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Knowing Your Cost Principles…

SEVERANCE PAY

(Editor's Note. As part of our continuing series on exploring a cost principle, we have selected a topic we are seeing government auditors paying particularly close attention to. We will present the general rules and add guidance the Defense Contract Audit Agency asks its auditors to follow when the guidance adds information not contained in the general rules. The source of this article is several texts we often use, the Defense Contract Audit Agency Manual (Chapter 7-2107) and a recent consulting engagement we had with a client whose severance costs were questioned by DCAA. As a bonus, we include an edited version of the position paper we prepared challenging the questioned costs which we believe may be instructive in what auditors may question, how to phrase written policies, demonstrate the need for employment agreements if compensation differs from written policies and reasons to closely examine surveys used by the government.)

General Rules

FAR 31.205-6(g) covers severance costs. Severance pay or dismissal wages are extra payments made to employees whose employment is involuntarily terminated. DCAA guidance provides for two types of "involuntary termination" (1) where the employee has no option of staying with the company and (2) where the company has an established goal for a reduction in work force. In the second case, it is irrelevant whether a specific employee is given an option but only requires a commitment to reach certain employment goals with the assurance that the severed workforce will not be replaced. Evidence of a commitment to workforce reduction would need to show that terminated employees will not be replaced i.e. their jobs have been abolished. The guidance recognizes that under the second circumstance, where severance costs are accompanied by a termination plan, the expenses may be higher than the established plan but would still be allowable if reasonable. Payments for voluntary terminations are unallowable.

Severance payments do not include payments under early-retirement incentive plans. Severance pay is normally allowable to the extent it is required by law, employer-employee agreement (including an unwritten established policy that implies an agreement) or circumstances of a particular employment (for example, a special employment agreement with an individual employee).

Payments made to employees who preserve credit for prior length of service by going to work for a replacement contractor or by going to work for an affiliated company of the contractor or at another facility of the contractor are not allowable. However, even these provisions may be overcome by a proper contract clause or special agreement that requires reimbursement by the government.

Normal and Abnormal Severance. "Normal severance" generally refers to routine employee terminations while "abnormal severance" refers to any mass termination of employees. Actual costs of normal severance must be allocated to all work performed at the facility where the severance costs were incurred. Accruals for normal severance pay are acceptable if (1) the amount is reasonable in light of prior experience and (2) it is allocable to both government and non-government work. Abnormal severance is unallowable as an accrued cost because of it is considered speculative. However, the government may consider allowability of actual payments for mass terminations on a case-by-case basis. Appeals board decisions have ruled that this provision does not grant a contractor a price adjustment on a fixed price contract that did not contain specific terms allowing abnormal severance costs. However, an advanced agreement may be developed on how to handle mass terminations should they occur.

Golden Parachutes and Handcuffs. In 1988, FAR 31.205-6 was revised to disallow costs of a "golden parachute" (pertaining to employees who leave the organization) and "golden handcuff" (pertaining to employees who stay with the organization) arrangements. These terms refer to employees' compensation in the event of a corporate merger or change in management control of an organization. Special compensation to terminated

employees after change in management control is unallowable to the extent that it exceeds normal severance pay. Special compensation contingent on the employee remaining with the organization after a change in management control is also considered unallowable.

Allocation. In Aerojet-General Corp. (ASBCA No. 34302), the government challenged the allocability of severance pay costs. In preparing for the final year of operation of a business unit, the contractor enhanced its severance pay policy to retain employees to complete two remaining cost reimbursement contracts. The government argued the severance pay should be allocated to the final two years of operation because two fixed price contracts completed in the next to last period also benefited from these expenses. Relying primarily on CAS 406 that establishes an appropriate accounting period, the Board ruled the costs were properly assigned to the last fiscal year concluding that severance pay costs were allocable to the year they were actually incurred.

WARN Act. The Worker Adjustment and Retraining Notification (WARN) Act requires certain employers to provide a 60-day notice to employees before a layoff. When the Act applies (e.g. at least 100 full time employees, at least one site shutdown, at least 33 percent of the workforce terminated) many contractors will put the laid off employees who hold sensitive positions on administrative leave for the notice period so they do not run the risk of retaliation from employees who are laid off. These costs are normally allowable if the employees are considered "high risk." DCAA guidance puts the burden on the contractor to demonstrate why the employees are "high risk" and cannot be reassigned elsewhere.

Foreign Nationals. Severance pay to foreign nationals for services performed outside the United States are unallowable to the extent those payments exceed amounts typically paid in the US. The "typical" amount is based on providing similar services in similar industries. Costs that are otherwise allowable are unallowable when termination of employment is a result of a facility closing or reduction at the request of that government. When the closing or reduction is a result of a country-to-country or a status-of-forces agreement the severance expenses are allowable if the head of an agency or their designee may allow the costs. Contractors should be alert for special contract clauses that may impact severance costs especially under circumstances where foreign nationals are used. For example in *T.E.A.S.A. (ASBCA 43844)* the Board held the contractor was not entitled to severance costs paid for nationals when a follow-on contract severed the foreign nationals because of a clause in the contract entitled "Severance Pay Resulting from Reduction in Scope of Contract."

Other DCAA Guidance

Types of severance expenses. DCAA guidance informs auditors that a severance policy normally pays employees a set number of weeks' pay based on years of service. It also recognizes contractors may offer additional termination benefits such as medical care, education and relocation expenses to reduce hardship of separation which it also includes under the term severance. It specifies such severance payments must be "reasonable" and opens the door to use of surveys to evaluate this reasonableness against compensation practices of other firms in the same industry as well as those engaged in non-government work.

Reasonableness of special termination plans. Contractors may offer special termination plans that offer enhanced benefits but result in overall savings by inducing voluntary employee terminations. DCAA recognizes the benefits of such special termination plans and stresses for these costs to be "reasonable" and hence allowable in accordance with FAR 31.205-6(b) (1) and FAR 31.201-3, the contractor should be able to demonstrate the benefit of such expenses exceeding the costs. Examples of such benefits might include lower overall compensation of remaining employees by keeping lower paid employees who will stay on longer or lower training and recruiting costs due to not having to hire new employees. Though it recognizes the validity of "intangible benefits" (e.g. employee morale, contractor's reputation as an employer), DCAA indicates such claimed cost savings should be preceded by an advanced agreement with the CO.

General release agreements. In 1995 the DCAM issued guidance advising auditors that costs related to obtaining employee general release agreements – agreements with terminated employees that release the contractor from demands and claims related to discrimination laws. The rationale for this guidance was that the payments were not for services actually rendered. Following much criticism, the guidance was cancelled and replaced by a policy to review the costs of such agreements on a case-by-case basis to assure the costs are reasonable.

Case Study

- **Background**

When the company decided to relocate corporate headquarters from San Francisco to Denver, Contractor negotiated a severance agreement with two senior

executives (Chief Financial Officer and President of a key business unit) that provided for one year of salary plus miscellaneous expenses such as accrued vacation, various post-severance expenses, outsourcing resources, etc. DCAA questioned one half of the salary expenses and all the additional severance related expenses asserting the severance expenses were unreasonable because (1) the amount of severance pay was contrary to the company's written policies and procedures that limited severance benefits to one week of salary for each year of employment (2) there was no separate employment agreement between the company and employees that waived this policy and (3) a survey used by DCAA (Lee Hecht Harrison) comparing comparable firms limited severance pay to two weeks of base pay for each year worked while another part of the survey capped such payments to 26 weeks of salary. DCAA compared the entire severance package with the equivalent of 26 weeks of base salary and questioned the difference as "unreasonable".

- **Response**

Response to DCAA's first two points were quickly disposed of. Though Contractor's written policy on severance payments did limit severance pay to one week of salary for each year worked the policy clearly stated "the firm reserves the right to make exceptions to the severance pay policy at its sole and absolute discretion." As for the absence of an agreement between the company and terminated employees, a copy of the agreements that provided for the severance payments were found and provided to DCAA.

The remainder of discussions with the government revolved around the 26 Page survey where we found several discussions that contradicted DCAA's conclusions and reported these differences to DCAA. For example:

1. The survey addresses base severance payments and considers other elements of compensation (e.g. paid vacations, outsourcing, various post-severance expenses, etc.) separately. Hence the employees' base salary, not total severance payments, should be benchmarked.

2. The 26 weeks the survey indicates is the "median maximum severance amount" applies to all employees of the companies surveyed. Since the two individuals were both officers and senior executives of the company, it is appropriate to evaluate their compensation against individuals in the same or similar positions, not all employees "for all levels." Hence, more than 26 weeks should be appropriate.

3. In the same paragraph that DCAA used to justify the two weeks of salary for each year worked, the following sentence provided the amount of time for officers and executives should be four weeks – "median minimum severance amounts of four weeks for officers and executives" – not two. Applying the four week for each year worked standard, both executives were entitled to a little over one year's salary.

4. The survey stated that severance payments, particularly for officers and senior employees are usually not limited to years of service but rather negotiated on a case-by-case basis – "many organizations base severance on more than a single factor, with years of service generally being one element in the formula...the higher the level of employee, the less likely it is that severance will be based on years of service only." Since the severance agreement provided for their continued services until replacements could be found a premium amount should be justified.

- **Conclusion**

DCAA and Contractor continued the dialogue and when it was clear neither DCAA nor Contractor would change their positions the parties went to the contracting officer to see whether it could be resolved. He indicated, informally, though our position was strong he did not want to totally reject DCAA's position and sought a compromise. Contractor identified a section in the survey that provided that officers of companies received, on average, 40 weeks of severance and after asking for evidence they were officers as well as senior executives, agreed that they would be entitled to 40 weeks of their salary plus the additional payments. All parties agreed to the compromise.

ORGANIZATION DESIGN CHANGES TO IMPROVE PERFORMANCE

(Editor's Note. We continue our practice of describing current business thinking by notable consulting firms and the implications of these ideas for government contractors. The following is an article by senior consultants for the Boston Consulting Group (BCG) written in July 2017.)

Many companies have been changing the design of their companies to meet changing economic pressures, market conditions, technological innovations and customer preferences. BCG has conducted surveys and concluded only half of these efforts are successful. In analyzing

their survey results, they found that six specific factors in organizational design stand the best chance for companies to become a top performer in their industry, grow faster and generate more profits.

1. Agile

"Agile" is a hot new concept. Such results as productivity improvements, creating new product features, employee engagement, rate of innovation and declines in defects are being touted as "stunning" for Agile adopters. Companies that have success with Agile report saving time, simplifying decision making and engaging and empowering individuals and teams. Agile began in software companies where it is now beginning to be integrated into a variety of companies. It began as a way to improve methods of software development where the old "waterfall" model (i.e. separate groups developing sequential progress before the next task was addressed) was being replaced by groups working together to develop simultaneous results. Agile is taking on numerous forms where BCG describes it as a "set of beliefs:" (1) iterative – repetition until things are done right (2) empirical – reliance on real time metrics to allow for immediate feedback and self-correction (3) cross-functional – teams consisting of members with a variety of relevant skills where each member has specific tasks (4) focused – teams exist for the duration of the project where they do not work on different projects or leave once their specific duty is done and (5) continually improving – constant measurement and experimentation to improve customer satisfaction. BCG's survey concludes Agile companies are up to five times more likely than their peers to be top performers. Such companies are likely to incorporate most if not all of the other factors discussed below.

Implications for Contractors. Agile companies will incorporate the factors discussed below where emphasis of teaming, centralized services, flatter management structure and changes to indirect cost rates will significantly affect contractor pricing and costing practices. These implications are discussed under each factor below.

2. Value-Adding Corporate Center

Headquarter functions are often seen as burdensome but companies with an effective corporate center are three times more likely to be top performers. Though the role of the center and specific value adding activities may vary, top performers go beyond the normal center role of allocating external and internal funds and overseeing strategy to provide functional expertise, create and promote standards and best practices, identify opportunities for business units to work together and ensure employee performance evaluation lines up with company goals. The most effective corporate centers improve their company's performance by avoiding multiple reporting lines, setting clear key performance indicators, building platforms for sharing best practices and developing a strong talent pool.

Implications. The move away from indirect activities at the business unit to more centralized activities will impact how these centers' costs are allocated. CAS 403, home office allocations will need to be adhered to. CAS 403 provides numerous ways of treating these costs which will allow for more creative pricing.

Also, business unit indirect cost pools will be affected where certain indirect costs will be moved from these pools. So, for example, moving normal overhead costs centrally may create lower overhead rates and higher G&A rates at the business unit since most home office allocations are charged to a business unit's G&A pool.

Also, movement of business unit costs either more centrally or to other business units that share the costs will affect how intra-company costs are transferred to contracts. Attention to whether such costs can be classified as commercial items, impact on allocations and whether accounting changes are considered to have occurred requiring cost impact analyses need to be considered.

3. Clearly Delineated Profit and Loss Responsibilities

Companies with clearly defined P&L responsibilities are three times more likely to have faster growth and higher profits than their competitors. These superior companies clarify P&L responsibility in two ways: First, they ensure that it matches the company's overall strategy. For example, if a company's operations are divided by geography, then P&L responsibility should be structured the same way. Second, they make sure leaders who bear responsibility are empowered to influence results, including deciding what products and services are offered and what their underlying cost structure is.

Implications. This exercise provides an opportunity for companies to consider re-defining their business units and re-examining what their business units do which always provides new strategy insights. For example, should business units serving the government marketplace be separated from other company units? Should separate

business units be divided by other considerations such as products and services offered, location, etc.? These decisions will certainly impact business units' indirect rate structure and provide new opportunities for pricing government products and services. For example, one business unit with high direct labor costs may choose to allocate most indirect costs as overhead while another business unit with high material or subcontract costs may need a different structure oriented to higher G&A rates to allocate less costs on labor and more on ODCs.

4. A Flat Management Structure with a Strong Frontline Focus

Companies that minimize the operational distance between the corporate center and customer are twice as likely as peers to become top performers. A company often does this by reducing management layers which improves its understanding of local markets and support for customers. A flatter management structure also results in greater cost efficiencies, creates increased spans of control, enhances communications between the center and frontline and expands manager accountability. Another way of reducing the distance between the center and frontline is to link country based operations directly to the center rather than regional offices.

Implications. Flatter management structure will usually require significant changes to compensation levels with the need to justify such levels to compensation auditors. For example, executives on various levels receiving higher compensation will likely be replaced by a management structure that pushes higher compensation levels to employees successfully interacting with clients. Salaries, bonuses and even fringe benefits will need to be rethought and justified to auditors. For example, higher compensation is often justified because it is paid to senior executives with such titles as CEO and COO while higher compensation to highly productive yet non-executives will need to be justified. Also, indirect cost pools may be significantly altered and higher compensation paid to direct employees will affect direct versus indirect cost allocations.

5. Effective Use of Shared Services

Companies that are able to move transaction-heavy administration functions from individual business units to centralized shared services are more than twice as likely to be top performers. 74% of respondents outsource shared service operations from divisions and business unites to dedicated centers. Common functions that are shared services include IT (68%), finance and accounting (58%), human resources (53%), procurement (38%), legal services (32%), communications and marketing (29%) and real estate services (26%). Sixty percent of those using shared services run them as individual entities while 40 percent move multiple services to cross-functional shared service centers. Despite publicity over off-shoring, companies rarely make use of low-cost options where 50% of respondents have a quarter or less of shared services in offshore locations and only 8% have three quarters offshore. Shared services are not guaranteed to make companies more efficient where only half the respondents said they add value. Multiple challenges can hamper effectiveness such as poorly defined processes, poor implementation, confusion about who owns the process and failure to meet the needs of business unit clients.

Implications. Shared services can have significant impact on cost and pricing. They often entail the need to create cost and service centers (we are seeing increased use in our consulting practice) where much thought needs to be put into how to price output. Like other factors, it often involves restructuring indirect rates. They also affect both pools and rates. For example, whereas shared service costs used to be embedded in indirect rate pools they now become located in separate service pools where such costs may be charged direct or indirect. How output of service centers are priced needs careful consideration. What costs are included in the pool and how unit costs are computed is carefully scrutinized by auditors. You will likely want to establish unit prices of the services based on market pricing rather than allow auditors the opportunity to question cost-based unit prices.

6. Support for People and Collaboration

Organizations with collaborative, people focused practices double their chances of being top performers but 40% report that their companies' day-to-day efforts to support people and collaboration are deficient. Ways cited to provide meaningful steps to hardwire trust-filled environments into operations means giving individuals clearly defined responsibilities both for their own jobs and work they do in teams. Top performing companies use simple decision making processes, reward collaboration and make sure meetings are productive and have clear objectives.

Implications. Emphasis on teaming will offer new ways to price proposals. For example, rather than price out each individual's hourly rate, average rates for more permanent

teams may be considered. In addition, bonuses will likely be oriented to team results rather than individual performance where contractors will need to quantify justification for such bonuses to create metrics than can provide objective measurements and avoid assertions of excessive subjectivity.

Though each of the six factors must be uniquely tailored to individual companies BCG's survey indicates that companies incorporating at least one of the six ingredients described above are likely to see above average growth and profit. Companies that incorporate all six increase the likelihood of becoming top performers by more than 50% where, by contrast, companies incorporating just one have a 20% chance of becoming top performers with a 44% change of underachieving.

DCAA CRITERIA FOR AN ADEQUATE PROPOSAL

(Editor's Note. The majority of government dollars spent are still included in proposals that are subject to being audited by the Defense Contract Audit Agency. If DCAA judges a proposal to be "inadequate" then it usually will not audit the proposal or will qualify its opinions to make it difficult for the agency to make a buy decision. DCAA has identified what it believes constitutes an adequate proposal and how it will audit cost elements in a proposal where we include here its most recent guidance developed in 2016. We intend to make this a two part article where here we identify the elements of an adequate proposal and what contractors can do to avoid an inadequate conclusion and in the second we cover what to expect from a DCAA audit.)

The following is intended to identify those "pricing deficiencies" in a proposal that auditors and negotiators consider sufficiently important to avoid beginning to negotiate a contract, let alone award one. We will identify and briefly discuss what they consider unacceptable and suggest what contractors can do to avoid such conclusions.

Chapter 9 of the of The Defense Contract Audit Manual (DCAM) is the guidance that DCAA auditors are asked to follow when reviewing a proposal and Chapter 9-200 is the section that auditors follow for determining the adequacy of a proposal. That section lists eleven common deficiencies that either alone or in combination are to be considered sufficiently poor for negative opinions. These eleven deficiencies that are discussed below include:

1. Significant amounts of unsupported costs. By "unsupported" costs, auditors mean insufficient documentation to form a basis of determining if a cost is allowable. For incurred cost proposals, it is pretty straightforward – a transaction is supported by a labor recording document, invoice or other documentation created at the time the transaction was recorded. For cost estimates, "support" is more problematic because an estimated cost has not occurred. It is quite common, however, for some auditors and price analysts to hold the same standard of supporting documents as would exist for incurred costs even though an estimated cost is largely judgmental.

Nevertheless, some form of support for the cost is required. For items previously produced, detailed support should be available. If circumstances are not expected to significantly change then historical cost rates would be considered reasonable support. "Engineering estimates", though considered "merely judgmental" is commonly accepted especially when the person doing the estimate has credibility.

2. Material differences between the proposal and supporting data resulting from the proposal being out of date or available historical data for the same or similar items not being used. If factual data is used by a contractor in its estimates, then that data should be current when the proposal is being prepared. After that time, the contractor should ensure the data used is current up to the time of price agreement. Ensuring the data is current should not be confused with the unjustified position of some auditors that a proposal needs to be updated. Numerous decisions by Boards of Contract Appeals have established that if a contractor updates its cost or pricing data but does not update its proposal per se the contractor has met its obligations.

The type and format of updated information has also been extensively litigated and is often a point of contention between auditors and contractors. For example, a contractor is not required to submit data in a requested format if it is not readily available. Or, for example, the years of historical production data needing to support an estimate has been litigated where a contractor's submission of two years worth of data was considered adequate when the government was seeking more years. What is considered sufficient can differ in each circumstance and the contractor should be prepared to justify its estimates by facts and resist unreasonable requests for more.

3. Large differences between detailed amounts and summary totals. It is clear that if summary totals do

not reconcile to detailed amounts in the proposal there can be problems. Less clear is when the data may exist somewhere (e.g. a shoe box, indecipherable spreadsheet) and is believed to "be all there" but effort is required to reconcile the amounts. If it is very time consuming or impossible to reconcile due to lack of detail a reviewer is usually justified in concluding the totals do not match the detailed amounts. In other cases where the auditor's unsuccessful attempts to reconcile totals to detailed cost data not used in preparing the proposal becomes not a reconciliation issue but an instance of an auditor substituting their judgment for the contractor's judgment and a judgement of inadequacy should be resisted and discussed at negotiations.

4. Absence of bill of materials or other consolidated listing of individual material items. The absence of such a listing could be legitimate grounds for a determination of inadequacy when the materials are known in sufficient detail at the time of price proposal. In other cases, such as the design, development and construction of a new item, there is insufficient knowledge of what are the necessary materials and a bill of material is not realistic. Auditors, used to reviewing proposals with nice neat bill of materials may automatically reject a proposal without one so either a bill of materials should be sought or convincing reasons should be offered for why one is not possible.

5. Failure to list parts, components, assemblies or services. FAR Table 15-2 instructions for supporting proposals lists these items to be provided if they exist. Like the discussion under bill of materials, they should be provided if they exist and if the nature of the contract makes their provision unrealistic (e.g. design, development, construction of items) then detailed reasons for their absence should be available if asked.

6. Differences in proposed unit prices based upon differences in required quantities. Auditors and price analysts closely examine whether proposed unit prices reflect the quantity discounts the proposed contract would offer. They usually assume the unit prices should reflect savings if the quantities will be purchased at one time while there may be many reasons why this is not appropriate (e.g. just-in-time inventory approach). When this is not the case, an auditor's opinion of inadequacy should be challenged and reasons for the different approach identified.

7. Problems with record access by subcontractors. The prime should be very familiar with FAR Part 12 exemptions (e.g. adequate price competition, catalogue or market price, commercial item, etc.) from requiring cost and pricing data to determine whether they are applicable to a subcontractor. As we have been writing about recently, the government is imposing more responsibilities on prime and upper-tier subcontractors to audit their subcontractors so to avoid such demands, those prime contractors may want to reconsider using a subcontractor for pricing purposes if auditors use the subcontractor's inability to justify its proposal on a cost basis as a problem.

8. Pricing inter-organizational costs. As mentioned above, the business unit preparing the proposal should be familiar with FAR Part 12 exemptions from submitting cost and pricing data from another organizational unit of the company. If one of the exemptions do not apply and cost and pricing data is required, the business unit must be able to justify its cost buildup. If this is problematic, then the proposing unit should consider another source for its proposal to avoid the possibility of an unwanted audit of the business unit.

9. Time phased breakdown of hours, rates or basis of proposal. The time phased requirement means that direct labor hours should be estimated by month, quarter or year and that direct labor rates also identified by time period. Contractors should be prepared to justify escalation rates, particularly if they exceed three percent. Whenever possible, an offeror should use labor categories that are established by its own system. If the solicitation asks for different labor categories, care must be taken to ensure a reconciliation of labor categories is documented.

10. Indirect cost rates. An offeror should indicate how the proposed indirect cost rates are computed, what are the cost elements used and how they are applied. Rates that are different than those incurred in the previous period should be supported by budgets. Elimination of any unallowed costs should be evident. For example, the cost should be identified and then clearly eliminated rather than merely not including it. If a solicitation requires proposing an indirect rate (e.g. fringe benefit rate) that does not correspond to the accounting practice of the contractor, the proposal should clearly show the computation as well as evidence double counting does not exist.

11. Multiyear budgets. Since most firms develop budgets for only one year, this is the one deficiency that we seldom see auditors taking a hard line on. If different rates are proposed then they should be documented. If the proposal is unusually large and is expected to be a significant part of the business base, auditors will want to see the impact of the contract on multiple years and some

projections would be required. Less formal steps than normal budgets can be used to make these projections.

CONSIDERATIONS FOR CONTRACT CLOSEOUTS

(Editor's Note. We have recently been helping clients close out their contracts. We have relearned several lessons for closing out contracts where we summarize some of them here as a list of considerations.)

1. Team effort. Closing out contracts is not just submitting a final invoice where it can be a long processes even after a contract is completed so several actions should be taken by staff who are still available and have fresh memories. It is a good idea to form a team of people who are familiar with the contract and are still available. Team members should include program managers, contract administrators and accounting personnel who will be assigned act specific actions with timelines.

2. Fee withholds of 15% on cost type contracts and labor withholds up to $50,000 on T&M contracts can hold up cashflow if your contract contains the clauses at FAR 52.216-8, fixed fee or 52.232-7, payments under T&M contracts. Of course, the best way of preventing these withholds and preventing the hassle of retrieving them is to waive these withhold requirements shortly after a contract is awarded. Also, be aware that recent controversy revolves around whether the fee withholds apply at the contract level versus the delivery/task order level.

3. If your contract includes FAR 52.216-7 you must submit incurred cost proposals each year. The ICP is audited (more often, rates are finalized based on the ICP) and then you are to submit a final invoice within 120 days (or longer with CO approval). We find it very common for such invoices not to have been submitted, even when there are significant dollars due where procedures need to be established.

4. Use quick-close out procedures found in FAR 42.708 whenever possible. Quick close out procedures can be used prior to a determination of final indirect cost rates when (a) the contract is complete (b) the amount of unsettled indirect costs to be allocated to any one contract does not exceed $1 million and the amount of unsettled indirect costs to be allocated to one or more contracts in a single year do not exceed 15% of the total unsettled indirect costs allocable to cost type contracts in that year (the 15% can and often is waived if the contractors' accounting, estimating and purchasing system is deemed adequate by its auditors) and (c) agreement can be reached on a reasonable estimate of allocable dollars. Keep in mind the procedures are final and are not considered binding for other contracts.

5. FAR 4-801-1 sets the time standards for closing out contract files: (a) files are considered closed for contracts using simplified acquisition procedures (SAP) when the CO receives evidence of receipt of property or service and final payment (b) non-SAP firm fixed price contracts should be closed within six months after date CO receives evidence of contract completion (c) contracts requiring settlement of indirect cost rates should be closed within 36 months of evidence of completion and (d) 20 months for all other contracts. A contract file should not be closed if the contract is in litigation, under appeal or if terminated, not until all actions are completed.

6. Physical completion of a contract triggers the close out process. Per FAR 4-804-4 the contract is considered physically complete when (a) required deliveries are made and government has inspected and accepted them (b) contractor has performed all services and government has accepted them (c) all option provisions have expired or the CO has provided notice the contract is compete. Cost type contracts need not necessarily be complete because under the Limitation of Funds and Payment clauses the contractor may cease contract performance once it has reach the cost ceiling of the contract and the government has not provided additional funding. Also, even though a contract is physically compete closeout can be delayed if, for example, the final amount has not been determined or there is an outstanding claim by or against the contractor.

Case Study…

JUSTIFYING ONE COMPANY-WIDE OVERHEAD RATE OVER MULTIPLE OVERHEAD RATES BY LOCATION

(Editor's Note. The following article is based on a position paper written in response to an assertion made by the Defense Contract Audit Agency that an engineering software design firm working out of multiple offices should use multiple indirect rates coinciding with its geographic locations. DCAA

usually has a preference for such multiple rates, especially when it believes such a practice will save the government money. When they express their preference, the burden often falls on the contractor to justify another approach. The following is an edited version of a position paper we prepared in support of our client's use of one company-wide overhead rate. We refer to our client as Contractor.)

Background

The contractor had been in business for over 20 years where their business has not fundamentally changed. They provide systems engineering support primarily to the federal government or federal prime contractors (75% of their business) in such areas as program management and support, aeronautics-satellite-communications services and hardware debugging. About 85 percent of the firm's government business is cost type or time and materials contracts. The company operates as a single business out of multiple offices.

The firm is labor intensive and the nature of its services require the same type of technical discipline and administrative support. It uses two indirect rates - a company-wide payroll burden rate applied to direct labor and a single company-wide overhead rate which includes a small amount of G&A type expenses applied to direct labor and labor burden. Though the company has grown considerably, its indirect rates have remained fairly constant over the years which is attributed to the fact that all personnel receive identical fringe benefits and the infrastructure (e.g. office space, computers, administrative support) that supports labor activity is directly related to direct labor. DCAA challenged its use of a company-wide overhead rate asserting such a practice was in violation of CAS 418 and said the company should, instead, use multiple overhead rates corresponding to its varied geographic locations.

Analysis of CAS 418

(Editor's Note. Though the paper addresses Cost Accounting Standard 418 partly because the client is CAS covered, we believe the arguments are equally valid to non-CAS covered contractors because (1) the substance of the standard is replicated in FAR 31.203 and (2) CAS are the most authoritative standards over cost allocation issues.)

CAS 418 provides an overall framework for accounting for and allocating direct and indirect costs and general guidelines for allocating indirect costs. The CAS Board defines a direct cost as "any cost which is identified specifically with a particular final cost objective." Indirect costs, by default, are simply all costs that are not direct costs. The standard, per se, does not establish criteria for distinguishing direct and indirect costs and treating indirect costs but requires contractors to develop their own criteria, demonstrating the CAS Board's intention to provide contractors flexibility. Rather, the CAS Board provides guidelines using concepts of "homogeneity" and "materiality" to be applied after the contractor has established its own policies.

What is an Appropriate Indirect Rate Structure

Authoritative texts indicate the following factors need to be considered when developing an indirect rate structure (see "Accounting for Government Contracts Cost Accounting Standards" by Lane Anderson):

1. Organization structure. A company's organization should be designed to meet its strategic objectives. For example, some companies organize around types of customers regardless of geographic location. Contractor's organization is frequently reshaped to meet customer program requirements which makes a company-wide rate compatible with its organization structure.

2. Diversity of Products or Services. Companies with few products or services usually adopt simple accounting systems. Contractor, for all practical purposes, provides only one service – systems engineering. The services are practically the same and consequently, the absence of diversity in services makes the two indirect pools quite sufficient.

3. Customer Mix. Doing work with the federal government is usually more expensive than for commercial customers. For example, maintaining an adequate accounting system, supporting government audits, keeping up on security requirements are all expensive. Since 75 % of the business is devoted to providing services under government contracts, the government receives the benefits of Contractor using a company-wide rate since some of its relatively high indirect costs are allocated across all work including its commercial contracts.

4. Pricing strategies. A contractor operating in a cost reimbursement environment must be able to fully recover its costs but must also maintain competitive pricing and keep a stable rate structure to adequately administer its contracts. A broad company-wide direct labor base as opposed to frequently changing labor at particular locations helps stabilize rates over a long period of time. Some of the Contractor's contracts extend over 10 years.

5. Administrative ease. Unduly complicating the accounting system will unnecessarily increase costs over use of a company-wide rate.

Fundamental Requirement of CAS 418

CAS 418 requires "a business unit shall have a written statement of accounting policies and practices clarifying costs as direct or indirect, which shall be consistently applied." The client complied by preparing a CASB Disclosure Statement that described its basis for classifying costs as direct and indirect and treating indirect costs which was deemed adequate by DCAA.

Next, CAS requires "indirect costs shall be accumulated in indirect cost pools which are homogeneous." The homogeneous requirement is satisfied by the fact the individual elements included in Contractor's labor burden and overhead pools have the same or similar beneficial or causal relationship to its direct labor base. The homogeneity of the pools may best be demonstrated by considering the groupings of the cost elements in Contractor's overhead and payroll burden pool.

Payroll related costs. Payroll taxes, health insurance, holiday, vacation, and other fringe benefits apply equally to all personnel. There is a "direct causal and beneficial relationship" of such costs to salaries and wages paid to employees.

Personnel support costs. These expenses include supervision, human resources, accounting and management information services. These services are provided on a company-wide basis and there is a direct causal and beneficial relationship between the direct labor and related support.

Facilities and office expense. The office facilities and equipment required to support system engineers are very similar because, for practical purposes, the company supplies the same type of services to all its customers. Regardless of where the employee is located, they require adequate office space and equipment. Hence there is a similar causal and beneficial relationship.

The Litton Case

A seminal case, *Litton Systems, Inc. ASBCA 37131,* explicitly established that CAS 418 does not require separate indirect expense pools be established for each location. The Board stated, in part "the standard does not mention the location of cost incurrence as a relevant factor, nor is it relevant from a purely conceptual view." Further, "nothing in CAS 418 or any other standard indicates that location of facilities or cost levels of operations has any effect on the characteristics of homogeneity of indirect cost pools."

Following meetings with DCAA management and particularly astute DCMA representatives, Contractor prevailed.

TIPS ON USING QUICKBOOKS FOR GOVERNMENT CONTRACT ACCOUNTING

(Editor's Note. Many of our small business clients and subscribers use Quickbooks and often express concerns about whether this accounting software is sufficient for government contracting purposes. We usually find it quite adequate for their needs until they outgrow it. We were happy to come across a May 11 blog by Cory Scott of the Redstone Group who apparently comes across similar concerns and puts forth ideas to make Quickbooks an adequate accounting system to track and report costs, especially on cost and T&M contracts. We find these tips are sufficient to meet government contractor requirements since government auditors are less concerned about the type of accounting software contractors use but rather whether it can provide the reports that contractors need to produce such as contract costing information, indirect cost rates, timekeeping and labor charging and segregation of unallowable costs reports.)

We agree with the author's assertion that Quickbooks is an excellent option for small government contractors where it is cost effective, easy to use and has access to numerous types of training given its popularity. Mr. Scott offers five tips to make sure your Quickbooks accounting system would be considered acceptable to government auditors.

1. Always enter your bills into the "Enter Bills" module. Though use of the "write checks" may be easier and more convenient to use, it does not adequately meet the requirements to accurately report incurred costs. For example, while contractors must assign the cost to the period the cost was incurred, the write checks function will allocate the cost to the period the check was written. Such cash accounting, as opposed to accrual accounting, is normally frowned upon.

2. Prepare labor accruals each month. Similar to the cash basis of "write checks" Quick books allocates labor costs to the period they are paid rather than performed which is considered the period the costs were incurred. A journal entry needs to be made at the end of the month to adjust this cash basis and, of course, reversed in the following month.

3. Prepare PTO accruals each month. The PTO expense reflected on the monthly P&L Statements should represent the sum of accrued hours times employees' hourly rate. The default amounts in Quickbooks is the amount of PTO hours used, not accrued.

4. Prepare revenue accruals on a monthly basis. Quickbooks recognizes revenue when it was billed – the date reflected on the invoice. However, proper recognition of revenue should be consistent with the way costs are reflected so there should be an adjustment made each month to align expenses and revenue.

5. Reconcile your direct costs on the P&L to your direct costs on the P&L by job. The P&L by job report is an excellent tool for government contractors where it provides a snapshot of each project broken down into costs elements and profitability. However, such a report is inaccurate. Every transaction entered into Quickbooks (including journal entries) should be allocated to a project to demonstrate you can track and report costs by final cost objective so you will need to select the appropriate project in the "Customer: Job" field.

Despite assertions to the contrary, there is no accounting software that is considered to be "DCAA approved accounting software." DCAA does not endorse or approve any software programs. We have seen systems using worksheets, even the proverbial shoe box system, deemed acceptable as long as the cost data generated can be shown to be accurate. Most products are fine as long as it is designed and installed properly and can be relied on to generate regular and accurate cost data.

DCAA'S RULES OF ENGAGEMENT FOR AUDITS

(Editor's Note. DCAA issued what it calls its "Rules of Engagement" in 2010 where more recently it issued a Power Point presentation used for training. We obtained a copy of this and thought it was worth summarizing below. It is important to know what these rules are since DCAA often fails to follow them when conducting an audit where such deficiencies can be used to challenge their conclusions. Examples might include failure to keep contractors informed of preliminary findings during the audit or a deficient exit conference.)

The Power Point presentation provides guidance for the role of auditors during each phase of the audit: attending procurement meetings prior to receipt of audit request, acknowledging the audit request, entrance conference, during the audit, exit conference and post report issuance.

Attending procurement meetings. Attendance does not impair auditor's independence where input by auditors may include procurement schedule requirements, expectations of timely input by contractors and identification of major subcontractors. Auditors may also provide general advice on what constitutes an adequate proposal (see article below).

Establishing the engagement. Upon receiving the request for audit, discussions should be held with the buyers to understand requestor's needs, identify specific areas of concern and discuss how DCAA can best meet those needs while complying with Generally Accepted Auditing standards. DCAA may be asked to audit only certain parts of the proposal and if risk factors indicate additional areas should be audited, discuss with requestor. A risk assessment of the proposal should be made promptly, a realistic expected report date provided and if proposal is inadequate then follow guidance in CAM 9-205(d). For audits that are not requested (e.g. incurred cost audits, post award – defective pricing, and business system) auditors should contact the CO to notify him of commencement of the audit and discuss any concerns.

Entrance Conference. Explain to contractor the purpose and overall plan of performance for the audit and general types of books, records and other data needed. Determine the nature and location of supporting data and discuss other matters as appropriate such as follow-up items identified during a walk through meeting and arrange for space close to relevant contractor personnel.

Communications with contractor during audit. Discuss matters to obtain a full understanding of contractor's basis for each item in the submission. Discuss preliminary audit findings (potential system deficiencies, FAR/CAS noncompliances, etc.) so that conclusions are based on a complete understanding of all pertinent facts. For the forward pricing proposal the discussions should be limited to factual differences for audits of forecasted costs subject to negotiations. Communications with the contractor during the audit should include immediate oral

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communications of major audit problems to contractor officials such as denial of access to records. On occasion the contractor may submit a revised submission during the audit but auditors should never solicit such a revision, the audit report should reflect results of the audit of original submission and all questioned costs or deficiencies found during the audit and revised submissions should be considered concurrence with the position in the report. Interim discussion with the contractor should be documented in accordance with CAM 4-303.1.

Communications with Requestor during the audit. Auditors, after discussion with their supervisor first, should keep requestor (CO) informed of major preliminary audit issues, not provide an audit opinion and clearly state status of the audit. Auditor should timely notify requestor of required extensions. During the course of the audit requestor may ask the branch manager to either change the type of engagement, change the audit scope or cancel the audit. Discussion with requestor should be fully documented. Before agreeing to convert or cancel the auditor should consider the reasons, especially if the audit is substantially complete and do not agree to a CO's request to cancel or convert to avoid a scope limitation, an adverse or qualified opinion or any other unfavorable result.

Exit conference. Help upon completion of field work and after supervisor and branch manager approval. The requestor/CO should be invited, especially if there are major or complex audit issues. Audit results are to be discussed with the contractor and contractors' views should be sought. Except for audits of forecasted costs that are subject to negotiations, provide a copy of the draft audit report or draft results of the audit section to the contractor with a copy to the requestor. This can may be provided prior to the exit conference to facilitate discussion and obtaining the contractors' views. If the report includes forecasted costs subject to negotiations contractor should not be provided a copy of the report where discussions should be limited to factual matters/differences. The branch manager may approve release of the draft audit report on a proposal to the CO after the exit conference when a final report will be issued shortly (within 5 days). The draft audit report may be released before the branch manager gives final review approval if the auditor and supervisor believe it is appropriate where the draft audit report should be clearly marked draft and subject to change based on final management review until the final report is issued. The results of the exit conference should be in the working papers along with the branch manager's approval to proceed with the exit conference.

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