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RULES OF ENGAGEMENT

(Editor's Note. We find one of the greatest problems contractors face during an audit is ascertaining what the auditor's position is during the audit where issuance of an adverse audit report often comes as an unpleasant surprise. This is not surprising since, as former DCAA auditors ourselves, we find many auditors are very reluctant to address adverse findings in face-to-face meetings with contractors. We were recently reminded that DCAA a few years ago put forth what it called "Rules of Engagement" which was designed to lessen these unpleasant surprises. The Rules of Engagement came in the form of a 41-page guidance divided into general comments, Q&A and a slide show section. We summarize these here.)

DCAA has issued guidelines they call "the rules of engagement" on proper communications with audit requestors (usually COs or ACOs) and contractors. Though much of the guidelines of communications with requesters are not of direct interest to contractors – we will focus primarily on what the guidelines prescribe for proper communications with contractors. The guidelines are to ensure DCAA audits are consistent with Generally Accepted Government Auditing Standards (GAGAS). Upon request to conduct an audit, which is limited normally to proposals and forward pricing rates, the auditor is told to hold discussions before an audit begins to obtain a clear understanding of the requester's needs, areas of concern and how DCAA can best meet these needs. Either at the time of audit request or at this meeting, DCAA is often asked to perform an audit of only parts of a proposal. This communication with the ACO defines the scope of audit which should be clearly communicated to the contractor.

Commencement of Audit Communications. Though not common, the guidance states the contractor should provide government representatives (e.g. DCAA, ACO and PCO) a "walk-through" of its "assertions" (proposals, incurred cost submissions). If problems are anticipated, (e.g. inability to audit subcontract costs), contractors should be aware of this option. The walk-through should occur after the auditor performs an initial adequacy review of the assertion and may occur either before or during an entrance conference. At this meeting, the contractor should explain its assertion and allow the auditors to ask questions.

Entrance Conference. Auditors are told to explain the purpose and overall plan for performance of the audit at the entrance conference along with discussing the types of books, records and other data that exists, where it is located and what they will need. This meeting should address the concerns and scope of audit the requester made.

Communications with Contractor During the Audit. Here it is important to understand the difference between audits of forward pricing, termination or requests for equitable adjustment proposals where findings are not disclosed to contractors but form the basis of negotiating positions of the government and audits of incurred costs, system reviews, floorchecks, etc. where all findings should be transparent. This is a critical step where throughout the audit, auditors are told to discuss matters with the contractor as needed to obtain a full understanding of the contractor's basis for each item of the proposal or each aspect of areas subject to audit. The auditor "should discuss preliminary findings (e.g. potential system deficiencies, potential FAR/CAS non-compliances, etc.) with the contractor to ensure conclusions are based on a complete understanding of all pertinent facts." To offset many auditors' inclination not to divulge deficiencies during the audit, they should be reminded of the requirement to disclose findings as early as the entrance conference with periodic status meeting held during the audit so minimal surprises come out. The guidance also alludes to the fact that some contractors revise their submittals during the audit in light of audit findings – auditors are told not to encourage this and to make sure their audit report addresses the original proposal, not the revised one. However, the contractor's revised submission should be considered the contractor's concurrence with the questioned costs.

Exit Conference. Upon completion of the fieldwork the guidance states the auditor should hold an exit conference to discuss audit results and obtain the contractor's views concerning findings, conclusions and recommendations for inclusion in the audit report. The recommended timing of the exit is after the supervisor completes their review of the working papers and draft report but before the branch manager completes their final review. To facilitate discussions during the exit, auditors may provide audit results and draft reports before the exit meeting unless the audit is for forward pricing in which case no draft report is provided where results of audit is limited to factual matters or "differences" (e.g. why was proposed material costs based on history of an older contract rather than more current data from a follow-on contract). Auditors are encouraged to invite the requestor/contracting officer to the exit conference especially if there are significant or complex audit issues.

The guidance states it is acceptable to release the draft audit report to the ACO after the exit conference but before the branch manager approves the final report if the final report is expected to be issued shortly (within five days) but the contractor must be informed the results are "subject to management review." Be aware that auditors may wish to "clean their desk" and release a final report quickly so if you want to include contractor comments in the final audit report or elevate areas of disagreement with the branch managers (or even higher) then you need to inform the auditor at the entrance conference of your intent.

Much of the Q&A section focused on actions that could potentially compromise the appearance of impairing the auditor's independence. For example:

1. Attendance at a pre-proposal meeting. The auditor should not attend meetings related to developing the contractor's proposal or input into draft proposals but may provide general advice on what constitutes an adequate proposal and answer general questions on FAR 15.408 (Table 15-2). So, for example, they should not advise on specific methodologies to estimate labor hours but may say that to be considered adequate, the proposal should include an explanation of the estimating process including judgmental factors and methods used to estimate that cost element.

2. Inviting the CO to the entrance conference. If you have had problems with the contractor in the past to, for example, obtain data on a timely basis, inviting the CO does not impair independence but is prudent given problems in the past.

3. Discussions resulted in contractor revising his proposal. The auditor should never provide preliminary findings to encourage the contractor to revise their submittal but if the discussion was for the purpose of considering all pertinent factors needed to obtain sufficient information then there is no impairment of independence.

4. Addressing apparent missing data. For example, inquiring why historical data for labor hours used data for all prior lots but one would not be impairment because you can ask questions about the specific methodology used to gain a better understanding of the contractor's basis for each item.

5. Requestor revising the scope of audit. For example, after finding significant issues related to proposed material costs and calling the requester to keep them informed, the requester changed the scope of the audit a few days later to only a rate check. The auditor should ask the requester why the scope change and explain the concern for risk to the government for the change. The guidance stresses DCAA should never agree to a CO's request to cancel or convert an audit to avoid an unfavorable audit opinion.

Case Study…

PROPOSED SALES COMMISSION SHOULD NOT BE PAID

(Editor's Note. One of the benefits of being a consulting company for over 25 years and having staff who have held a variety of positions such as CFO/Controller/Contracts Manager, DCAA auditors, DCAM managers, proposal managers and attorneys as well as publishers of these newsletters we are often called upon to provide litigation support and expert testimony services in cases involving federal contract cost and pricing issues. The following is a real life engagement where we provided those services. We provide only a highly edited version of our response where we limit several issues addressed to only those involving cost and pricing issues and we disguise the identify of our client by changing their name, and the nature and amount of costs involved.)

Background

Our client, to be called Contractor, had a consulting arrangement with a company who held itself out as a “sales agent” (we refer to them as Consultant) to generate government contract business for providing radar equipment for lightweight airplanes where much of the technology had defense applications. Consultant was to provide direct selling services in accordance with FAR 31.205-38, selling costs to help obtain government contracts and when these efforts resulted in obtaining a contract Contractor was to pay Consultant a sales commission worth 15 percent of the amount of revenue received. It is not disputed that Consultant did provide selling services for the first contract awarded during 2013 such as getting “support letters” from members of Congress and familiarizing the head of the program with Contractor’s capabilities. Payments to Consultant for the contract were not based on hours worked by the Consultant (they did not keep track of their time) but rather on the 15% of revenue collected. When Contractor received a later contract in 2016 to provide different radar equipment Consultant claimed entitlement for a commission on revenue generated for that because it considered the second contract a “technical continuation” of the first contract. Contractor disagreed and denied payment asserting the second contract was for different equipment with different technologies and since no direct selling effort could be shown, it did not owe a commission on the second contract. Though we provided opinions about the differences between the equipment, nature of the two contracts (the first was fixed price while the second one was cost reimbursable) and whether there was evidence of any direct selling effort on the second contract by Consultant, we focus here only on some of the costing issues we addressed since they are the most relevant to our readers.

Are the Commission Costs Allowable, Allocable and Reimbursable By the Government?

A cost incurred for government contracts should be reimbursable in order for a contractor to be able to recover its expenses. Not being able to recover selling expenses or any other significant cost means the contractor must absorb the cost out of its profit. In the cases of the two contracts here, the failure to recover the 15 percent commission would most assuredly put those contracts in a loss position which could jeopardize its ability to pass a financial capability review by the government, put forth a cost competitive proposal and continue generating investor interest.

- **What Makes a Cost Allowable`**

In order to be reimbursed for either its projected costs on fixed price contracts or its actual incurred costs on cost type contracts, those costs must be deemed “allowable.” FAR 31.201 defines allowable costs.

(a) A cost is allowable only when the cost complies with all of the following requirements:
1. Reasonableness

2. Allocability

3, Standards promulgated by the CAS Board, if applicable, or generally accepted accounting principles and practices appropriate to the circumstances

4. Terms of the contract

5. Any limitations set forth in this subpart (i.e. FAR 31.205)

We focus on three of these conditions – relevant FAR Part 31.205 cost principles, reasonableness and allocability.

- **What to Expect from DCAA Auditors in Determining Whether the Commission Costs are Allowable**

Unlike the commercial marketplace where prices of goods and services are based on what the market will bear, prices for goods and services in the government sphere is largely based on what the government says are allowable incurred costs. For defense contracts, the Defense Contract Audit Agency (DCAA) largely makes these determinations. How would they evaluate the commission costs in question? As former DCAA auditors and supervisors, we can confirm that DCAA would take the following steps to determine allowability of the commission costs:

1. They would determine what cost principles apply to the commission costs. Their audit guidance, DCAA Contract Audit Manual (DCAM) Chapter 7-1303, states there are several cost principles that may apply such as advertising, corporate image enhancement, bid and proposal, Entertainment, long-range marketing or direct selling.

2. Auditors will typically take several preliminary steps. They will review the relevant agreements between Contractor and Consultant, examine the invoices from Consultant, inquire into the nature of tasks taken that generated the expenses, and ask to see (7-1304.1) expense reports. Per DCAM Chapter 7-1303.3 they should attempt to identify improperly classified selling costs by applying such techniques as (a) floor checks and interviews with personnel (b) review of documentary evidence establishing purpose of the effort such as work order authorizations, expenditure authorizations, management reports, board minutes and (c) examination of correspondence between selling agents to ascertain true nature of activities and evidence of disputes over amounts.

3. Determining whether the costs are allocable. They will determine whether the costs are properly direct or indirect costs, whether the costs are properly assigned to the correct accounting period and if indirect costs (fringe benefits, overhead, G&A) are appropriately allocated to government contracts (7-1304.1).

4. Determining whether the costs are reasonable (7-1305) where they are told to consider such factors as (a) nature and amount of these costs in light of the expenses which a prudent individual would incur in the conduct of competitive business (b) proportionate amount of government and commercial business (c) trend and comparability of the company's current period costs compared to prior periods (d) general level of such costs in the industry and (e) nature and extent of the sales effort in relation to the selling costs and the contract value.

Auditors are told to be alert for high selling costs under cost type contracts where contractors may be encouraged to increase selling costs without constraint since they can be compensated as a cost of doing business where other companies without cost type contracts would be at a competitive disadvantage. As we discuss below, we believe DCAA would question the commission costs.

1. FAR Cost Principles Test

There are, at least, two FAR cost principles that are relevant to the commission costs in question:

- **FAR 31.205-38 Selling costs**

(a) Selling is a generic term encompassing all efforts to market the contractor's products or services, some of which is included in other subsections of 31.205 (e.g. advertising, corporate image enhancement, bid and proposal (B&P) and market planning).

Section (5) of the FAR 31.205-38 describes the types of activities that are considered to be direct selling while section (6) addresses the type of direct selling costs that are incurred and states they are allowable only when paid "to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business."

- **Lobbying and Political Activity Costs**

FAR 31.205-22(a) (6) makes it clear that lobbying activities are unallowable. It was first promulgated to address the legislative branch of government where it was defined as any activity that is intended or designed to influence members of Congress or state or local legislatures to favor or oppose pending or proposed or existing legislation. In 1986, following congressional concern over lobbying of the executive as well as the legislative branch, the executive branch lobbying costs were added to the unallowable category: "Costs incurred in attempting to improperly influence (see 3.401), either directly or indirectly, an employee or officer of the Executive branch of the Federal Government to give consideration to or act regarding a regulatory or contract matter" are explicitly unallowable. In practice, any acts that may even remotely be interpreted as lobbying costs are scrupulously screened by contractors and excluded from either direct or indirect costs of government contracts. Contractors must be very careful to exclude such costs because (1) explicitly unallowable costs are subject to 100% to 300% penalties for the amounts claimed and (2) the hint of improper influence will most assuredly have an adverse impact on contractors in this period of instant news.

- **Is Consultant a bona fide sales agency?**

As we discuss above, FAR 31.205-38 makes contingent fee arrangements unallowable unless these fees are paid to bona fide employees or bona fide sales agencies. The question is whether Consultant is clearly a bona fide sales agency where we believe it is doubtful.

Consultant has two sources of income in its contracts – one source is from direct selling efforts and the other source is for "lobbying activities" (we viewed testimony stating the firm engages in lobbying activities). The problem that we see is that Consultant holds itself out as both a provider of lobbying and selling efforts. Lobbying firms (think K Street firms in Washington DC) provide lobbying

services who use their staff of former legislative and executive branch people to work primarily with congress or executive branch decision makers to affect laws and help win contracts. In our experience, fees charged by such firms are never charged by government contractors to the government due to the clear, explicit prohibition of the lobbying cost principle. Firms providing selling services are a different story. They are commonly firms staffed by former government employees and industry specialists where their focus is on government buyers and contractors as opposed to Congress. These latter firms are typically the type of firms considered to be bona fide sales agencies. They provide strictly sales and marketing services as opposed to lobbying services and the costs represented on their invoices are usually considered allowable sales and marketing costs and hence are included in contractors' general and administrative indirect cost pools.

The two types of firms, lobbyists and sales/marketing firms, are distinct where the lobbying firm's invoices are flagged and excluded as unallowable costs while the sales/marketing firms' invoices are usually allowable costs where only excess travel or entertainment expenses may be flagged as unallowable. The problem with Consultant is they offer both types of services – lobbying and direct selling where, since they do not "track time" an auditor has no way of documenting which activities are allowable sales or unallowable lobbying work. Such a failure seems to be the case here where without clearly documenting the nature of the activities using, for example, timesheets or time logs, we believe they would have trouble convincing auditors they deserve the designation as a "bona fide sales agency."

2. Reasonableness Test

After addressing the history and meaning of the concept of "reasonableness", we turn to whether the sales commission would be considered by auditors to be reasonable and hence allowable. We asserted auditors would conclude the commission for sales activity of over $800K for the second contract would be considered unreasonable and put forth the following reasons:

1. The fact that Consultant cannot clearly distinguish between unallowable "lobbying" activities and allowable selling expense costs would lead to the conclusion that allowing such questionable costs would represent an unreasonable risk to the government.

2. DCAA would closely examine the nature of the claimed sales commission. In examining the nature of the amount, they would want to make sure that the conditions for allowable selling expenses in FAR 31.205-38 were met. They would certainly ask: Is Consultant a bona fide sales agency? Did Consultant conduct sales activities or were other activities involved? In addition to the problem of failing to meet the criteria for being a bona fide sales agency discussed above we believe they would not be able to demonstrate that actual sales activities occurred for the second contract. Specifically, based on the six depositions we read, we found numerous examples of B&P and contracting administration type activities but we found no examples of actual sales activities being performed for the second contract.

3. DCAA would also closely examine the amount of the claimed sales commission. Because the amount of costs were significant (15 percent of the actual costs incurred) the amount would be closely scrutinized. Not only would DCAA be concerned about whether sales activities occurred but if they were deemed to have occurred, was the amount paid reasonable. The first thing DCAA would ask for is documentation showing the effort expended. Since no timesheets or other proof of activities were kept, the absence of such documentation would, in itself, justify questioning the costs. If they did come up with an estimate of time spent, the next step would be to compute an hourly rate by dividing the sales commission by the hours spent. If we assume, for example, 100 hours could be documented for sales activities, the hourly rate would be over $8,000 ($800,000 plus divided by 100 hours). This would far exceed the amount that would be considered a reasonable hourly rate. Since the statutory top salary compensation allowed to contractor employees in 2015 was $487,000 that hourly rate is $234 ($487,000 divided by 2,080 hours in a year). Consultant's hourly amount far exceeded what is allowed to senior executives and would provide a basis for concluding the amount paid to Consultant was unreasonable.

3. Allocability Test

As FAR 31.001 specifies the term "allocate" means to assign or distribute an item of cost or group of costs to one or more cost objectives and includes both the direct assignment of cost and the reassignment of a share from an indirect cost pool to proper accounting periods. After discussing the meaning of allocability, we turned to whether the sales commission would be allocable to the

second contract. For government contract accounting practices the commission costs are considered to be "period costs" and hence need to be allocated to the period the sales activities occurred. This is consistent with FAR 31.203(g) that establishes "a base period for allocating indirect costs is the cost accounting period during which such costs are incurred." According to the depositions, there may have been legitimate sales activities leading up to the award of the first contract but there is no sales activities related to the second contract. Accordingly, if the commission costs were considered to be allowable, the sales commission costs would be allocable to the period the activities occurred - sometime before the first contract was awarded. Since the costs are allocable to the 2011-2012 period, they would not have been reimbursable costs by the government during the period of performance for the second contract in 2016-2017. There would be no accounting mechanism to recover the expenses in 2017 if they were incurred in an earlier period. Since the first contract was fixed price (the price already established) there was no way to recoup additional costs not included in the first contract's price.

- **The Sales Commission is Uneconomic**

The fixed fee negotiated on the second contract was 6.0 percent. This is consistent with industry findings of the profitability of government contracts. For example, the Grant Thornton Annual Government Contractor Industry Survey shows the average profit amount for federal cost reimbursable contracts was 6-7% (it should be noted these negotiated profit rates are computed after deducting unallowable costs and before income taxes so actual profit rates are lower). Payment of an additional 15% of actual revenue that was not reimbursable would put the second contract in a significant loss position. This could have very adverse results for Contractor. First, the fact that its contract was in a loss position would likely raise concerns by the government about Contractor's ability to perform on the second contract or subsequent government programs. Second, since Contractor's finances depend highly on the funds and perceptions of investors, if the second contract was in a loss position it can adversely affect its ability to attract investments. Third, FAR 31.205-23, Losses on other contracts provides that excess costs over income are unallowable, putting in jeopardy recovery of other allocable and allowable costs under the contract.

- **Allowing the BAA Sales Commission would Make the Proposal Non-Competitive**

Adding a $800,000 of additional costs to its second contract proposal would have most likely made its proposed price too high since its competitive offerors (15 at one time) would presumably not have incurred this sales commission. Since award of the second contract was based on technical considerations and proposed price where each factor was equal in weight even if it received high technical marks the high proposed price would have made its price non-competitive and Contractor would likely not have received the second contract award. The proposed price included a G&A rate of 18%, which is within the range of 15-20% average rate the Grant Thorton surveys shows. Adding an additional amount of $800K to its G&A pool would have soared its G&A rate, certainly making its proposed costs non-competitive.

Consultant Was at Fault for the Way it Structured its Fees

We have discussed above the fact that the commission costs would have been considered non-recoverable. In our opinion, a large part of the reason for this result lies in the hands of Consultant, particularly in the way it structured its fees, which would have been undetectable by such a new, inexperienced government contractor as Contractor. Consultant has the obligation to structure their arrangements with government contractor clients so as to ensure they can recover the fees from the government. Who determines whether the cost is allowable usually turns on the opinion of what an auditor from DCAA would opine. In our opinion, Consultant had the obligation to ensure the fees it charged its clients could be reimbursable as a contract cost. As discussed above there are several reasons why the compensation paid to Consultant would be disallowed by the government where Consultant had the responsibility to eliminate (or, at least, minimize) these reasons. Several examples come to mind. (1) it should have eliminated confusion of what activities were lobbying versus selling effort or better yet, eliminate any association with lobbying activities which leads to questioning whether Consultant is a bona fide sales agency (2) it should have documented the time spent on the selling expenses in timesheets and timelogs where otherwise an auditor would conclude there was no documentation supporting the costs (3) it should have ensured that its clients have written policies in place to justify payments where in their absence auditors often

question the costs and (4) it should have ensured the amount paid would not be considered unreasonable. This later action could have been accomplished by, for example, establishing a consulting arrangement where reasonable annual amounts would be justified (up to $200,000 per year) where proper invoices and policies would be in place to comply with consulting cost requirements. Alternatively, it could have reclassified problematic commission costs to reflect more accurately the consulting activities that actually occurred (help on bid and proposals, contract administration functions) where such activities would not be considered unallowable direct selling expenses.

CHARGING SUBCONTRACT LABOR ON TIME AND MATERIAL CONTRACTS

(Editor's Note. For several years the government has been tinkering with rules related to billing subcontract costs to the government. Despite periodic changes to such clauses as FAR 52.232-7, Payment Under Time-and-Materials Contracts (the most recent major changes occurred in 2006) we still find it confusing especially how subcontract services should be treated. We take a stab at clarifying the rules here, taking into account subsequent changes since 2006 where the government puts more emphasis on prime contractors "managing" their subcontractors.)

In the past some COs permitted prime contractors to augment their own workforces with subcontractor personnel and propose and invoice the subcontractors providing these services at the hourly rates specified in the contract. Sometimes, COs actually required this. However, DCAA complicated this by adhering to the position that subcontractors' provided services could only be invoiced at cost. As a result, these conflicting positions often caused problems where an attempt to clarify the proper operation of the payments clause was found in a new version promulgated on Dec. 12, 2006. The revision also allowed the use of T&M contracts to acquire commercial services and added an Alternate 1 to FAR 52.214-4 to cover this. To facilitate these changes three new solicitation provisions were added to provide guidance on pricing T&M contracts. Regulatory changes were made to FAR Parts 12 and 16 to explain these new clauses which were effective Feb 7, 2007. We discuss below only noncommercial items.

Noncommercial T&M contracts can be for supplies and services where they can be awarded using full and open competition, set-aside or sole sources bases. Changes to FAR Part 16 attempted to discourage use of T&M contract vehicles, favoring instead fixed price contracts. It stated that whatever procedure is used T&M may be used only "when it is not possible at the time of placing the contract to estimate accurately the extent or duration of the work or to anticipate costs with reasonable assurance."

Along with changes to the FAR payments clause two additional provisions were put forth. FAR 52.216-29 is to be used when the CO anticipates there will be adequate price competition while FAR 52.216-31 will be used when the CO does not anticipate obtaining adequate price competition. What is meant by "price competition" is not defined while FAR Part 16 does not address the issue. Nonetheless, when price competition is anticipated FAR 52.216-31 states the offeror must establish hourly rates using:

- Separate rates for each category of labor to be performed by the offerer, each subcontractor and each category of labor to be transferred between divisions, subsidiaries or affiliates (we will call them affiliates).
- Blended rates for each category of labor to be performed by each of the three
- Any combination of separate and blended rates for each category of labor to be performed by the three.

FAR 16-601(e) permits agencies to promulgate regulations that authorize COs to require contractors to use one of the three procedures. For defense contractors, DFARS 252.216-7002, Alt A requires separate rates for each labor category be established for offerors, subcontractors and affiliates.

When price competition is not anticipated under FAR 52.216-31, offerors have more limited options. Offerors must specify separate fixed hourly rates in its offer that includes wages, overhead, general and administrative expenses and profit for each category of labor as well as for subcontractors and affiliates. Under this FAR provision, profit may not be included for affiliates but only for the prime contractor unless the item being transferred is a commercial item which presumably includes profit in its established price

On July 31, 2007 DCAA issued guidance on the changes. One interesting item in the guidance stated both the prime and subcontractor can include profit thus allowing profit on profit for subcontract prices but not for affiliated transfer prices unless they were commercial items.

Billing for Labor

Changes to FAR 52.237-7 incorporated historical practices that allow an offeror to propose hourly rates for labor to be performed by both itself and its subcontractors. Under paragraph a(1) the term "hourly rate" is defined as "rate(s) prescribed in the contract for payments of labor that meets the qualifications of a labor category specified in the contract that are performed by the contractor or subcontractors." It is now clear that if a prime contractor proposes to use subcontractor labor to perform work called for in the contract then that subcontract labor can be billed at the labor rates specified in the contract. The FAR does not provide any guidance on what loadings the prime can add to the subcontractor labor. Instead the clause states the "hourly shall include wages, indirect costs, G&A and profit." Though the FAR is silent, DCAA states that when subcontractor labor is separately stated, the prime may properly allocate its indirect costs and a profit element.

As mentioned above, FAR 52.237-7(a) (1) makes payment for an hour of labor contingent upon the person performing that labor meets "the labor category qualification of a labor category specified in the contract." Paragraph (a)(3) continues the concept by limiting such payment stating "labor hours incurred to perform tasks for which labor qualifications were specified in the contract will not be paid to the extent the work performed by employees that do not meet the qualification specified in the contract unless specifically authorized by the contracting officer."

Who is to propose these qualifications and how they are established in not clear. Despite their lack of experience, DCAA audit guidance has tasked its auditors to ensure contractor compliance with this requirement before authorizing costs. In addition, recent emphasis on having prime contractors audit their subcontractors means the prime is responsible for validating their subcontractors' invoices such as validating labor hours billed. It is important for prime contractors to obtain real time access to subcontractors' timekeeping records where if you wait for auditors to show up at your doorstep it may be too late where they are likely to disallow the subcontractor costs as being "unsupported."

Material Costs

The new clause has substantially expanded what is considered to be "material" which is now defined as:

- Direct materials, including supplies transferred between affiliates
- Subcontracts for supplies and incidental services for which there is no labor category in the contract
- Other direct costs (e.g. incidental services for which there is no labor category in the contract, travel, computer usage, etc.) and
- Applicable indirect costs.

Of note is the emphasis on "incidental services" where commentators have stressed potential disadvantages for contractors. It is very common for contractors not to list all labor categories required for contract performance where when labor is identified it is considered to be incidental services where billed by the prime or subcontractor which is considered to be an other direct cost. Though relevant indirect costs (e.g. G&A) may be billed, (b)(7) it disallows profit or fee on material except if it is a commercial item and the cost may not exceed the contractor's catalog or market price adjusted for quantities purchased.

Problems of Including ACP Clause

Though FAR 52.216-7, Allowable Cost and Payment (ACP) used to be optional and rarely used in T&M contracts since it applies primarily to cost reimbursable contracts the changes have, for some unknown reason, made inclusion mandatory in T&M contracts. Though missing from the T&M payments clause, the ACP requires that indirect cost rates be established. The implications are:

Though T&M payments can occur whenever invoices are submitted, the ACP limits frequency of invoice submission to once every two weeks

Paragraph (a)(1) of the ACP states invoices are not subject to the Prompt Payment clause penalties while T&M contracts are

If a contractor has both cost type and T&M contracts there should be no problems submitting incurred cost proposals (ICPs). However, proper submission of an ICP for T&M contracts only is uncertain. Though it has not

issued guidance in this area we find most DCAA offices require ICP submittals when only T&M contracts exist.

Timing of final vouchers for T&M requirements is within one year after the contract is completed while for cost reimbursable contracts the period is 120 days after final indirect cost rates are established.

UNBILLED ACCOUNTS RECEIVABLE

(Editor's Note. Our consulting engagements with government contractors often involve working with clients' banks, potential buyers and financial auditors. One area of questioning that keeps popping up is what are the bases of such accounts having names such "Unbilled Accounts Receivable" and whether such amounts can be included as assets to lend money against. For example, banks providing critical working capital funds often inquire into the collectability of these unbilled amounts to determine the percentage of assets it will loan against or refrain from doing so. There are several reasons for the existence of these amounts where some are more collectable than others so outside parties need to be aware of these differences. We thought it would be a good idea to probe into this area so contractors have a better way to use and explain these accounts. We have relied on numerous sources we have found where we have oriented them to government contractors.)

Unbilled receivable arise when revenue, though properly recorded, can not yet be billed under the terms of the contract. Since having unbilled A/R means you have recorded revenue but not yet billed for it usually raises red flags with financial and government contract auditors, banks, potential buyers and certain vendors. This highly sensitive account requires vigilant monitoring and abilities to explain it.

Examples of Unbilled A/R

There are many reasons that government contractors may incur unbilled A/R.

1. *Timing Differences.* The major source for incurring costs in one period and being able to bill those in another is usually a result of administrative delays. For example, the time employees complete their timesheets and for those sheets to be reviewed by supervisors and input into the accounting system can take several days where they are not complete by the end of the month closing. So though an invoice may be generated in the prior month it will be considered unbilled A/R because it is not recorded until the next month.

2. *Rate variances.* This occurs when actual indirect rates are different than provisional rates used for billing cost type contracts. When actual rates are higher than provisional ones, a positive unbilled A/R balance will arise meaning the company is not billing as much as it can. When actual rates are lower than provisional ones, a negative unbilled A/R will arise indicating the company is billing more than it can and hence owes the government.

3. *Retainage.* Contracts that have fee withhold clauses per FAR 52.216-8, Fixed fee give the contracting officer the option of withholding 15% (not to exceed $100,000) of fixed fee on cost reimbursable contracts or 5% (not to exceed $50,000) under T&M contracts per FAR 52.232-7, Payments under Time and Material contracts. Under these terms, the government retains a portion of the amount due until the contract is completed.

4. *Costs in excess of billings.* These occur under firm-fixed price contracts where the customer is billed less than the amount recognized on the contract to date based on the percentage-of-completion method of recognizing revenue.

5. *Billings in excess of costs.* This results from the customer billing more than its costs to date.

6. *Cost overruns.* This occurs when the costs on a fixed price contract have exceeded the price of the job. When this occurs, contractors will often seek a change order or request for equitable adjustment to increase the price.

7. *At risk projects.* This arises when the company starts working on a project without a signed contract or before official start date. At risk projects can also occur if the contractor is performing work beyond current funding levels or the period of performance.

8. *Milestone billing.* They may occur when work is done prior to completing a milestone (i.e. specific portion of the work on a fixed price contract triggering an invoice).

9. *Award or incentive fee.* This may occur when the contractor is unable to bill for an award or incentive fee until the government formally approves payment under, for example, a contract modification.

Since banks, auditors, some vendors and acquirers of companies are concerned about the speed of converting unbilled A/R into cash, contractors will need to demonstrate the collectability of these unbilled A/Rs

to avoid, for example, being lent funds on only a low percentage of the unbilled A/R amounts. Contractors have some flexibility in mitigating some potentially adverse impacts of high unbilled A/R amounts.

1. Analyze and classify the unbilled A/R amounts each month into the categories identified above.

2. Unbilled A/R related to timing differences should be turned within 30 days where bankers may rely on these fast turns.

3. Unbilled A/R related to rate variances should be closely monitored and variances closed. Rate variances should be adjusted at least annually. If it is clear by the end of the fiscal year that the rate variance will be billable soon, your banker may lend against this category of unbilled A/R within 30-60 days of your forecast billing date.

4. Unbilled A/R related to retainage, progress to date should be compared against expected completion to get an idea on when retainage can be billed. Since retainage can take years to collect, contractors should aggressively seek waiving withhold requirements on cost and T&M contracts. If you can accurately forecast the dates that significant retainages can be billed, banks may lend against those coming due in 30-60 days.

5. Costs in excess of billings and billing in excess of costs are usually related to timing differences and effort should be made to turn them over within 30 days.

6. For cost overruns, contractors should be able to demonstrate pending change orders to give lenders an idea on the collectability of these overruns. Be aware banks usually do not lend on pending modifications.

7. For "at risk" unbilled A/R, contractors should demonstrate why work being performed is likely to be paid. Again, banks normally do not lend on at risk items.

8. On milestone billing contracts, contractors should be able to point to reliable schedules of billing, the likelihood of achieving the milestones and its past performance in meeting the schedules.

9. On award and incentive fee contracts, the contractor should be able to demonstrate how the fees are being accrued, the award fee schedule and the past performance in obtaining award fees.

Oldie but goodie...

CONTRACT DOCUMENTATION

(Editor's Note. We are constantly reminded, whether it involves a contract dispute, performance assessment or successful claim or termination resolution, about the importance of good documentation. The burden of asserting and proving facts usually falls on the contractor, not government. The contractor must usually prove what was said or done, what cost was incurred, etc. Carefully documenting important items without getting lost in an avalanche of paper is critical. We contacted a colleague of ours, Tim Power of the Law Offices of Tim Power in Walnut Creek, CA to provide our readers with some sound practical advice on documentation.)

Studies have pointed to an interesting conflict – government contracts usually require much more paperwork and administrative effort on the one hand yet effective communication and timely resolution of problems between companies are usually handled better in the private sector. Tim believes that emphasis on the right documentation during the entire contracting cycle is critical.

Bidding Phase

Some of the most important documentation requirements during this phase relate to requests for clarification during the bidding process since only written clarifications are binding. Requests for clarifications should be made in writing and kept in a file with any related correspondences. If telephone calls are used, notes should be kept about the call and retrieved. Be sure to write a memo to the agency confirming the main points of the telephone conversation. Ask to receive clarification in writing, email or by fax. Tim says he could not count how many claims were lost because there were unclear specifications but the contractor failed to show it questioned specifications during the bidding stage. Though it is not the contractor's responsibility to rewrite faulty specs it is the contractor's obligation to bring up discrepancies or ambiguities that are obvious before bidding and allow the CO to correct them.

For example, a contractor lost his claim for the higher cost of using new parts rather than reconditioned parts because he did not ask the CO before bidding if reconditioned

parts could be used. The confusion should have been resolved during the bidding process and documentation of this effort demonstrated.

Though there is no requirement that bid and proposal worksheets be left after a bid is submitted they should be kept. If a contractor asserts there was a mistake in its bid and wants to correct it, the worksheets are usually needed to show what mistakes were made, how it was made and what was the correct bid amount. If a claim is filed, it is often important to show what costs for the original work were anticipated and which costs were included in the bid even when the contract price is not cost-based. If you win a protest, the GAO may likely allow recovery of original bid and proposal costs if they are documented. Under a termination for convenience, start up costs may be recovered.

Performance Phase

A contractor, not the government, has the burden of proving all elements of a claim so it is necessary to prepare and keep documents during performance that will support any potential claims that may arise. For instance, if there is a delay, the contractor must show it was beyond its control. If it asserts the government caused the delay, the contractor must show what caused the delay and that the CO or authorized representative was responsible for it. In most such delay claims, it falls to the contractor to show what happened during performance. Since it is usually not always known if there will be a claim or what will be needed later, contractors need to develop a routine system to document performance that meets their individual needs. Tim provides some examples that may be relevant to your needs:

1. A claim for additional costs caused by the lack of heat in a building was successful because the contractor could show that the same crew did the same work in a similar building in half the time. Daily reports showing where each employee worked were used to challenge the government's assertions that different crews worked in the various buildings.

2. Key field personnel should keep a diary where they may record observations along with their reports. These observations might include telephone calls, material deliveries, comments by inspectors and subcontractors, etc.

3. Documentation of differing positions should be kept when possible. Numerous forms, often required by the contracts, such as daily reports, quality control reports, inspection reports have room for contractor comments and disagreements should be noted on them. Failure to make comments are often interpreted as proof no disagreements existed. Contractors, especially more inexperienced ones, should resist inclinations to not want to challenge inspectors.

4. The numerous responses to COs need documentation efforts. Examples include confirmation of inspectors' directions, requests to clarify ambiguous directions, requests to clarify whether acceleration is expected, etc.

5. Telephone and verbal directions are common on government contracts. All conversations with government representatives need to be documented, especially directions and clarifications from the field. This can often be a simple confirmation memo with the date of conversation and short report on what was discussed. Files of these memos should be maintained.

6. The lines of authority specified in the contract should be followed where directions are confirmed with the proper authorized contract administrators. Tim mentions that he has encountered numerous instances where claims for changes resulting from inspectors' directions were rejected on grounds they had no authority to make a change and the contractor did not tell the CO about the direction until the work was done. If the contractor told the CO about its disputed directions and the discussions/written notice were documented then the CO would have confirmed the directive and there would have been a bona fide change or the CO would have overruled the directive and the extra work would not have been required.

7. Meeting notes should be written up and distributed to participants at the meeting. The ACO, if not present, should receive a copy. A distribution list should be on the meeting notes. However, in-house meeting notes should be for office distribution only so as to encourage personnel to speak freely on any possible parts of the contract.

8. Various logs should be kept. For example, logs for Requests for Information should note the date the information was requested and the date received while logs of shop drawing approvals should be kept, noting dates sent, dates received and actions taken.

9. Taking photographs or videos is a good way to document performance, especially in this age of the smart phone. Pictures are the best way to show the conditions described in inspection reports. For example, a claim for

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improper deductions was successful because a contractor's photos showed the overall work was proper. On another claim for improper deductions on an Air Force base maintenance contract, dozens of pictures of the grounds were taken documenting how the base looked. The photos were numbered and placed on a map to show where they were taken which allowed the contractor to demonstrate the government's negative inspection reports were excessively selective, representing only a few small areas rather the general level of work.

Completion Phase

Since employees may leave or, in service contracts, work for the successor contractor, key management and field personnel should write an evaluation of work performance. They should be asked to write down their perceptions and what they see as potential problem areas on future contracts with the same agency. This should mitigate the common tendency for potential witnesses to tell a different story once they leave or work for the successor contractor.

For example, a claim for government interference with performance on a service contract was almost lost because the former project manager changed his position when hired by the follow-on contractor. During performance the manager claimed government interference harmed performance and wrote memos about the interferences. When the same manager was hired by the follow-on contractor and was dealing with the same inspectors he changed his position. His memos showed his true feelings but getting a statement about the problem when he was still an employee would have helped more.

Conclusion

Careful documentation is the least expensive thing a contractor can do to protect itself from loss and often provides great payback. If a claim is filed, well-organized clear records will help establish the basis and amount due. Time spent later organizing documents and interviewing employees to try and piece together what happened is expensive and inaccurate. It is often impossible to reconstruct what happened, resulting in lost income opportunity from failing to convince a CO your position is justified.

Keeping documentation should become a routine. Peoples' memory fades, they move on and even die making claims difficult to prove. Keeping "better" rather than "more" paperwork can mean the difference between recovering a claim or taking a loss on a contract because there is inadequate support.

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