 3% of revenue (1%), 4% of revenue (1%) and 5% or more of revenue (5%). Of those companies experiencing audit issues, 36% were very satisfied with the resolution of the issues, 53% were somewhat satisfied and 11% were not satisfied.

Executive Compensation

(Editor's Note. Care should be used if our readers consider substituting the following results for a bona fide compensation survey where sometimes hundreds of firms are surveyed. However, the results shown below are interesting.) Surveyed companies provided information on the four highest paid executives in the company and the results are presented by company size measured by revenue for 25th, median and 75th percentiles. The following is a summary of the results.

Highest Position (in thousands)

Revenue	25%	Med.	75%
$0-10 M	200	280	410
$11-50M	280	350	545
$51-150M	450	680	875
>$150M	725	980	1,250

Second Highest Position

Revenue	25%	Med.	75%
$0-10 M	140	234	280
$11-50M	200	260	337
$51-150M	325	450	525
$>$150M	380	590	750

Third Highest Position

Revenue	25%	Med.	75%
$0-10 M	120	160	240
$11-50M	165	210	290
$51-150M	275	380	475
>$150M	380	590	750

Fourth Highest Position

$0-10 M	100	130	190
$11-50M	140	175	250
$51-150M	210	325	420
>$150M	290	460	580

Companies whose executive compensation was challenged by DCAA and provided rebuttals and/or additional information state 40% of their positions were sustained, 45% stated a reasonable compromise was achieved and 15% stated DCAA's position was unreasonable.

REVIEW OF 2016 PROCUREMENT AND COSTING ISSUES

(Editor's Note. Though we usually summarize prior year important cases affecting contractors at this time of year, we decided to, instead, summarize recent new rule changes since there were so many passed in 2016, some of which were reported in the prior year's GCA REPORT. We plan on addressing important 2016 cases in the next issue. The source of this article is the January 2017 Briefing Papers written by Michael Schaengold and Miki Sager.)

Amendments to certain Sections 820-893 41 U.S.C.A include:

Expand Government Technical Data Rights (Sec 809). The US government will have government purpose rights in technical data pertaining to a major system for items or processes developed in part with federal funds and in part at private expense. DOD may now negotiate rights that extend beyond the government purpose rights if it is determined to be in the government's best interest. The new rule revises the current provision the US may have government purpose rights in technical data if developed exclusively at private expense.

Restriction on Undefinized Contracts (Sec 811). No undefinitized contract action may now extend beyond 90 days without written determination of the Secretary of the military department.

Lowest Price/Technically Acceptable Source Selection (Sec 813). It is now DOD policy to avoid using LPTA source selection criteria if it would deny it the benefits of cost and technical tradeoffs in selecting an awardee. LPTAs may be used only in situations where six factors exist such as minimum requirements can be clearly described, DOD would receive no or minimal value from exceeding minimal technical requirements, the CO has established written justification for LPTA evaluation and the CO has determined the lowest price reflects full life-cycle costs including operations and support.

Cost Accounting Standards (Sec 820). A new rule has established certain duties of the Cost Accounting Standards Board such as relying on commercial standards and accounting practices to the maximum extent possible, that CAS conforms to generally accepted accounting principles and minimizes the burden on contractors while protecting the interests of the government. A Defense CAS Board is established to review CAS and recommend changes to the non-Defense CASB. It is unclear at this time whether either of the boards can implement its own sets of cost accounting standards. Also, DOD contractors and DCAA must accept, without performing additional audits, a summary of audit findings prepared by a commercial auditor if the auditor previously performed an audit of allowability of costs and allocation of indirect costs and that relevant commercial auditing standards were followed. DCAA may still audit direct costs or if there is "a predominance" of cost type contracts as a percent of sales, they may audit both direct and indirect costs.

Increased Micro-Purchase Threshold (Sec 821). The micro-purchases threshold for DOD procurements has been increased to $5,000 where $3,500 still applies to non-DOD agencies and non-construction acquisitions. Micro-purchases do not require most FAR clauses and competition is not required if the purchaser considers price reasonableness.

Enhanced Competition (Sec 822). Circumstances for when an offeror for a prime contract must submit cost or pricing data before award has been narrowed. Whereas before submission of cost or pricing data was required for procurements other than seal bidding exceeding $500,000 now limits the requirement only to those procurements which have the expectation that only one bid will be received. Also, certified cost or pricing data will not be required when a contract, subcontract or modification for which the price agreed upon is based on adequate competition that results in two or more responsive bids. In addition, the rule clarifies the role of a prime contractor determining whether a subcontract is exempt from submitting cost or pricing data if there was adequate competition resulting in two or more bids or the acquisition was for commercial items. Though the change places greater responsibility on the prime contractor, the government still reserves the right for reviewing prime contractors' determinations.

Treatment of Bid and Proposal Costs (Sec 824). B&P costs must now be separately identifiable from IR&D costs. The DOD Secretary is also required to establish a goal of

limiting the amount of B&P costs it pays to one percent of total aggregate industry sales to DOD.

Exception to Considering Price as a Factor in Award of Multiple Award Contracts (Sec 825). When an agency issues a solicitation for multiple task or delivery order contracts for the same or similar services and intends to make a contract award to each qualified offeror cost or price to the government need not, at the government's discretion, be considered as an evaluation factor. Under such circumstances, cost or price will be a consideration in awards of task or delivery orders under such contracts. This provision does not apply to sole source contracts under the 8(a) program.

DOD Preference for Fixed Price Contracts (Sec 829). The DFARS is to be revised to establish a preference for fixed-price contracts, including fixed price incentive fee contracts, in determining contract type. Use of cost type contracts must be approved by one level above the CO, contractors' accounting systems must be adequate to determine contract costs and adequate government resources exist to manage the contract. In addition, the section establishes a preference for performance-based contracting whenever practicable (i.e. payment when pre-established milestones are performed).

Commercial Item Changes. Recent changes have focused much attention on acquisition of commercial items. Notable provisions include: (1) emphasizes the requirement to conduct market research where the offeror is required to submit relevant information (Sec 871) (2) expanded information a contractor may submit for determining price reasonableness for major weapon systems or components as commercial items where prior information focused mostly on historic pricing data now other means of demonstrating a value analysis is allowed (Sec 872) (3) ensures that commercial or non-government specifications and standards are used in lieu of military specs and standards unless there is no alternative to meet its needs (Sec. 873) (4) ensure DOD fully complies with guidance to ensure a preference for commercial items is present and that appropriate market research is conducted (Sec 876) and (5) authorizes establishing a Defense pilot program authorizing a military secretary acquire innovative commercial items, technologies and services on a fixed price basis using competitive selection (Sec 879) while similar pilot programs are authorized for the Dept. of Homeland Security and the General Services Administration (Sec 880).

Authority to Provide Reimbursable Auditing Services to Non-Defense Agencies. Permission for DCAA to provide its audit services to the Dept. of Energy is re-established (Sec. 893).

Fair Pay & Safe Workplace. In August 2016 the FAR Council published a final rule implementing Pres. Obama's Executive Order No. 13673 when the night before it was to be effective the US District Court issued a preliminary injunction enjoining most of the final rule and related Labor Dept. guidance. The rule would have created a new FAR section and clauses requiring an offeror for any solicitation exceeding $500,000 to represent whether it has any administrative merit determinations, arbitral awards or decisions or civil judgments rendered against it for violations of 14 listed labor laws in the previous three years. The final rule's new paycheck reporting requirements and complaint and dispute transparency requirements were not enjoined and hence were effective Oct. 25, 2016. On March 6, 2017 the Senate approved a measure nullifying the FAR rule.

Limitation on Allowable Compensation Costs. The FAR Council finalized a previous interim rule capping the allowability of compensation for all contractor employees (not just executives) at the benchmark amount set by Congress in the Bipartisan Budget Act at $487,000. The cap covers all compensation – total amount of wages, salary, bonuses, deferred compensation and employer contributions to defined contributions pension plans. The final rule allows exceptions approved by agency heads to allow for "narrowly targeted" scientists, engineers or other specialists *(Fed. Reg. 67778).*

IR&D Costs. DOD issued a final rule requiring contractors to have "technical exchanges" with the Pentagon before being allowed to generate independent research and development costs. To be allowable, major contractors (defined as those whose covered segments allocated more than $11 million in IR&D and bid and proposal costs to covered contracts in the previous year) must report annually to DOD with copies to the ACO and DCAA regarding ongoing and completed IR&D projects and communicate proposed IR&D efforts to appropriate DOD personnel by means of "technical exchanges" before any proposed new IR&D costs are generated *(Fed. Reg. 78008).*

GSA-Transactional Data Reporting. The General Services Administration issued a final report requiring its contract holders (FSS and non-FSS) to report certain transactional data related to government orders. Under a new GSAR clause, contractors are required, on a monthly basis, to report 11 separate elements of data including the unit measure, quantity of items sold, Universal Product Codes, prices paid per unit and total price *(Fed. Reg. 41103).*

SBA – Mentor-Protégé Program Expansion. The Small Business Administration issued a final rule expanding mentor/protégé joint venture opportunities through all

SBA contracting programs for small businesses. The standards for being a mentor are the same as for the 8(a) mentor/protégé program but the qualification to be a protégé has been significantly changed. The rule allows firms to qualify as protégés as long as they qualify as small under a primary NAICS code while the rule further allows protégés to qualify under a secondary NAICS code as long as it is a logical progression for the firm. A new web portal, programs agreements and training requirements were issued *(Fed. Reg. 48558).*

SBA – Limitation on Subcontracting. The SBA issued a final rule changing the methodology for calculating the amount of work that must be performed by a small business prime contractor under a set-aside contract, commonly known as the limitation on subcontracting or the 50% rule. The new rule requires prime contractors under small business set-aside contracts to agree that they will not pay more than a certain percentage of the amount they receive from the government to subcontractors. The percentage is 50% for services and supply contracts and 85% for construction. The substance of the limitation has not changed but a new methodology focuses on the amount paid to subcontractors rather than the prior method that required a calculation of the percentage of contract costs incurred by the prime and its subcontractors. The new rule also relaxes performance requirements by effectively allowing them to count work performed by "similarly situated entities" as their own work. Thus if a prime contractor performs 35% of the work and one of its small business subcontractors perform 15% of the work, the prime will have met its limitation of subcontracting *(Fed. Reg. 34243).*

DOL – Paid Sick Leave. The Dept. of Labor issued a final rule implementing Executive Order 13796 which requires covered contractors to allow covered employees to accrue at least one hour of paid sick leave for every 30 hours worked in connection with its covered contract, subcontract or other contracting vehicles (those covered by the Service Contract Act, Davis Bacon or Fair Labor Standards Act (FSLA). The accrual rate works out to be 56 hours per year for 40 hours per week (we have written in depth on this in the last issue of the DIGEST) *(Fed. Reg. 67598).*

DOL – "White Collar" Minimum Wage and Overtime Pay Exemption. The DOL issued a final rule modifying the white collar employee exemption of the Federal Labor Standards Act minimum wage and overtime pay requirements where the final rule significantly increased the salary thresholds at which employees would qualify for the exemption on overtime pay. The salary threshold for which employees would qualify went from $455 a week to $913 a week (or $47,476 per year). The rule automatically updates compensation thresholds and allows certain nondiscretionary bonuses, incentive pay and commissions to count toward the threshold. The changes will mean more employees will be covered by the Service Contract Act while less employees will be covered by uncompensated overtime rules. Prior to the effective date of the new rule, the US District Court issues a preliminary injunction enjoining implementation so as of now the status quo remains in effect *(Fed. Reg. 3239).*

SBA – Rule of Two Rule. Following the Supreme Court ruling in Kingdomware Technologies V US the Veterans Administration issued a memo emphasizing the need to comply with the "rule of two" on all awards including task and delivery orders. The rule of two provides that COs will award set aside contracts to veteran owned small businesses if there is a reasonable expectation that two or more such firms will be competing for the award and their proposed prices are fair and reasonable. Afterward, the SBA issued guidance the memo should apply government-wide to all contracts and task orders above the simplified acquisition threshold where now the General Services Administration is disputing the expansion saying it should be limited to only VA acquisitions.

Treasury – Interest Rates. For the period beginning July 2016 and ending Dec. 31, 2016, the Treasury Dept. lowered the prompt payment interest rate from 2.5% for the prior six months to 1.875% per year. For the first six months of 2017, the rate is 2.5% *(Fed. Reg. 910).*

Knowing Your Cost Principles…

CONTINGENCY TYPE COSTS

(Editor's Note. In recent times, many contractors have been taking a more aggressive approach at including contingency type costs in their forward pricing proposals where there has been considerable pushback by auditors (especially audits conducted by CPA firms). While it is often prudent to include a "contingency factor" when pricing commercial contracts, the pricing of government contracts significantly limits such practices, particularly when cost estimates are used for pricing purposes. As part of our continuing series of examining different types of costs, we thought it would be useful to discuss the allowability and allocability of "contingency type" costs. Our sources includes several texts including Mathew Benders "Accounting for Government Contracts" as well as our experience as former DCAA auditors and our current role as consultants.)

General Comments

Contingent costs are initially unrealized costs. They are costs that may or may not actually be incurred in the

future. Examples of contingent expenses are service costs, warranty costs, insurance, indemnification and bonding costs as well as potential lawsuit liabilities. FAR 31.205-7 addresses "contingencies" as a generic cost and defines it as a possible future event or condition arising from presently known or unknown causes, the outcome of which is presently indeterminable.

Allowability. FAR 31.205-7(b) provides that contingency costs are generally unallowable for historical costing purposes because such costs deal with costs incurred and recorded in contractors' books of accounts. It does provide for exceptions to this rule citing terminations costs as an example. Inclusion of contingency costs in claims and even incurred costs submittals as well as termination settlement proposals may be appropriate if they involve "minor unsettled factors in the interest of expediting settlement."

Certain contingency costs are generally allowable for purposes of making cost projections for proposals for either cost type or fixed price work. The FAR follows generally accepted accounting practices in distinguishing between two categories of contingency costs. The first category consists of contingencies that arise from presently known and existing conditions whose effects are reasonably foreseeable. Common examples of such costs are anticipated costs of rejects or defective work where costs of salvage and rework can be included in cost estimates. The Board of Contract Appeals has overturned challenges to use of a factor for warranty costs on the grounds they could be known based on exiting conditions (ASBCA No 12538). Historical data are usually relied on – so, for example, rejects occurring on similar contracts or provision of similar goods and services can be known and used as a basis for estimating the costs of rejects on the current contract.

The second category consists of contingencies that arise from conditions either known or unknown but whose effect cannot be sufficiently measured to provide equitable results to either the contractor or the government. Most lawsuits are considered examples of this second category where they are excluded from routine cost estimates. If inclusion of the contingency costs are included in cost estimates, the burden falls on the contractor to demonstrate they are of the first category. Also, though the second category of costs are excluded from routine cost estimates they may be separately estimated to negotiate an appropriate contractual coverage of costs (e.g. contract re-opener clause) though such action is usually a tough sell.

Service and Warranty Costs

Service costs arise from contractual obligations to provide, for example, installation and training. When not considered inconsistent with contract terms, these costs are allowable. Warranty costs resulting from contractual provisions to correct product defects, replace defective parts and make refunds in the event of inadequate performance is allowable. You should expect to receive audit scrutiny to provide assurance that "double counting" is not occurring where there is a duplication of recovery first as a cost of production and then as a separate cost. For example, production cost estimates should exclude service costs from the production cost history when the proposal estimates separate service costs.

Service and warranty costs can be a direct contract charge, indirect period cost or an indirect cost allocated on a reserve basis. As a direct charge, the cost must be included in the contract cost estimate as another direct cost and then allocated specifically to that contract. As an indirect period cost, the costs of all warranties are estimated for the period and included in the appropriate indirect cost pool. As actual costs are incurred, the costs are associated with the same cost pool. As an indirect cost allocated on a reserve basis, the estimated annual costs are either charged directly to cost objectives or to an indirect cost pool with a corresponding credit to a reserve for warranties. When actual costs are incurred, the charge is made to the reserve account.

When evaluating proposals, auditors can be expected to verify that a warranty was either requested by the contract solicitation or required by regulation. Auditors commonly check for inconsistencies between government and commercial product warranties, examine historical warranty cost data, try to identify trends that might have an impact on future warranty costs and review historical costs to assure that product and warranty costs have been segregated. To assure there is an equitable allocation auditors also review warranty costs by product line to determine the relationship between the costs and the government purchases.

In 1983 Congress passed legislation to require extensive use of warranties in purchasing weapon systems. Before 1983 warranty provisions were generally limited to other than cost type contracts and DOD still holds this position. Because of the problems in estimating and negotiating warranty costs many fixed price contracts still do not contain warranties, reasoning that the cost is too great to be justified by the benefit.

Insurance and Indemnification

Though we plan on addressing insurance costs in considerable depth in the future we thought we would provide some summary information in this section since

insurance costs are an important subset of contingency costs. Allowability criteria are as follows:

1. Self insurance plans need to meet the requirements of CAS 416 as well as the administrative requirements established by FAR 28. The self insurance costs plus administrative expenses of the program cannot exceed the cost of purchased insurance when it is available. Self insurance for catastrophic losses is not allowable.

2. Costs of insurance related to the general conduct of business is allowable with certain exceptions. The type of coverage must follow sound business practices common in the industry and the cost must be "reasonable."

3. Business interruption insurance premiums are allowable except for any portion that provides for coverage for loss of profits.

4. Life insurance on company officers is considered additional compensation when the policy names another officer as a beneficiary. If the company is the beneficiary, the costs are unallowable.

5. If insurance coverage exists for a particular occurrence the contractor must seek recovery on the insurance rather than indemnification from the government.

6. We have often seen the government attempt to challenge the cost of professional liability insurance by arguing the government work does not subject a company to liability suits or the government indemnifies contractors for legitimate claims. In other circumstances, the government may not challenge the allowability of the costs but will challenge the allocability of the costs to government contracts. Though auditors are required to compare the commercial and government work to ensure the relative risk is similar, we believe questioned costs based on either allowability or allocability should usually be challenged.

7. Since insurance premiums are reimbursed by the government, actual losses are generally not allowable unless they are (a) expressly provided for in the contract (b) nominal deductibles not covered by purchased insurance policies or (c) minor loses that occur in the ordinary course of business and are not normally covered by insurance (e.g. spoilage, breakage).

8. The costs of insurance protecting against contractor defects are unallowable except for casualty losses (e.g. fires, floods). The rationale is the government does not want to pay to insure against the contractor's own poor performance – it expects to obtain a quality product or service for the price paid.

Bonding Costs

Bonding costs occur when the government requires assurance against financial loss to itself or to others due to an act of default by a contractor. In addition, a contractor may require similar assurances from subcontractors. These bonds which include bid performance, payment, advanced payment, infringement and fidelity bonds are generally allowable if required by the contract or if required by the general conduct of the business.

Case Study…

RESPONSE TO IG'S QUESTIONING OF INDIRECT COSTS

(Editor's Note. We are finding a proliferation of different contract vehicles today such as grants, other transaction authority contracts, etc. They have unique features (e.g. terms and conditions, contract type not identified), different sets of applicable regulations (e.g. OMB Circular A-87) and often different sets of auditors like private CPA firms and Inspector General Offices that have their own peculiar perspective on contracting and accounting rules. The following is a highly edited version of a response to an IG audit report we were asked to provide and is intended to highlight some of the issues that arise from use of these unique contracting vehicles. Our client is referred to as "Contractor" and we have disguised the actors and data.)

The IG audit reports for four years concluded that Contractor did not comply with the requirements of its NASA grant to submit an indirect cost rate proposal (ICRP) to be able to charge its indirect cost rates during contract performance,. The audit reports assert that Contractor "charged" the government too much since the final indirect cost rates used were different than the minimum default rate of 7% ("default rate") the Grant's terms and condition allowed. The audit reports questioned specifically all indirect costs included in Contractor's four Summaries of Incurred Costs ("Summaries") that were in excess of the default rate of 7%, resulting in approximately $4 million of questioned costs that must be returned to the government.

The required budgets Contractor presented at the beginning of the grant period projected costs at approximately $28 million where annual budgets were for approximately $7 million. Though the auditor appeared not to realize it, the budget reflected use of the default indirect cost rate applied to direct labor (the T of C allowed the rate to be applied to all costs). Also not

apparently known by the audited, the billed amount to the government was based on the annual budget where each month it billed the government one twelfth of the budgeted amount. At the end of the fourth year (as well as each year) Contractor provided Summaries as required by the Grant that identified its actual costs which reflected higher actual indirect cost rates (35%-55%) and total incurred costs of approximately $31 million. The auditor asserted these Summary amounts were what was “charged” to the government and since it failed to submit an ICRP, it owed the difference between the indirect costs it charged versus use of the 7% default rate.

Our Response

We believe the audit finding that leads to the recommendation that Contractor return $4 million to NASA (1) is based on an incorrect conclusion that the de minimis default rate represents a fixed or capped amount; (2) fails to recognize the cost reimbursement nature of the grant; (3) incorrectly characterizes costs as “questioned”; and (4) provides an unreasonable result.

The audit report is based on the conclusion that the default rate should be fixed or capped rather than serve as a temporary rate to use in lieu of an indirect cost rate agreement. The 7% default rate was provided to allow those of the 50 NASA grantees inexperienced in government contracting an opportunity to recover a small part of their indirect costs until an ICRA is established. The 7% default rate is truly de minimis, where we provided data from the Grant Thorton Survey (see above article) showing actual indirect cost rates are much higher. We provided extensive documentation that showed there is no language or intention in the Grant to cap the rate at 7% or even to cap an approved incurred cost rate for the duration of the grant period.

Most significantly, the audit opinion fails to recognize that the Grant is a cost reimbursable contract vehicle. This appears to be the primary reason for the conclusion that Contractor should return $4 million. There are only three types of government contract vehicles – (1) fixed price (FAR 16.201); (2) time-and-material (FAR 16.601); and (3) cost reimbursable (FAR 16.302). The Grant is clearly not fixed price, where a price is established and actual costs are irrelevant nor time-and-material where no fixed billing rates are established for relevant labor categories and all submitted budget and Summaries showed actual or projected actual costs. That leaves only the third type of government contract vehicle – a cost reimbursable grant, which are by far the most widely-used vehicles for government grants.

In all material respects, the Grant is structured as a cost reimbursable contract. While NASA does not directly refer to it as such, other Federal agencies are more explicit. We provided quotes from other agencies who state their grants are “normally cost reimbursable type awards.”

As the FAR and OMB Circular A-87 describes it, cost reimbursable contract vehicles are characterized by (1) an initial estimated budget to provide funding levels (2) establishing provisional or billing rates and (3) final rates provided at interim periods at the end of the grant period.

The reporting requirements of the Grant are the same as those for a cost reimbursable contract. The budget data is provided both initially and annually. The provisional billing rates are established by offering two options at the beginning of performance – either an Incurred Cost Rate Agreement at the beginning of the grant period or use of the 7% default rate. Interim incurred cost rates were provided and opportunities to adjust the provisional billing rates where the Terms and Conditions of the Grant state the reports provided “ will account for all uses of award monies during the previous period and project uses of award money for the ensuing period.” In addition, direct and indirect costs were reported in Quarterly reports contractor was required to submit. It should be stressed that while the terms and conditions of the Grant provided the opportunity to use revised billing rates, the company nonetheless continued using its 7% default rate for all of its billings to the government.

An administrative deficiency in Contractor’s indirect cost rate process should not be misinterpreted as questioned costs; the costs were incurred. Contractor spent the NASA funds received, $28 million (plus approximately $3 million of its own unreimbursed funds). It makes no sense that the perceived shortcoming should attempt to erase the very fact that Contractor spent the money on the Grant. To now insist that Contractor return $4 million (approximately 15% of the budget) because it did not submit an ICRP to establish initial billing rates for the Grant is not only an impossible burden to meet, but an unreasonable conclusion.

The company met the Grant’s operational commitments. There was no harm caused to NASA with the manner in which it presented its indirect costs. While Contractor did not submit an ICRP at the beginning of the Grant period, it did comply with the requirements of the cost reimbursable nature of the Grant. Contractor provided initial and interim budget data, established an initial provisional rate in the form of the 7% default rate and used that rate throughout the budget and billing process, disclosed information about its actual costs during Grant performance, adjusted provisional billing rates

and disclosed these changes in the quarterly operational reports and ultimately prepared the Summaries to identify its incurred costs. We believe the failure to provide an ICRP at the beginning of the Grant period is an administrative deficiency which caused no harm to the government and which does not deserve the draconian penalty to return more than 15% of the allowable costs it incurred to perform under the Grant.

(Editor's Note. We are pleased to announce that the IG has agreed to amend its audit reports to delete the questioned costs. We are awaiting the actual audit amendments and whether the CO will accept the revised positions.)

FIRM OF THE FUTURE

(Editor's Note. As part of our continuing series of discussing how modern business ideas affect government contractors, we address an article written by James Allen, James Root and Andrew Schedule of Bain Consulting that considers some of the future characteristics of modern businesses.)

The authors assert there have been distinct eras in business which shift about every 50 years where since the 1970's the major theme has been what they call shareholder primacy which is characterized by the relentless and prioritized pursuit of shareholder value. The fundamental goals of this strategy will not change where they will continue to pursue and prioritize scale, meeting customer expectations with ever more speed. However the way it pursues these goals will look very different in the near future. The authors address four emerging themes of interest to us that will produce this new era which is just coming to be.

1. Scale and Customer Intimacy. New disrupter companies like Google, Amazon, Facebook and Tesla as well as more traditional firms like Starbucks, Lego and Vangaurd are replacing large, multi-divisional firms like General Motors and General Electric. A long held belief was there was a tradeoff between being big and low cost or being a champion of the customer. Today's companies no longer accept the tradeoff where now they seek to drive scale and benefits of experience and still learn what their customers want and be able to delivery quickly on those preferences.

Today, technology and data analytics are eliminating this tradeoff. Consider $14 Billion Nordstrom, the retailer long famous for its strong customer advocacy, grew 50% in the last five years after making investments in software allowing its store associates to get closer to its customers via texts and purchase of a personal assistance company. Or Starbucks delivering intimacy through its baristas while investing in superior mobile experiences and loyalty programs. Or Vanguard, the mutual fund company, who has invested in large scale technology driving down the cost of its advising services.

Scale will continue offering benefits but the dynamics of scale are changing. First, it is now possible for even small firms to access the benefits of large companies without having to own the assets or capabilities they have developed. Amazon Web Services, Salesforce and Workday are just the beginning of a new wave of cloud based capabilities that other firms can rent at a price. Second, the importance of speed has exceeded scale in such areas as new products and services offerings, time to gather and learn from feedback and time to make decisions. Speed is essential in customer intimacy performance where continuous improvement in products and services can allow small firms to outcompete their larger rivals. Third, as digital technology and changing customer expectations are pushing companies to adapt quickly, a Bain Study showed large firms are slower.

Historically, the experience curve was an essential tool to help companies achieve lower costs by increasing scale. New metrics will need to measure speed. They will need to develop operations to allow the creation of teams to work quickly on a new task, solve it and move on rather than remaining trapped in organizational structures promoting annual planning and activity cycles. Example of these agile methods are Public Broadcasting where these agile teams develop new programming or John Deere and Saab develop new products where cycle time has been reduced by up to 75%. Or Enterprise Rent-A-Car shows that the local branch makes most of the decisions affecting customer satisfaction where branch managers have great discretion in handling problems and all complaints. Successes are quickly communicated to other branches where,for example, news spread after the success of offering free water bottles to customers. The results of these trends are firms will combine big data with human intelligence from frontline experiences with customers and the resulting information will be instantly available throughout the company. Non-customer activities and routine interactions will become automated opening up more opportunities for customer engagement. Cloud based services will become default providers of back and middle office functions which will significantly shrink the size of the organization.

Implications for Contractors. Along with labor saving technologies of the past these new trends will mean firms will continue to shrink. Automation and outsourcing of traditional overhead functions will reduce overhead costs while increasing use of agile teams at the expense of layers of management will likely also result in lower overhead costs. Emphasis on agile teams will change the costing structure of government contractors where many

of these team efforts can be charged as direct costs with the resulting decreases in indirect support costs. Creative pricing of the new cost substitutions will emerge.

2. Professional Managers Versus Mission Critical Roles. Most successful companies are defining a bold clear mission for themselves in how they will serve their customers. This mission becomes a governing rule in how they organize their business, culture and people. Once a mission is defined, it can then define the critical roles central to delivering it. For example, at the home furnishings company IKEA the mission is to create well designed products at breathtaking low prices which demands low initial costs in its design then relentless cost reduction where the critical roles are purchasing and product design. At the Chinese supermarket chain Yonghui the mission is to provide safe food for Chinese families where the supply chain teams working with Chinese farmers is elevated to be a mission-critical role.

These mission critical roles will change the rest of the organization. Budgeting and planning will be revamped. Teams will be project oriented blending the right amount of internal and external people. Employees will not have permanent bosses but will instead have mentors and coaches to guide their careers from project to project. Firms will have much less professional managers. Management spans of authority will widen as more work is done by peer-to-peer methods at lower levels. The definition of leadership will change with multiple tracks available where there will be a premium placed on coaching and mentoring required as apprentices migrate from team to team. Most work will be project oriented and self-managed with agile teams being dominant. Examples include Spotify where mission critical roles are filled by software engineers where self-managing teams of no more than eight members have end-to-end responsibility to decide what to build and who they need. Or Haier, a $30 billion Chinese white goods manufacturers has self-organizing teams in critical roles in design, marketing and manufacturing where teams are fluid, focused on specific projects and staffed by an internal market for talent. It has eliminated most support teams that provide coordinating functions and has teamed with external partners.

Implications. Less bosses and continued outsourcing of non-essential functions will put greater emphasis on hiring "hands on" people skilled in getting results with agile teams. Traditional salary and bonus schemes will need to accommodate the shift from heavy management levels to non-manager team members where justification for higher compensation for these non-management talents will need to be made. Also, hiring, training and performance reviews that formally focused on individual performance need to be revised to emphasize team building skills. Less focus on management hierarchy and greater expansion of control will result in many organizational changes (e.g. budget and planning efforts will likely take on a lesser role). Team members will likely be considered direct labor while lesser focus on the professional management model and increased outsourcing of less critical areas will likely significantly affect your and competitors' indirect rates which need to be considered when pricing new work.

3. Assets Versus Ecosystems. Turn the clock back 100 years and leading firms were vertically integrated. Think Ford that owned farms to raise sheep to provide seat covers and owned coal firing plants and coal freighters for its sprawling manufacturing complex. Later, Japan created an "ecosystem" out of legally separate companies that cooperated strategically and financially. Today the auto industry is split up vertically but collaboration both internally (Toyota and BMW are collaborating to build the next generation sports car) and externally (BMW is collaborating with Intel to build self-driving cars). Outsourcing of increasing numbers of activities has expanded where now no area of a company cannot be outsourced. Outsourcing was been accompanied by shedding of assets and renting capabilities by both large and small companies.

Increasingly, outsourcing can be provided by individuals who have a transactional relationship with the firm. Recent estimates show as much as 40% of US workers engage in a variety of nontraditional employment arrangements, including part time and independent contractor work where employers can access this labor in diverse fields. At the extreme, technology-based "platform" companies like Google, Facebook and Apple have earned huge revenues from a very small employee base - $2.1 million per employee at Apple and $1.4 million at Google compared to $0.7 million at Procter & Gamble and $0.3 at Wells Fargo.

Implications. The model of assets previously owned and now rented will have significant impact on contract costing. Capital leasing and heavy depreciation expenses will replaced by operating lease arrangements. The operating lease model will allow direct charging replacing the indirect costing of asset related equipment like depreciation and maintenance. Outsourcing of more and more activities will entail decisions on how these costs will be allocated – direct, overhead, G&A. Most significantly, the new personnel relationships will mean substitution of traditional employee relationships with varied, transactional relationships. Full time employees will be supplemented by "variable" employees receiving less fringe benefits (only payroll taxes), part timers receiving some but not all benefits and independent

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contractors receiving none. Pricing proposals and use of company billing rates for these varied employees will need to be carefully crafted to meet pricing strategies of either maximizing billings or minimizing prices to the government. Finally, teaming arrangement with other companies will increase (combining small firms to seek small business setasides, mentor/protégé relations and increased mergers and acquisitions to meet expanding government needs.

4. Engine 1, Engine 2. Innovation in core businesses, usually incremental, has always been pursued. However, innovations that upend industries are proliferating where companies must be constantly on the lookout and ready to mobilize resources to adjust to changing circumstances. Accordingly, companies need to continue seeking sustaining innovations of their core business engine but also need to create new businesses - tomorrow's engine – that reflect new customer needs, new competitors or new economics. This Engine 1, Engine 2 approach is what allowed Marvel to continue its publishing business but to license its character business or Netflix to keep its DVR business but get into high growth streaming or IBM to move from hardware to software and services Of course, most dramatically, is the genius of Steve Jobs at Apple where everyone was focused on Generation 1 while he looked beyond to Generation 2 and 3 products.

The two engines require different approaches. Engine 1 needs the discipline, repeatability and small improvements while Engine 2 needs the agility and creativity to jump into the unknown with the understanding that only a small minority of such investments will pay off. Companies will likely set up and manage Engine 2 under the corporate umbrella but it will likely structure, staff and fund it separately. Top talent will likely rotate between both engines learning to balance skills and critical mission roles.

Implications. Engine 1 and 2 approaches will involve consideration in how to allocate costs from home office and intermediate home offices, how the cost support work from Engine 1 company for Engine 2 and how to cost and price intercompany pricing. If both groups seek government contracts contracting vehicles will likely be quite different (e.g. service and product contracts from Engine 1 versus R&D work from Engine 2. Charging of IR&D versus RD work must be carefully considered, especially in light of recent court decisions.

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