GCA DIGEST

(A publication of Government Contract Associates)

First Quarter 2018 Vol 21, No. 1

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 services and supply federal contractors and provides some very useful financial and contracting information. The latest survey for 2016 has several changes (e.g. no executive compensation, profit for different types of contracts and accounting for uncompensated overtime) but we have tried to make up for some of these deletions by adjusting prior years' results. You can find the complete survey now at their website rather than paying the $1,000 fee we used to pay.

Company Profile

Most surveyed companies say their primary customer is the federal government. 24% of surveyed companies report their revenue came from the Defense Department, 30% from other federal agencies, 13% came from state and local government and 21% was commercial. The survey shows government business trends are higher where 66% of respondents had increased revenue over the prior year, 21% had no significant change while 21% had reductions. Revenue from GSA or other IDIQ contracts increased for 51% of respondents, decreased for 16% and 33% saw no change. Revenue from cost reimbursable contracts was 31% (down from 34-46% the prior 5 years), 39% from time and material contracts and 30% from fixed price contracts (up from 20% the last five years).

Employee Trends

50% of respondents report an increase in number of employees (significant increase over last year), 16% report a decrease and 34% report no change. Turnover rates appear to be increasing where rates of 0-5% are reported by 35% of respondents, 28% report 6-10% turnover rates, 26% report 11-15% rates and 15% report turnover rates of more than 15%. Wage increases ranged from 0 to 9% where the median response was 2.5%.

Government Contracts

Fees. Though these fees were not reported in the current survey we have reproduced prior years' results since they have not varied much through the years. 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 26% (last year 35%) and was 54% (75% last year) when they were the incumbent. Win rates when either a special business unit or joint ventures were created was 36%.

Bid and Proposal costs as a Percent of Revenue. 36% reported less than 1%, 20% 1-2% while 45% 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. 40% of the respondents said their procedures for recognizing out of scope work are very effective, 37% said somewhat effective and 27% said not effective. 84% of respondents said the government requests out-of-scope work either occasionally or frequently without issuing contract mods. 15% 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 27% of all respondents had a contract terminated for convenience in recent times where 25% submitted a settlement proposal while 75% 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, 12% of those experiencing a partial termination actually negotiated a price adjustment on continuing work while 88% 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). 48% of the respondents said they have undergone an accounting system audit which was approved, 12% underwent an accounting system review with deficiencies and 40 % had not been audited.

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. 16% of respondents reported no profit, 30% reported 1-5% profit, 46% reported 6-10% and 13% had profit over 10%.

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 41% when bonuses were included and 36% when excluded which is an increase from last year.

Indirect Cost Rate Trends. Indirect cost rates are increasing at 33% of companies while 30% are decreasing. Comparing provisional versus actual rates, 9% reported their actual rates were higher, 47% said provisional rates were higher and 44% were approximately the same.

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 rates are definitely trending downward where they are: (a) on-site direct labor (on-site means performed at company sites) - 60% compared to 77% in 2015 (b) on site direct labor and fringes – 33% compared to 36% in 2015 (c) off-site direct labor – 33% as opposed to 49% 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 and customer.

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 14% (13% in 2015) while those using a value added cost input was 13% (17% in 2015).

Material handling and subcontract administration costs. 27% 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 2.1 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. Though the 2016 survey did not address this area we did decide to include last year's results since this is such a significant issue and results did not differ from year to year in the past.) Uncompensated overtime refers to hours worked exceeding the normal 40-hour workweek by those salaried employees exempt from the Fair Labor Standards Act. In 2015, 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. 82% of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract or subcontract (substantial increase) while 16% 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.

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, 70% say auditors' opinions are substantiated with appropriate references and 30% are arbitrary and not substantiated while 65 % of auditors are open-minded and receptive to contractor rebuttals (substantial increase) and 35% say auditors are inflexible and are rarely receptive. Contracting officers receive lower ratings where 57% of their opinions are considered substantiated with references and 43% are arbitrary while 57% are open-minded and receptive and 29% 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% last year) while 10% said it had improved.* The most frequent types of costs questioned by DCAA are executive compensation (14%), consultant costs (13%), incentive compensation (10%), labor charging (3%) and indirect cost allocations (3%). Most frequently cited violations of cost accounting standards, which has substantially increased, were CAS 403, home office expenses (7%) and CAS 405, Unallowable costs (5%). Costs questioned as a percent of revenue were less than 1% of revenue (70%), 1% of revenue (13%), 2% of revenue (5%), 3% of revenue (7%), 4% of revenue (1%) and 5% or more of revenue (5%).

Executive Compensation

(Editor's Note. For some reason, the 2016 survey did not address executive compensation. We have always cautioned readers against substituting the results of this survey for a bona fide compensation survey that may include hundreds of firms. However, the results are nonetheless interesting and often consistent with other surveys so we always liked including results here so we adjusted 2015 results by increasing the amount by about 3%, a rough approximation of salary increases. 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	205	290	420
$11-50M	290	360	560
$51-150M	460	700	890
>$150M	750	1010	1,290

Second Highest Position

Revenue	25%	Med.	75%
$0-10 M	145	240	290
$11-50M	205	270	350
$51-150M	335	465	540
$>$150M	390	610	770

Third Highest Position

Revenue	25%	Med.	75%
$0-10 M	125	165	250
$11-50M	170	215	300
$51-150M	280	390	490
>$150M	390	610	770

Fourth Highest Position

Revenue	25%	Med.	75%
$0-10 M	105	135	195
$11-50M	145	180	260
$51-150M	215	335	430
>$150M	300	475	595

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. These results are consistent with challenges we have made to

DCAA findings in our consulting experience where they should encourage challenging DCAA's conclusions.

INDIRECT COST RATES

(Editor's Note. Both inquiries by subscribers and consulting engagements evaluating clients' indirect rate structure has substantially increased recently. We frequently encounter numerous misconceptions about indirect cost rates by both contractors and government representatives. We decided to present some of the most common misconceptions we encounter and provide some basic information about them and hope the article will be useful to both new and veteran contractors.)

Some of the common misconceptions we encounter include:

- High indirect rates are a bad thing and low ones are good
- All companies should have the same rates where a comparison of rates should reveal which ones are more desirable
- What companies call "overhead" or "G&A" should be consistent
- The FAR and even CAS prescribes how you should track and allocate indirect costs
- Most successful companies have the same rate structure
- Indirect rates are just fluff that contractors use to plump up profits

Defining Indirect Costs and Rate

An expense is either a direct cost charged to a project or an indirect expense that benefits various projects and the company as a whole. FAR 31.203 provides a fairly lengthy definition of direct costs which can be boiled down to: if a cost is easily identifiable to a single project, it is generally considered to be a direct cost. Obvious examples of direct costs are labor performed while working on a project, travel to project meetings, material consumed entirely on a project and subcontractors and consultants hired to work on a specific problem of the project. A good question to ask is "if we did not have this contract would we still incur the cost?" If the answer is "yes" then it is probably an indirect cost.

Though indirect costs are often considered "everything else" FAR 31.203 actually provides for an even greater detailed definition. Again, indirect costs can be boiled down to: if the cost incurred (1) benefits more than one contract (2) is incurred for the common good of the company (3) is impractical to split and (4) can be considered an immaterial direct cost. Examples of indirect costs include general business insurance, legal and accounting costs, general office supplies and magazine subscriptions.

Gray areas. With clear definitions, does this mean all companies would treat the same cost in the same manner? The answer is "no" where there is considerable latitude in how companies treat similar costs. Take overnight charges. Company A ships a monthly report to their client and since they can clearly identify what the cost was for they charge it against their contract. Company B also obtains a monthly report of their shipping charges which though they can identify to specific projects they nonetheless charge all shipping to an overhead account because they have determined it is not worth the additional administrative cost to track, allocate and bill for overnight packages. The same approach is taken for many other types of expenses. Even labor charges such as supervision and administrative effort fall into this gray area. Both Company A and B have project management meeting where managers from all five different projects meet to discuss overall resources, schedules and priorities. Company A may ask each person to charge all of their time to overhead while Company B may require each person to split their time among different projects they are managing. Or, for administrative support, Company A may charge all their time to overhead while Company B has their admin staff charge time to specific projects when they are supporting a specific project.

Types of Indirect Costs

Just as there are differences in how companies distinguish between direct and indirect costs, there are differences in how companies structure their indirect costs and rates. Common groupings (called a pool) and their definitions include:

Fringe benefits. Expenses incurred for the benefit of employees where examples include payroll taxes, medical insurance paid by the company and company contributions to 401(k).

Overhead. Expenses typically incurred to support day-to-day technical operations of the company which is

generally considered to be expenses needed to give the staff the resources needed to do their job. Examples include supervision, professional dues, recruiting, relocation, depreciation and equipment.

Subcontractor/Material Handling. Expenses associated with the administration of subcontract and material acquisitions. This can include selecting, negotiating and managing these purchases.

G & A. Costs associated with general administration and management of the company. Examples include finance and accounting, business planning and sales and marketing.

Principles of Direct versus Indirect costing.

It should be clear by now that even with FAR detailed definitions, companies have great latitude in making their decisions. The following is a few principles to keep in mind.

- Nowhere in the FAR does it state the government can tell a company how to keep its books and allocate its costs. Though the cost accounting standards sometimes provide more specific prescriptions the principle of wide latitude applies to FAR and CAS.
- The period for allocating indirect cots should be the contractor's fiscal year
- When substantially the same result can be achieved through less precise methods a company is allowed to keep the allocation simple and not be forced into more complicated allocation formulas that may be technically more accurate but not materially different
- Consistency – once treated as direct or indirect a cost should be treated consistently
- The only requirement is that accumulating and allocating indirect costs be fair, reasonable and equitable.

Computing Indirect Rates

Computation of indirect rates is a simple math exercise – dividing a pool of costs (numerator) by a base of costs (denominator). For example, fringe benefits are often divided by total labor costs and overhead costs are usually divided by direct labor costs. However, as we have seen in much readings and experience which has been confirmed by several studies, contractor data for direct costs such as labor, material, subcontracts and pools of costs such as G&A, overhead and fringe benefits costs can yield almost unlimited different sets of indirect rates despite the fact that each rate was mathematically correct. The range of fringe benefit rates in one study was 30-42%, overhead rates went from 17%-56% and G&A went from 25% to 50%. The lessons from these wide range of rates are: (1) there is no right or wrong way to compute rates (2) even similar companies can develop significantly different rates (3) a direct comparison of rates cannot be justifiably made since though rates may be widely different, the government usually does not really pay any more or less despite the appearance.

The widely different methods of computing rates illustrates some important implications.

1. Though a company may have high rates they are not really more expensive.

2. To satisfy your government customers it is usually best to present the lowest possible rates though there is no impact on what the government will pay.

3. There are several ways of achieving the perception of lower rates: (a) charge as many costs as possible direct since this would lessen the amount of costs in an indirect pool (b) closely related, attempt to charge major costs or unique costs directly to a contract (c) create more indirect rates by splitting up large groupings such as creating separate fringe benefit and overhead rates rather than combining fringe benefit costs in an overhead pool resulting in a change of say, 80% overhead to 40% fringe and 40% overhead (d) create new indirect rates for different types of work (e.g. split an overhead rate into on-site and off-site rates) (e) expand the costs that are included in the base or denominator (f) create service center(s) that can be grouped together and charged direct and indirect (e.g. combine computer costs into a separate center and charge contracts directly for these costs and the rest charged to indirect cost pools).

Developing and using rate projections

Larger companies commonly create detailed budgets which can be used to project future costs to create indirect cost rates. This formal budgeting process is less common for smaller companies where whether formal budgets or more simplified future cost projections are used, indirect rates normally consist of four steps: (1)

forecasting revenue – this is the starting point (2) estimate labor requirements (both direct and indirect) since this is usually the largest cost element where an overall percentage can be used and then broken down into direct and indirect costs (3) estimate other direct costs for all projects such as material, subcontracts, travel, etc. which, again can usually be estimated as a percentage of revenue and (4) estimate the amount of operating expenses for the company.

Once future costs are estimated contractors will use the results in several ways.

1. Provisional rates. These are rates usually presented to the government at the end of the previous year to be used in the next year's billing of indirect rates for cost and T&M contracts. Whereas in the past they were rarely reviewed, in recent times they have become much more subject to audits since they often give auditors the sole opportunity to review contractors' rates due to the low number of incurred cost proposal (ICP) audits due to the backlog of DCAA incurred cost proposals and reduced audits of "low risk" ICPs.

2. Forward pricing rate agreement. Most large and many medium sized contractors submit proposed rates that are reviewed and approved for use in all or most proposals in the coming year.

3. Specific billing rates. Submission of individual proposals for the year will include cost sections that proposed individual indirect cost rates become applicable to the proposed contract. The forward pricing rates are used for all types of proposals and increasingly, we are seeing them being ceiling rates for flexible contracts or even negotiated rates that are below what are actually projected.

Monitoring Rates

If a contractor has flexible contracts a critical internal control is the practice of monitoring rates during the current year. Contractors need to show they have policies and practices in place that allow them to (1) monitor actual indirect rates during the year (compute annualized rates using actual and projected amounts) (2) propose to adjust billing rates on flexible contracts during the year (no problems decreasing rates but increased ones need to be approved) and (3) submittal of revised invoices to make an adjustment for earlier invoiced amount and amounts using adjusted rates.

In addition to the internal controls, contractors need to consider the impact of indirect cost rates on their cash flow and generally accepted accounting practices. Realization that they are underrunning their estimated rates – actual rates are lower than approved provisional rates – means they are likely to be expected to reimburse the government for the excess billed amounts. Conversely, overrunning their estimated rates means they will be entitled to additional amounts. Financial statements, covenants with financial institutions and possible acquisitions of business by others will be affected by their adjustments. In addition to impacts on cost type contracts, profitability of fixed price and T&M contracts (the fixed labor portions) will also be impacted.

Case Study…

CHALLENGING QUESTIONED COSTS FOR CLOSELY HELD FACILITY AND EMPLOYEE BONUSES

(Editor's Note. The following is part of our ongoing series of presenting real life challenges to government auditors' positions. This abbreviated opinion is instructional because not only do we present arguments against DCAA questioning the costs but it shows common reasons DCAA puts forth for questioning these costs and also presents prudent actions to preclude DCAA questioning the costs. We disguise the identify of our client – referring to them as Contractor – and change the numbers.)

Background

During the audit of its 2014 incurred cost proposal, DCAA questioned costs related to use of a property owned by the owners of a small business and bonuses earned and claimed in 2014 that were paid in 2015. DCAA argued the bonus costs should be questioned and if allowed, they should have been recognized in 2015, not 2014. Such a result would significantly adversely affect Contractor since its 2015 claimed costs had already exceeded allowable billing rates so any additional bonus costs would not be reimbursable on its major cost type contract.

DCAA's Position

- **Cost of Ownership of Residential property used for Contractor business.**

DCAA states it disagrees with Contractor charging the cost of ownership (CoO) of the residential property its owners possessed. Though Contractor has been charging the ownership costs of its personal property expenses as rental fees to the government for many years these costs are unallowable for the following reasons:

1. When it rented its main facility (office) in FY 2012 it should have rented sufficient space to accommodate its business activity. Therefore, there is no need to charge costs of its owners' personal property as additional rental costs.

2. In support of its position DCAA cited FAR 31.201-3(a) which states that "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." In their opinion, the claimed CoO is considered unreasonable, thus unallowable per FAR 31.201-3(a).

3. Costs of ownership should not include a cost of money factor which is a violation of CAS 414.

- **Bonus**

Whether it is considered a deferred or contractual bonus, it is an unallowable cost in 2014.

1. DCAA first asserted that the bonus in question is a form of deferred compensation. As for the correct cost principle, DCAA originally asserted the deferred payment should be governed by the relevant sections of FAR 31.205-6(k) and CAS 415 that addressed "incurred obligations." They stated, "We question the $750K entirely per FAR 31.205-6 and CAS 415 where Contractor has not demonstrated that the bonus cost is an incurred obligation to the employees." Further, DCAA asserted there was no agreement signed by the employees prior to the services nor specific amounts identified and therefore in essence no agreement exits and hence there is no deferred compensation bonus obligation. They said if in the future employees receive the bonus payments, the amount paid should be assigned to the cost accounting period in which the payment is made. Therefore, the amount paid in 2015 should be allocated to that period and not 2014.

2. Once the designation of the costs of "deferred compensation" was dropped the relevant cost principle became FAR 31.205-6(f), bonuses and incentive compensation, which the auditor quotes extensively from. DCAA asserts that the bonus established in 2014 and paid in 2015 is a "contractual bonus" and if it was to be allowed, it must be claimed in the period it was paid, 2015. In its allusion to the section FAR 31.205-6(f), DCAA cites what it considers to be the conditions for a bonus. The first thing DCAA asserts is that the "bonus" is not part of a "written agreement" between the company and its employees.

3. Based on its interpretation of the requirements of FAR 31.205-6(f), DCAA then sought evidence for a written agreement that provided the basis for the contractual bonus. After asking to see a document/agreement that shows employees were aware of the bonus Contractor's owners provided a notification that had been posted on the company message board located in the office's kitchen. When DCAA asked if the notice had been given, reviewed & signed by the 95 employee signatures who were intended to receive the bonus in 2015 the owners said it was posted in the kitchen for employees to see despite there being no signature or other confirmation by employees. DCAA concluded the notice is not considered an agreement because they are not convinced that all the prime employees had reviewed the notice let alone signed it. They said the notification did not constitute a written agreement between the individual employees and Contractor which made the bonus non-compliant with FAR and hence unallowable.

4. In addition to the kitchen notification, DCAA was provided a copy of an earlier draft bonus policy and copies of letters sent out to employees who were eligible for the bonus. DCAA asserted the policy did not address the type of bonus envisioned and none of the documents provided constituted a "written agreement" between the company and employees and hence the bonus was unallowable.

Our Response to the Questioned Costs

Our position is that DCAA's position contains significant factual errors, either alludes to inappropriate FAR sections and ignores others and misinterprets the requirements of the FAR sections cited. As a result, we believe these errors do not provide a fair and valid basis for making a determination of whether the costs questioned are justified.

- **Rental fees on Personal Properties**

1. Based on their 20 years of experience Contractor concluded they needed a separate space to store sensitive data, have a private office and conduct sensitive meetings away from its office where security requirements precluded access by unauthorized personnel. For example, during our visit, we witnessed board of director meetings, discussions about what to do with a project manager that was disliked by both employees and the client, bonuses and meetings where "secret" documents were reviewed.

2. The residential facility has long been used exclusively for Contractor's business. It was once a residence for the owners but upon buying its other residence in 1990s, the owners decided to use it for Contractor business which it has continued doing. This use of offsite property has been reviewed and accepted by DCAA in the past where the CEO had no reason to believe any conditions had changed.

3. Though the DCAA memo does not cite it, FAR 31.205-36, rental costs clearly makes these costs allowable. Section (3) of that cost principle provides the basis for computing allowable costs of rental expenses for properties held by related parties. It states "Charges in the nature of rent for property between divisions, subsidiaries, or organizations under common control, to the extent they do not exceed the normal costs of ownership such as depreciation, taxes, insurance, facilities capital cost of money and maintenance (excluding interest and other unallowable costs pursuant to Part 31), provided that no part of such costs shall duplicate any other allowed costs..." are allowable.

4. The costs meet the FAR 31.203 condition of reasonableness. Though Contractor could rent other facilities, the owner concluded that using the residential property represents a lower cost than would be incurred by renting separate properties. The property has a long history of use for Contractor business. Changing that, incurring additional costs and efforts in locating another facility is both expensive and unnecessary. The owners also control the cost of the residential property by lessening the percentage of costs that are allocated to Contractor. In spite of business use of 100%, the owners have voluntarily reduced the cost of ownership of the property by assuming only 60% Contractor usage. This results in a significant savings to the government where the per square footage cost of ownership is significantly lower than that of its office and other offices in the area. The annual per footage cost at the residential property is $120 per square foot where the square footage cost at its main office is $180 per square foot.

5. The auditor erroneously assumes Contractor would know its space needs when it rented its office. The auditor's assertion that Contractor should have known is simply unrealistic. Contractor had never had any contract effort worth more than $4 Million per year. However, when it won a large contract in 2012, potentially worth between zero and $30 Million per year (it actually exceeded this amount), all it knew was its needs would likely increase. However, the company neither knew the dollar value, personnel needs or location of the employees it might need to hire.

6. In addition, no FAR requirement stipulates where any personnel should be located. The audit report simply asserts, as an unsubstantiated opinion, that the CEO should be located at the office where any other facility should be deemed unallowable. This is simply an incorrect assertion, based neither on an understanding of the company's needs, economics nor FAR requirements. Decisions for what facilities to use and where employees should be located should be based solely on business judgment of the contractor, not an auditor's opinion. The prudent person rule of reasonableness should dictate, not an auditor's unfounded opinion.

7. As for the assertion there is a CAS non-compliance for inclusion of a cost of money factor in computing the cost of ownership is incorrect. First, cost of money is a perfectly allowable and allocable cost to apply to the cost of an asset when computing the cost of ownership of that asset where FAR 31.205-36 includes it as an explicit allowable cost of ownership just like any other allowable cost would be (e.g. utilities, repair and maintenance, etc.). Second, since interest costs are unallowable – the government does not want to pay for costs a contractor incurs due to its choice to finance rather than to use its funds – the government applies a cost of money (COM) factor that allows contractors to recover the net value of the assets times the appropriate interest rate so as not to benefit a decision to borrow versus pay out of its own funds.

- **Contractor's Accrual of the Bonus**

Contractor established an accrued bonus in 2014 to be paid to all eligible employees at the end of 2015. The bonus is a result of superior performance of Contractor's relevant employees in 2014 which is properly accrued in 2014. This accrual is compliant with requirements

specified in FAR 31.205-6(k) and CAS 415 as well as consistent with Contractor's policy, corporate minutes and prior practices that have been reviewed by DCAA.

As DCAA first indicated, the most relevant regulations addressing the accrued bonus is FAR 31.205-6(k), deferred compensation other than pensions which references CAS 415 as the proper regulation addressing how the bonus is to be allocated. The bonus is consistent with CAS 415. Specifically:

1. The bonus is allocated to the period 2014 when an obligation to pay was established. CAS 415-40 states, "The cost of deferred compensation shall be assigned to the cost of accounting period in which the contractor incurs an obligation to compensate the employee." In fact, in his commentary on CAS 415, Lane Anderson in Accounting for Government Contracts state, "the period when the obligation was established must be the period the expense is recognized." To accrue the cost to another period would be improper.

2. The obligated bonus in its entirety will be paid to all eligible employees on a *group* basis. The bonus will be paid to all eligible employees (e.g. those employees who were employed in 2014, are classified as prime employees as opposed to term employees). The stated amount of the bonus, $750,000 will be paid out and that amount has been set aside in a separate bank account. The bonus meets the requirements of how it will be measured – both as a separate award and as an award provided on a group basis. Estimates of individuals' bonuses are not required. CAS 415-40 states, "The cost of each award of deferred compensation shall be considered separately for purposes of measurement and assignment of such costs to the cost accounting period. However, if the cost of deferred compensation for the employees covered by a deferred compensation plan can be measured and assigned with reasonable accuracy on a group basis, separate computations for each employee are not required."

3. The bonus is a bona fide obligation of the company and meets all of the conditions for such a bonus. In our response, we detailed how each of these conditions were met.

- **Contractor's Response to DCAA Position**

DCAA is citing the wrong section of the cost principles, misinterprets the requirements of the section it does quote and does not possess sufficient facts to make a determination.

1. In as much as DCAA first addressed deferred compensation alluding to section (k) of FAR 31.205-6 and CAS 415 and then switched citation to section (f) it is unclear if DCAA is aware of the fact that sections (k) and (j) address different types of compensation with different conditions for allowability. As discussed above we have identified in depth how the conditions for deferred compensation identified in (k) and CAS 415 had been met. Since the nature of the bonus is clearly deferred compensation, we believe section (k) of the compensation cost principle and CAS 415 should govern this payment.

2. Even if FAR 205-6(f) is asserted to apply DCAA is incorrectly asserting conditions for allowability. The request for a written document/agreement showing awareness of the bonus is an unreasonable requirement that neither reflects the requirement of FAR 31.205-6(f) nor is consistent with industry practice. First, there is no requirement for a *written* agreement. The section quoted by DCAA throughout their memo that does address agreements contains no requirement that those agreements be in writing. Further, the sections of the FAR (FAR 31.205-6(k) and CAS (CAS 415) that more appropriately apply to the payment in question do not require a written agreement. In fact, "agreement" is not mentioned, written or not.

3. DCAA alludes extensively to the word "agreement" in its narrative but it fails to refer to the operative phrase "in effect, an agreement" where written agreement is neither mentioned nor is it practiced.

> (f)(1) Bonuses and incentive compensation are allowable provided the Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment;

If the FAR Councils intended to require a formal written agreement it would have said so as it does throughout the FAR. In addition, it would not have added the qualifying words "in effect" had it intended to require a formal written agreement.

4. DCAA asserts that the kitchen notification was the only written notification to employees about the deferred payment. This is factually incorrect. In addition to the

kitchen notification, DCAA sent out a formal notification to all eligible employees. We have attached an example of a notification sent to all employees.

5. The kitchen notification was posted in anticipation of DCAA's erroneous insistence that written notification had to be made. It was not intended to be a written agreement presented to each employee but rather public notification that the accrual made in 2014 would be paid to eligible employees in the following year. It was intended to be one piece of evidence that an obligation was established. It was not intended to be a formal agreement with each employee. As for visibility of the notice, visits by virtually all employees to the message board in the kitchen area are made, including those who work offsite. It represents the best visibility for all notifications.

6. DCAA's assertion that Contractor does not have a signed and dated policy is factually incorrect. It was learned that DCAA possessed a copy of an earlier draft copy of a bonus policy that was inadvertently provided to DCAA. We have attached a copy of the bonus policy that applied in 2014 where the type of bonus in question is addressed.

In conclusion, there is extensive evidence of factual errors and misinterpretations of FAR by DCAA in concluding the deferred payment is unallowable. In summary, first an "agreement" is not required as part of deferred compensation. Second, even if the payment was considered a bonus an "in effect" agreement is not equivalent to a formal "written agreement" that is neither required by the cost principle nor practiced in industry. Third, written notification was given to all eligible employees. Fourth, the kitchen notification was never considered to be a formal "written agreement". Fifth, Contractor does have a signed and dated policy where the payment in question is alluded to where the policy DCAA apparently possesses was a draft of an earlier one which was inadvertently sent. We are waiting for DCAA's response.

Knowing Your Cost Principles…

DIRECT SELLING COSTS

(Editor's Note. In our consulting practice, we often encounter numerous challenges to the way contractors allocate selling costs. Imprecise rules and conflicting appeals boards' decisions provide opportunities for the government to challenge allocations of otherwise allowable selling expenses to government contracts which they frequently do. We have relied on one of our favorite texts, Accounting for Government Contracts Federal Acquisition Regulation, edited by Lane Anderson as well as our own experiences as consultants for this article.)

Selling is a generic term that includes all effort to market a contractor's goods and services. Individual portions of the Federal Acquisition Regulation cover various aspects of selling and marketing activities: advertising and public relations – FAR 31.205-1, bid and proposal costs – FAR 31.205-18, market planning – FAR 31.205-12 and direct selling costs – FAR 31.205-38. We will focus on direct selling costs which are defined as actions to induce particular customers to purchase a contractor's goods and services. These efforts are usually characterized by person-to-person contact with potential customers. Selling activities include identifying potential buyers, learning of buyers' needs, convincing potential buyers to purchase the contractors' goods and services, negotiation and liaison between contractor and customer personnel, technical and consulting activities and individual demonstrations.

Allowability

Selling costs are allowable if they are reasonable. There are certain prohibitions: (1) if they are considered advertising costs such as sales promotion or (2) sellers' agents' compensation – whether called commissions, fees, percentages, retainers, brokerage fees – is not provided by "bona-fide employees or established selling agencies." The latter simply means that compensation must be for actual legitimate sales services rather than that considered "influence" payments.

Other than challenges to non-allocability, if these prohibitions are not met then the only other basis to question the expenses is they are unreasonable. In determining reasonableness, the government considers the nature and amount of expense in light of expenses a prudent person would incur, the proportionate amount spent between government and commercial business, the trend and comparability with historical costs, general level of selling costs in the industry and nature and value of the expense in relation to contract value.

Allocability

Unlike CAS 420, where allocation of bid and proposal costs are spelled out, none of the cost accounting standards address selling. The original CAS Board did consider addressing selling and marketing expenses but decided against it. Though the CAS Board did not assert sales

expenses were a general and administrative cost, CAS 410 states the expenses may be included in G&A costs.

In general, the government views selling costs as being more closely related to commercial business and it is not uncommon to see the government (i.e. auditors) attempt to single out selling expenses as applying to commercial work only. Where some selling costs produce a clearly recognizable "benefit" to the government (say, cost of service incurred to adapt a commercial product to government use), other costs demonstrate less direct benefit. Auditors may suggest several methods to exclude allocation of selling costs to government contracts (e.g. they should be direct charged to commercial contracts, two or more selling cost pools should be created) and contractors need to counter with arguments that justify allocation to government. For example, to the direct charge to commercial contract contention, contractors can argue that selling costs are not incurred specifically for a contract because no contract exists when the costs are incurred – after all, the purpose of the expenditure is to secure a contract. *(Editor's Note. Auditors are prone to more aggressively question costs in certain areas with the understanding they may have to soften their stand if the contractor appears adamant in challenging their position. Allocation of selling costs is one of those areas and contractors should be prepared to state their position forcibly.)*

- **Inconclusive Board Decisions**

The appeals boards decisions are not always consistent and there seems to be enough decisions to be cited on both sides. On the side justifying allocation of selling costs to government contracts, the appeal boards have sympathized with the position that selling costs included in the G&A pool that are allocated to all work is appropriate due to the fact that as the business expands all contracts benefit because G&A is allocated over a broader base. Since there is no definite cause and effect selling costs are reasonably considered an overall cost of doing business. Acceptable allocation of indirect cots to a contract often depends on whether "benefit" to that contract can be demonstrated. In *Lockheed- Georgia Co. (ASBCA 27660)*, which cited an earlier case – *Lockheed Aircraft Corp v. US 375 Fwd 786* – the Board concluded the requirement to allocate costs on a benefit basis is established by any sound method of allocating indirect costs to government and commercial work. Similarly, in *General Dynamics Corp (ASBCA No 18503)* the requirement to distribute costs in proportion to benefit may be satisfied by any reasonable method of allocating costs to both government and commercial work. Its selling costs for a commercial contract was allocable to government work because its success would reduce fixed overhead expenses. In *Daedalus Enterprise Inc. (ASBCA 43602)* bid and proposal costs for a foreign contract was also allocable to a government contract because the government benefits from a lower G&A rate as a result of foreign business. The Board understands that benefit exists because fixed expenses are allocated over a larger base.

Aydin Corp (West) (ASBCA 42760) provides further justification for allocating sales expenses to government contracts. The contractor's practice was to record all commissions as an indirect cost and in one year when a non-government contract represented 91 percent of all commissions while the contract represented only 19 percent of the G&A base costs, the government and Appeals Board asserted allocation of 81 percent of the commissions to the government contract was inequitable. The US Court of Appeals reversed this position ruling the mere size of the commissions was not sufficient to justify a different allocation method of the same costs – commissions – and to do so would be to violate CAS 402.

Though the cases discussed above support the conclusion that increasing a contractor's overall business base justifies allocation of selling costs to government contracts it is not always a "slam dunk." In *Capital Engineering Corp (ASBCA 11453)* and *Phillips Petroleum Co. (ASBCA 6830)* the appeals board held new business ventures were so clearly commercial that an allocation to government work was not appropriate. In *KMS Fusion (24 Cl. Cl. 582)* and *Sanders Associates (ASBCA 15518)* certain clearly commercial selling costs were also not allocable to government contracts. Numerous ASBCA cases have held that salaries of sales people who are not involved in government contracts are not properly allocable to government contracts (see *Century Title Co. ASBCA No. 1733, Wichita Engineering Co. ASBCA 2522 and Habney Brothers, Inc. – ASBCA 3629*).

- **Other Allocation Issues**

Deferral. In order to better match revenue and expenses many contractors are tempted to defer selling and marketing expenses to future periods for future contracts. Most authorities will reject this deferral because they view selling and marketing as period costs. Their similarity to bid and proposal costs where FAR 31.205-18 prohibits such deferrals supports their conclusion that selling costs should not be deferred.

Foreign Selling Expenses. Foreign selling expenses related to foreign military sales (FMS) have created special problems

GCA REPORT
P.O. Box 1235
Alamo, CA 94507

FIRST CLASS
U.S. Postage
PAID
CONCORD,

because of the changing regulations covering them. We often encounter confusion by both government and contractor representatives. A summary of the cost rule provisions are: Before March 1979, foreign selling costs were allowable. From March 1979 to January 1986, these costs were considered "unallocable" to US government contracts. Between January 1986 and May 1991, the FAR made these costs unallowable because a court decision confirmed the earlier "unallocable" position and the FAR Council said their unallocability made them "unallowable." After May 15, 1991, these costs are allowable if they consist of significant efforts to export products normally sold to the US government.

Commissions and Retainers. Commissions were once unallowable but are now considered allowable. The government has frequently tried to insist contractors treat them as direct costs. In *Cubic Corp (ASBCA 8125)*, the government contended that all commissions should have been treated as direct costs of the applicable contracts but the appeals board ruled that commissions, like other selling costs, be treated as indirect expenses. In *Daedalus*, the same issued was addressed with the same conclusions. CAS 402 (as well as FAR 31.203 for non-CAS covered contracts) requires expenses, such as selling costs, be allocated either as direct or indirect to prevent double counting where a contract is allocated its share of selling costs as a direct cost and also receives an indirect cost allocation of the selling costs related to other contracts. The *Cubic* and *Daedalus* cases discussed above ruled that selling costs are incurred for the same purpose under like circumstances whether or not the selling effort was successful in obtaining new business. If the cost of successful selling efforts are allocated direct and those unsuccessful efforts allocated indirect, the Board rules a violation of CAS 402 and FAR 31.203 results.

Retainers, which are payments for general representation without regard to sales levels (most commissions are based on actual sales made) are considered a type of commission and follow the same rules of allowability and allocability.

Separate cost pools. In one form or another, the government may propose that several selling cost pools be created. When new work – government or commercial – is performed in an indirect cost pool where the base includes government and commercial work, both types of customers reap the benefit of increased business volume. The referenced text suggests it is generally inequitable to require separate selling cost pools for government and commercial work when the work is performed in the same indirect cost pool and hence the suggestion should be resisted.

INDEX

GRANT THORTON SURVEY ON PROFESSIONAL FIRMS....1

INDIRECT COST RATES....4

Case Study…
CHALLENGING QUESTIONED COSTS FOR CLOSELY HELD FACILITY AND EMPLOYEE BONUSES....6

Knowing Your Cost Principles…
DIRECT SELLING COSTS....10

GCA DIGEST P.O. Box 1235 Alamo, CA 94507 (tel) 925-362-0712 (fax) 925-362-0806 Email: gcaconsult@earthlink.net
website: www.govcontractassoc.com
This publication provides general information and is not a substitute for accounting, legal, or other professional advice.
Duplication of this publication, without writeen permission, is prohibited.
Subscription: $175 for one year, $325 for two years.