GCA Report

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NEW DEVELPMENTS

NDAA 2018 Creates Several Changes

The National Defense Authorization Act for FY 2018 includes several significant changes affecting government contractors. Some include:

Incurred cost audit requirements. Several provisions were put forth that are intended to improve the efficiency and effectiveness of incurred cost audits and to eliminate DCAA's backlog of incurred cost audits. Major ones include: (1) by 2020, DOD will be required to comply to commercially accepted standards of risk and materiality in performing IC audits (2) use qualified private auditors to perform sufficient audits to eliminate backlog by 2020, ensure audits are completed within one year of receipt of qualified IC proposals (ICP), maintain an appropriate mix of private and public auditors to meet DOD's current and future needs and, ensure private auditors conduct enough IC audits to improve their efficiency (3) restrict multi-year audits to only ICPs submitted before Dec 2016 (4) private auditors must not have any conflict of interest, must be independent, sign a non-disclosure agreement where if they breach their contractual obligations related to disclosing proprietary data will be subject to criminal, civil and administrative actions (5) DCAA may issue unqualified audit findings of an ICP only if it passed a peer review by a commercial auditor and (6) require DCAA to accept audit findings by a commercial auditor in certain circumstances and restrict DCAA authority to audit only indirect costs except for contractors with a preponderance of cost type contracts as a percent of sales. DCAA Director Anita Bales has testified against many of these changes and is proposing legislation to eliminate the requirement to rely on commercial audits.

New Thresholds. The simplified acquisition threshold has been increased from $100,000 to $250,000 and the micropurchase threshold has been increased from $3,000 to $10,000. In addition, there is an increase in the threshold for submission of cost or pricing data from $750,000 to $2 million for contracts awarded after June 30, 2018. The $2 million threshold applies also to modifications of such contracts except for those contracts awarded before June 30, 2018 where the $750K amount will still apply. The NDAA also deleted the statutory mandate for COs to require submission of other than certified cost or pricing data to determine the price reasonableness of contracts, subcontracts or modifications where now substituted language is "the offeror shall be required to submit to the CO data other than certified cost or pricing data (if requested by the CO), or to the extent necessary."

More Detailed DCAA annual reports. Now, in addition to reporting total number of audit reports completed and pending in its annual progress report, DCAA must include the dollar value and separately list by type of audit, the number of reports completed and pending. Rather than reporting on length of time taken for each type of audit, DCAA must report length of time from date of receipt of qualified ICP and date the audit starts and total number and dollar value of incurred cost audits completed and number and dollar value of IC audits pending for over one year. It must report not just sustained questioned costs but now must report sustained cost by type of audit both as a total value and percentage of total questioned costs. "Sustained costs" is meant to be questioned costs that were recovered by the federal government as a result of negotiations related to such costs.

Commercial items. Items determined to be a commercial item under FAR Part 12 in the past will now serve as a commercial item determination for that item unless DOD states in writing it is no longer valid. In addition, it prohibits acquisition of items under FAR Part 15 that were previously acquired using FAR Part 12 unless the head of an agency rules it is appropriate. In addition, the definition of "subcontracts" under commercial item acquisitions is not to include the supply of commodities that are intended for use of multiple contracts for either the federal government or other parties not identified as one particular contract.

New Contract-Related Interest Rate Set for First Half of 2018

The Treasury Secretary has set a rate of 2.625% for the period January through June 2018. The new rate is an increase from 2.37% applicable to the last six months of 2017. The Secretary of the Treasury semiannually establishes an interest rate that is then applied for several

government contract-related purposes. Among other things, the rates apply to (1) what a contractor must pay the government under the "Interest" clause at FAR 52.232-17 and (2) what the government must pay a contractor on either a claim decided in its favor under the Contract Disputes Act or payment delays under the Prompt Payment Act. The rate also applies to cost of money calculations under Cost Accounting Standards 414 and 417 as well as FAR 31.205-10 and when a discount factor is used to calculate the present value of future payments (e.g. deferred compensation).

Market Trends

Several trends are emerging according to several commentators we have read. Some include:

1. The Defense Department's National Defense Strategy is emphasizing that potential conflicts with China and Russia are taking center stage under the Trump Administration compared to the Obama-era focus on extremist organizations. Contractors will still need to support US military fighting against the Islamic State and similar forces in the Middle East and elsewhere but more funding preparing to fight conventional wars against powerful countries will be stressed. The first four capabilities being targeted are nuclear forces; space and cyberspace; command, control communications, computers, intelligence and surveillance (C4ISR); and missile defense. Priority areas are speed of delivery, continuous adaptation and frequent modular upgrades.

2. Pentagon acquisition management state a major restructuring is set to start early next year where it is gearing up to award a large, multibillion dollar cloud contract. Big restructuring of the DOD acquisition function, continued and expanded use of other transaction contracts (i.e. transactions most often used for prototype and other technology projects which are not bound by standard federal procurement regulations), begin working on online marketplace programs which will allow retailers such as Amazon and Staples to sell commercial goods throughout the government, bid protest changes which will decide what to do with a recent Rand Corp. report covering more than a dozen topics related to bid protests (see article below) and expanded awards to small businesses where recent mentor-protégé success is being cited.

3. Four federal contract spending trends over the past five years are also being emphasized including: (a) federal defense spending has broken the half trillion barrier where over $522 billion on unclassified contracts was spent (b) federal spending on government-wide acquisition contracts which consolidate innumerable contracts used to buy new IT and upgrade legacy systems (c) spending on simplified acquisitions which all agencies like because they avoid many procurement regulations and (d) shift to fixed price contracting which is perceived to save money where dollar spending is about the same but number of fixed price contracts have expanded.

Some Implications of New Tax Law on Contractors

Commentary on the impact of the new tax law on government contractors is beginning to come in. Some interesting ones we have seen include:

1. Relocation Costs. While the Act eliminated moving expenses as a deductible expense and moving expense reimbursements are not excluded from taxable income, the FAR has not changed. FAR 31.205-35, Relocation addresses allowability of these costs and it still permits the contractor to reimburse employees for increased FICA and income taxes that are incident to allowable "tax gross up" payments.

2. Depreciation Costs. While the Act allows businesses to deduct 100% of the costs of qualifying property CAS 404 and 409 that address capitalization and depreciation have not changed nor has FAR 31.205-11 which permits depreciation costs that do not exceed the amount used for financial reporting.

3. Compensation for publicly traded companies. While the Act limits compensation to $1 million for specified executives, government contractors are limited to the cap of $487,000 for any employee (as we often say, lower levels apply to smaller, non-publicly traded companies). Also, the IRS and FAR differ on the terms of what elements of compensation are subject to the tax.

4. Bonuses. The Act is being touted as providing "windfall" opportunities to increase bonuses to employees due to the decrease of corporate tax rates. Contractors will need to make sure they have policies and practices in place to prevent disallowance of these bonus payments. Many commentators are saying that to be conservative, ACOs should be notified of the new bonuses and make sure bonus plans account for the bonus payments.

GSA Allows Order-Level Materials on MAS Task Orders

A final rule of the General Services Acquisition Regulation allows agencies to procure order-level materials (OLMs) on multiple award schedule task and delivery orders. OLMs are sometimes referred to as other direct costs or incidental expenses not specifically identified in the contract in

accordance with FAR 8.402 which are not known at the time a Federal Supply Schedule contract is awarded. Vendors that propose OLMs as part of a solution need to obtain three quotes for each OLM that is above the simplified acquisition threshold where the quotes need not be submitted with an offer but should be maintained in the contract files and are subject to audit. The three quote requirement does not apply to contracts with an approved contractor purchasing system by DCMA. The cumulative value of OLMs on a given task or delivery order may not exceed 33.33 percent of the order total value *(Fed. Reg. 3275).*

Security Clearance Process is Now Considered a High Risk

The Government Accountability Office has added government-wide personnel security clearance processes to its High Risk List after the Defense Department's investigative unit issued 486 clearance denials to contractor personnel when it learned workers ran afoul of guidelines involving drug use, felony criminal conduct and even "foreign influence" according to a recent letter by Director Daniel Payne. The letter alluded to the fact that few of the interim clearances granted in 2017 have made it through the investigation process where there is a current backlog of more than 700,000 cases.

Business Opportunities

Business opportunities for contractors continue to soar. A few include:

1. 68 small business concerns have won slots (do a google search to see awardees) for the Alliant 2 Small Business (ASB) contract vehicle with a ceiling value of $15 billion for various service based products. Only six companies are incumbents on the previous Alliant 2 Small Business (A2SB) contract to end April 2019 where many of the successful small businesses are no longer small businesses. Companies that missed out on awards will have a difficult time buying their way into contracts where, for example, a merger or acquisition, with or without contract novation, requires a re-representation within 30 days to determine whether it is still a small business. If an A2SB awardee is no longer a small business it can still accept an order issued on a sole-source basis which is typically for follow on work and it can begin competing once it becomes a small business due to a spin-off, merger or acquisition. New rules will likely dissuade large companies from acquiring ASB holders. The temporary hold-up in awarding Alliant 2 Large Business contract has been lifted since the protests of the award have been lifted.

2. 31 companies have been awarded more contracts on the General Services Administration's professional services vehicle, One Acquisition for Integrated Services – Small Business (OASIS SB). A google search will identify the awardees (many are subscribers to this newsletters as well as a couple of clients).

3. Overseas spending on weapons and military equipment more than doubled to $54.2 billion in 2017 from $36.7 billion in 2016. About 59 percent came from Middle East customers where the largest sales were for 32 Boeing F/A-18E aircraft. Experts are estimating that growing global tensions from Jerusalem to Korea will result in lucrative and growing overseas business.

4. The Defense Threat Reduction Agency is preparing a final RFP for a 10 year $435 million contract (I2TS) for IT and technology services as small business set-asides. Many large businesses were unpleasantly surprised to see the shift from full and open competition to small business set-asides.

5. The Navy is preparing for a new $128 billion Columbus-class nuclear powered submarine where General Dynamics will be the prime contractor. The Navy estimates $2.8 billion to be spent in 2019 (up from $773 million this year) growing to $5.1 billion in 2022 which does not include long range operating and support costs. The 12 vessel buy is behind only the $406 billion F-35, $165 billion multiservice ballistic-missile defense network and the Navy's $164 billion Virginia class submarine program.

Audit Guidance Ends Technical Exchange Requirements for IR&D Costs

DCAA has issued guidance that eliminates the requirement for government contractors to engage in technical exchanges before incurring independent research and development costs. The guidance follows a recent DOD class deviation ending the requirement. The audit guidance states that no audit procedures will be used to ascertain whether technical exchanges had occurred *(MRD 17-PAC-00R).*

Lockheed Seeks Reimbursement of Some Costs of its Acquisition of Sikorsky

Lockheed Martin is asking the Pentagon for $212 million as part of its restructuring costs for its $9 billion acquisition of Sikorsky Aircraft by Lockheed's Rotary and Mission Systems division. Lockheed is asserting the purchase will save taxpayers $8 in efficiencies for every $1 spent. DFARS 231.205-70 allows for the reimbursement of restructuring costs if projected savings exceed $2 on every $1 spent where restructuring costs are defined as "nonroutine, nonrecurring or extraordinary activities

to combine facilities, operations, or the workforce to eliminate redundant capabilities, improve future operations and reduce overall costs." The activities include such costs as severance pay and early retirement incentive payments to employees, employee training costs, relocation expenses for retained employees and plant and equipment. Lockheed is asserting the savings include efforts such as combining its IT infrastructure and consolidating its human resources and contracting departments. DOD is resisting saying the rationale for proposed savings does not appear to meet the "required definition of external restructuring activities" where it has not been able to demonstrate "labor savings at the contract or program level" and purchasing savings because there are not many common suppliers between Sikorsky and Lockheed's Rotary and Mission Systems.

ADR is Generating Praise

The ability of alternative dispute resolution to resolve protest actions is being praised as resulting in more favorable rulings and able to reduce costs related to bid protests and appeals. The ADR success rate at the GAO in 2017 was 90 percent for bid protest matters. High success rates are attributable to ADR motivating the parties to make pre-litigation deals and the exceptional competence of government attorneys and judges. The 90 percent success rate compares to GAO's effectiveness rate of 47 percent which refers to instances in which protesters convinced the GAO to sustain its protest or an agency fixed a procurement error with corrective action. The GAO may use ADR procedures at the request of a party in a protest or where the GAO deems appropriate and may take the form of negotiation assistance before or after the filing of a protest or use outcome prediction where the GAO advises the parties of the likely outcome of a protest. Ground rules of ADR usually require agreement of the parties to "strongly consider" withdrawing the protest if the GAO predicts a denial and or the government taking corrective action if a sustainment is predicted.

Labor Audits Are Expected to Continue Under Trump

Federal contractors in 2018 can expect a continuation of the lengthy audits by the Department of Labor focusing on pay equity, affirmative action, controversial data collection and analysis rules related to outreach, recruitment and hiring disabled individuals and military veterans. Also, policies related to workplace bias protections based on sexual orientation and gender identify, prohibition of pay secrecy policies and sex discrimination guidelines will also be audited. DOL has announced "skilled regional centers" in San Francisco and New York where 1,000 Corporate Scheduling Announcement Letters to federal contractors have been sent.

Rand Study on Protests Issued

Following congressional requests for a study of long term viability of the protest process, the Rand Corp completed its study. It noted protests stemming from defense and nondefense acquisitions roughly doubled from 2008 to 2016 yet only 0.3 percent of contracts are protested implying they are rare. The study stated the Pentagon and contracting industry view the protest system differently – DOD stating the rules allow excessive numbers of "weak allegations" and allow too much time to protest and resolve cases while contractors state protests are a healthy component of the acquisition process and keeps the government accountable. Though Congress asked that 14 elements be examined four elements were not able to be reviewed due to lack of data such as effects of protests on procurement and time and cost for handling protests. Six recommendations were made including enhancing the quality of post-award debriefings and more care in considering restrictions on task order protests since they are more likely to be sustained or result in corrective action. Also, recommendations to reduce and improve small business protests were put forth by improving debriefing and mandating legal counsel or legal assistance for prospective protesters and using an expedited process for protests of procurements valued at $100,000 or less which makes up 8% of protests.

DECISIONS & CASES

Termination Settlement Must be Based on Cost, Not Contract Price

Atlas computed its settlement costs on its contract's termination for convenience by using its CLIN pricing in the contract. Atlas asserted the CLIN pricing approach was the most reliable method for determining fair compensation because it could not provide documentation to support a cost based claim since it was having a dispute with its principal supplier. The Board stated generalized claims about a conflict with its supplier does not justify "an inability to substantiate the amount of its injury" and ruled there was reasonable documentation or otherwise plausible reasoning on many of the costs such administrative costs for four employees working on resolving the termination and its severance costs which were consistent with local laws. The Board ruled that CLIN prices are based on price and are established for fully completed components of contract performance

and do not reflect what transpired after contract award whereas termination settlements are based on cost *(Atlas Sahil Constr. Co., ASBCA No 58951).*

Final Decision on DCAA Cost Decrement Provides Adequate Notice

DCAA questioned L-3's airfare costs on its incurred cost proposal where rather than auditing its airfare costs it applied a 79 percent decrement factor based on prior year audits of L-3's airfare costs. L-3 appealed asserting the CO's final decision failed to provide adequate notice of the bases and amounts of the government's claim where only the amount claimed was put forth but failed to identify any particular trip itinerary or reason for the disallowance. Rather, the CO simply listed all the various reasons airfare costs could be unallowable such as improper premium airfare, improper use of foreign-flag carriers, cost reasonableness and lack of supporting documentation. The Board disagreed saying the CO did not need to identify specific items of costs it determined to be unallowable nor state the basis for disallowing specific costs but found the final decision to be adequate where it demanded payment in a sum certain, referenced the DCAA audit report and provided adequate notice of the bases of the claim by stating it was for recoupment of premium airfare costs. In support of its position the Board stated that prior cases had ruled that "the minimum amount of information sufficient to provide adequate notice is quite low" and concluded that requiring claims to specify the amount claimed for each cost element would result "in dismissal of many meritorious contractor claims" *(L-3 Comm. Integrated Sys., ASBCA No. 60713).*

Claim for Extra Work is Barred by Release and Final Payment

Washington submitted an invoice for final payment and a release of claims required by FAR 52.232-5. Outstanding claims section of the release was left blank and the box beside it was checked "none". Two years later Washington filed an appeal to the Board for $142,000 for extra work performed on the contract. The Board stated the general rule is that a final release followed by final payment to a contractor generally bars recovery of the contractor's claim except for those excepted on the release but added there are special and limited situations in which a claim can be prosecuted despite the execution of a general release such as mutual mistake, continued consideration of a claim or fraud or duress. Since none of these exceptions applied, the Board ruled the general rule should govern *(Washington Star Const., ASBCA No. 61065).*

Corrective Action Plan is Excessive

Following a successful protest of nine contract awards for $5 billion the Army took corrective action that involved opening up discussions with dozens of offerors and allowing proposal revisions. Dell, one of the awardees, filed suit asserting the corrective action went overboard and was unfair to the nine original awardees where far-reaching discussions should not be allowed because they allow all the competitors to revise their technical proposals and benefit from knowing what the winning bid prices were. The Court sided with Dell saying the corrective action plan was "akin to killing an ant with a sledgehammer when a rolled up newspaper would have sufficed" *(Dell Fed. Sys. V HPI Fed., Fed. Cir. Nos. 2017-2516).*

Lack of Escobar Materiality Results in Overturning of $348 Million Penalty

(Editor's Note. The concept of what is material continues to evolve following the Escobar case. Here is one of many cases addressing the concept.)

Under a qui tam suit relator Angela asserted the healthcare provider had fraudulently received $348 million because it had failed to maintain a comprehensive care plan and various paperwork defects such as unsigned or undated documents. The Court turned to findings in a recent Supreme Court case – *Universal Health Servs. V Escobar* – that said the False Claims Act may impose liability for implied false certification if (1) a claim for payment makes specific representations about the services or products provided (2) defendant knowingly fails to disclose non-compliance with a law or contract requirement and (3) the omission renders the misrepresentations misleading where the misrepresentations "must be material to the government's decision to pay." The Court noted that Escobar required a "rigorous" and "demanding" standard of materiality that precludes claims for minor or insubstantial violations which is not true here. It ruled Angela needed not just to show recordkeeping deficiencies but also the government would have refused to pay for the services if they had known of the deficiencies. The facts showed the healthcare provider considered the deficiencies immaterial and they would not threaten non-payment where if the court ruled in favor of Angela the verdict would be "unwarranted, unjustified, unconscionable and probably unconstitutional" *(U.S. & State Fla exc Rycjh V Salus Rehabe, 2018 WL37520).*

Costs Were Reimbursable Because They Were Reasonably Incurred Under a Termination Contract

2Connect purchased a telecommunications circuit that would be needed only for its telecommunications facilities delivery order. When the delivery order was terminated for convenience the government refused reimbursement for the circuit citing DFARS 252.239-7007, Cancellation of Orders which it said prevented non-recoverable costs for use on existing contracts from being reimbursed. However, 2Connect said the government's interpretation of the clause was incorrect stating it provides that if the government cancels services orders under a contract before it receives services the government must reimburse the contractor for actual non-recoverable costs the contractor reasonably incurred in providing facilities and equipment for which the contractor has no foreseeable reuse. The ASBCA ruled 2Connect was entitled to compensation for the non-recoverable circuits because they were reasonably incurred to meet contract performances adding there would be no windfall because there was no foreseeable reuse of the items *(2Connect, ASBCA No. 56769).*

No Flaw in Small Business Set-Aside Decision

Sigmatech, the incumbent contractor who is not a small business, protested the Army's decision to set aside the follow-on contract to a small business. Sigmatech asserted the set-aside decision was flawed because the Army failed to assess whether small-business potential bidders were capable of performing. The Court ruled against Sigmatech saying they were not using the correct standard concluding the Army, under the Rule of Two, was only required to determine whether it had a reasonable expectation of receiving offers from at least two responsible small business concerns and that the price was reasonable which was the case here *(Sigmatech Inc. v US, Fed. Cl. No. 17-183C)*

SMALL/NEW CONTRACTORS

Hot Areas of DCAA Audit Scrutiny

Both our consulting and newsletter experience reveal significant "hot" audit areas. In addition to listing many priority audit areas the Grant Thorton survey shows (see our last GCA DIGEST issue) - executive compensation, consulting, legal, employee morale, labor charging costs - we have identified several other "hot" areas that are being audited these days. It's a good idea to ensure the written policies and procedures as well as practices in these areas are in good shape.

1. Increased focus on *marketing costs.* You can expect more transaction testing to identify unallowable activities (e.g. trade shows, entertainment, personal use, excess expenses). We also find both contractors and many auditors (especially independent CPA firms currently auditing incurred cost proposals) mistakenly believe "marketing costs" are unallowable while bid and proposal and business development costs are allowable. Be aware, that many state government contracts do disallow such costs.

2. There is increased scrutiny over *expense resports* including those expended by consultants and subcontractors. We are seeing more detailed examination of expense reports to ascertain the purpose of the trips and expenses as well as proper completion of expense reports (e.g. identification of unallowable costs, employee and supervisor signatures). Also samples of transactions are often used to inappropriately assert the findings can be applied to the universe of expense reports.

3. Following publicity on *overrun* government projects, auditors are checking on projects to ascertain whether they are in an overrun or loss position. They are examining whether such costs are inappropriately being billed to the government and closely scrutinizing whether they are being charged to other contracts or are buried in indirect cost pools.

4. Auditors are making sure that claimed *depreciation costs* are consistent with the way they account (or are supposed to account) for them using generally accepted accounting principles as opposed to those used for federal tax purposes. For example, accelerated depreciation, IRS Section 179 deductions (write off of capital costs in one year especially), for the new tax law used for government costing purposes are usually disallowed unless contractors can demonstrate such treatments are consistent with actual usage (e.g. one year of contract performance).

5. With less incurred cost audits being conducted by DCAA, they are increasingly scrutinizing both *provisional billing rates* and samples of *invoices* on cost type contracts. Whereas provisional billing rates were rarely audited in the past since incurred cost audits "trued up" costs incurred, provisional billing rates have become the substitute for incurred cost audits. Detailed focus on selected cost elements are quite common. Also, DCAA is frequently selecting samples of invoices to determine if direct costs being billed are accurate and consistent with contract terms.

6. Auditors will be examining whether contractors have and are following adequate *estimating system procedures.* They

will be asking to examine written estimating procedures and whether proposals are consistent with them. We are also seeing DCAA inquire into purchasing practices of mid-sized to large contractors – though purchasing system is now under the purview of the Defense Contract Management Agency DCAA is examining purchasing practices and policies to determine whether they should provide audit leads to DCMA.

7. Though recent changes have reduced audits of forward pricing rates (e.g. only >$10 Million fixed price and >$100 Million cost type contracts) DCMA is asking cognizant DCAA offices to review detailed *budgeted costs* that form the basis of many forward pricing rates. Also, we are seeing prior year actuals used for projecting future costs are being audited as if they were incurred cost audits.

8. *Bonus plans* are being audited carefully where the absence of written bonus plans are being cited as grounds for disallowing the costs or failure of written bonus plans covering the specific bonus being examined. In the past, a written bonus plan was usually not considered a requirement to allow bonus costs – FAR 31.205-6(f) states "an agreement" or an established plan or policy are in place to mean "in effect, an agreement" – whereas now an increased number of auditors including independent CPA firms are requiring a written bonus plan to exist for bonus costs to be considered allowable.

9. *Personal use of cell phones and vehicles* are being more closely examined. Auditors will generally be looking for written policies to either identify personal use of cell phones and vehicles or practices to make them a form of compensation so no tracking of personal use is needed.

QUESTIONS & ANSWERS

Q. We recently were notified that we were not selected for award of a large IDIQ contract. We have filed a protest. Are the legal fees associated with the development of and submission of our protest allowable?

A. We are getting ready to write an article about what litigation costs might be reimbursable. As for protest costs, they are considered unallowable legal costs. However, if you clearly prevail you might be able to be reimbursed for your protest costs.

Q. We are a 100% commercial business that bid on a FFP/CPFF government contract. I have heard that you may not have two sets of books/accounting practices where if you have a government contract your entire business must use government timekeeping/accounting practices even if the majority of the employees do not work on the contract. Is that true? What FAR/DFAR clauses apply?

A. There really are no FAR or DFARS regs that specifically answer your question. The closest thing you will find is DCAA guidance found at Chapters 5.909 and 6.405 in the DCAA Contract Audit Manual. As for you other inquiry, the answer is a little mushy. First, the requirements to accurately track direct contract labor differs according to the type of contract you have. FFP have far less requirements than CPFF and time-and-material contracts. Second, the regulations and even DCAA guidance is not clear on who must follow government timekeeping practices. Certainly, for CPFF and time-and-material contracts all direct employees working on government contracts as well as indirect employees that sometimes work on these contracts need to track their time and costs. If you have these types of contracts DCAA is supposed to occasionally come in unannounced and conduct a floor check to see whether timekeeping policies and practices are adhered to. Their guidance does not say who is supposed to complete timesheets but only to review timesheets for those who complete them. They will normally not check to see whether direct employees working 100% on commercial contracts or indirect employees working 100% indirect are completing timesheets but unfortunately you can't depend on this.

The problem is you are working with auditors who may not be familiar with rules about timekeeping (they usually assign their most inexperienced auditors to do floor checks) and we sometimes see them erroneously issuing opinions that contractors have inadequate labor charging practices. So, at the least, you want to make sure that all employees who charge government contracts directly fill out proper timesheets. If you want to be conservative you probably want to make sure that all direct employees, whether they are working on government or commercial contracts, complete timesheets since that is what these inexperienced auditors are used to seeing. You should be OK by not having 100% indirect employees not completing timesheets unless some of their costs are split between different indirect cost pools like overhead and G&A.

Q. I recently read your article about bonuses and compensation in a recent GCA Digest. Some of the points in this article have caused me to be concerned about our bonus program. We have a pretty robust bonus program for our executive team. I thought that we were doing things appropriately as the bonus program is in writing, issued to the employee before the bonus is earned, and is based on objective criteria. However, a portion of the

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bonus is based on profit. I would like to retain you to provide consulting services for this question.

A. Let's see if I can save you some consulting expenses. The question of profit is somewhat murky, and often results in misinterpretations by "creative" auditors. Yes, you need to avoid the appearance of distribution of profit. However, there is nothing wrong with conditioning the creation of a bonus pool on whether or not the company has generated profit. You need to make explicitly clear in your bonus policy this does not mean the bonus is a distribution of profit but rather a condition for being able to afford bonuses. It seems like your other practices around bonuses are sound

Q. We are preparing a claim (which our firm is working on) and in addition to all the costs we have identified we want to assert the government-caused delay made our employees less efficient. Is this a valid item to include in our claim and how should we quantify it?

A. Whether caused by delays, interruptions, differing site conditions, different specifications or requirements to accelerate work, loss of productivity is common and several texts and a case approve use of the "measured mile" technique for quantifying this loss. The measured mile technique compares the productivity of labor in the period that was impacted by the delays or other causes with the productivity in some period where normal productivity was accomplished.

Two considerations for using the measured mile are key: (1) the compared work must be "equivalent" – since work is rarely identical "equivalent" has been ruled sufficient; if not equivalent but in some way comparable, adjustments for the two periods to achieve comparability have been ruled valid and (2) data must be reliable – though the best data to use is from the same contract comparisons with other contracts and use of industry statistics have been held to be acceptable. Expert industry opinions have also been held to be valid but opinions are useless unless the data is credible.

Q. We follow FAS 46 and capitalize our independent research and development costs. When we expense these costs are they allowable costs?

A. It depends on when they were incurred. If they were incurred in the same year they are claimed for government costing purposes, no problem. If they were incurred in a prior year then you may not claim them for government costing purposes unless you meet the several conditions for deferred IR&D. This is one of those examples of where GAAP accounting is not consistent with contract costing.

Q. In general, who has the responsibility of demonstrating a given cost practice is proper or improper – do we have to show it is appropriate or does the government have to prove it is inappropriate?

A. We put this question of who has the burden of proof on cost allowability and allocation practices to one of our GCA attorney colleagues. For questions of *reasonableness* the burden used to fall on the government to show a given cost was unreasonable but that was changed in the 80s so now all contracts that contain the FAR 31.201-3 provision requires the contractor to demonstrate both its indirect and direct costs are reasonable. For questions related to *allocability*, though there is no statute or regulation, court cases have uniformly held the contractor has the burden of proving the costs are allocable to the contract or other claimed cost objective. As for *allowability* of costs, most cases have put the burden of proving unallowability of costs on the government once a contractor has established the cost is reasonable and allocable.

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