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COST RELATED ISSUES IN 2017

(Editor's Note. There were an unusual number of new regulations and cases in 2017 addressing procurement issues where we report on most of the significant ones below. We have substituted these for our normal annual summary of cases addressing other non-cost areas.)

The National Defense Authorization Act (NDAA) for Fiscal Year 2018 contained numerous procurement related provisions. Some of the most interesting ones for our subscribers include:

Incurred Cost Audits. Section 803 of the NDAA authorizes use of qualified private auditors to perform "a sufficient number of incurred cost audits of DOD contracts" to eliminate any backlog of incurred cost audits and to ensure that incurred cost audits are completed not later than one year after the date of receipt of a qualified cost submission. If audit findings are not issued within one year after receipt of the submission the audit will be considered to be complete where no additional audit effort will be conducted. *(Editor's Note. Some commentators praise the one year development but express concern for more audits by third party CPA firms where their opinions are often questionable.)* The DOD Comptroller may waive this requirement on a case-by-case basis if DCAA submits a written request. The 803 section directs DCAA to comply with commercially accepted standards of risk and materiality when performing incurred cost audits and prohibits DOD from differentiating private auditors and DCAA when considering audit results.

Increased Simplified-Purchase Threshold. Section 805 increases the simplified acquisition threshold government-wide from $150,000 to $250,000. The simplified acquisition procedures provide for significantly less burdensome requirements such as reduced competitive procedures and less documentation requirements.

Modification to Cost or Pricing Data and reporting requirements. Sec. 811 increases the Truth in Negotiation Act (TINA) certified cost and pricing data threshold from $750,000 (which had recently been increased from $550,000) to $2 million for all contracts entered into on or after July 1, 2018. The threshold for submission of certified cost or pricing data for legacy contracts will increase from $100,000 to $750,000. These thresholds will increase periodically to be updated for inflation. TINA language has also been changed which previously required the contracting officer to request other than cost or pricing data "to the extent necessary" to now require it "if requested by" the CO. These changes are intended to reduce the number of contracts, subcontracts and modifications that are subject to TINA which is now known as the Truthful Cost or Pricing Data statute.

Enhanced postaward debriefing rules. The DFARS is to be revised to (1) disclose agency's written source selection award determination redacted to protect confidential and proprietary information for all contracts over $100 million (2) allow requests for such information by small or nontraditional contractors for awards over $10 million (3) a requirement for a written or oral debriefing for all contract awards and task or delivery orders valued at $10 million or higher and (4) provisions ensuring both unsuccessful or winning offerors are entitled to the same disclosures and debriefings. In addition, disappointed offerors for DOD contracts will have the opportunity to submit within two business days after receiving a post award debriefing additional questions related to the debriefing where the agency must then respond to the questions within five business days of its receipt.

Change to definition of subcontract under certain circumstances. Sec. 820 adds language that is intended to clarify that commodity purchase agreements which are not identified to a particular government contract but which support both federal contracts and other parties are not "subcontracts" for purposes of federal procurement requirements. As a result, the agreements should be excluded from flow down and other subcontract requirements and will permit commodity acquisitions under standard industry terms.

Use of LPTA source selection process. In Sec. 820, Congress has continued its war against use of the lowest price technically acceptable source selection procedures where situations where LPTA may be used has been further narrowed by adding two limitations. Now, in addition to limitations set by the 2017 NDAA, LPTAs may be used only where (7) DOD would realize no or minimal additional innovation or future technological advantage by using a different methodology and (8) for contracts for the "procurement of goods, the goods procured are predominately expendable in nature, nontechnical or have a short life expectancy or short shelf life." In addition, Sec 832 prohibits uses of LPTA for the engineering and manufacturing prime contract of a major defense program.

Expanded use of E-commerce portals. Sec 846 provided that the administrator of the General Services Administration (GSA) will establish a program to procure commercial products through commercial E-commerce portals for the purposes of "enhancing competition, expediting procurements, enabling market research and ensuring reasonable pricing of commercial products." "Commercial products" means a commercially available off-the-shelf item but does not include services. The program will be carried out by multiple contracts with multiple e-commerce portal providers and implemented in three phases.

DOD commercial item determination. Under Sec 848, DOD's acquisition of a commercial item under FAR 12 will serve as "binding" for future DOD acquisitions of that item unless the senior procurement executive determines in writing that the prior provisions may not be used if the item was acquired using FAR Part 12 procedures. These provisions are intended to improve consistency for commercial item determinations and streamline the determination process.

Preference for Use of OTA Authority. In executing science and technology and prototype programs Sec 867 provides the DOD Secretary is directed to establish a preference for using transactions other than contracts, cooperative agreements or grants.

Additional procurement related changes included:

Buy America. Pres. Trump signed Executive Order 13783 "Buy American and Hire American" that orders federal agencies to enforce and assess compliance with "Buy America" laws which generally provide preferences for the procurement of domestically produced goods and services. The EO also provides additional constraints on waivers for Buy America laws.

Simplified Acquisition Thresholds. Implementing the 2016 NDAA, the FAR was amended to increase the simplified acquisition thresholds for special emergency procurement authority from $300,000 to $750,000 within the US and from $1 million to $1.5 million outside the US.

Prohibition on Reimbursement for Congressional Inquiries. Adding another element of what constitutes unallowable costs under FAR 31.205-47(b), the FAR was amended to make unallowable costs incurred "in connection with a congressional investigation or inquiry that results in a criminal conviction; a finding of civil liability for fraud or other similar misconduct; a decision to debar or suspend the contractors; rescind or terminate a contract for default or; a disposition of the matter that resulted in a compromise if the proceedings could have led to one of the above outcomes.

Prompt Payment interest rates. For the six month period beginning July 1, 2017, the Dept. of Treasury lowered the prompt payment interest rate from 2.5% to 2.375% and for the six month period beginning Jan. 1, 2018 the rate was increased to 2.625%.

In addition, there were several cases related to cost and pricing issues.

Equitable Adjustments. An equitable adjustment is the difference between the reasonable cost of the work required on a contract and the actual reasonable cost to the contractor of performing changed work plus indirect costs where the burden of proving the amount falls on the contractor. To bring a viable claim the plaintiff must show three elements – liability, causation and resultant injury *(Pyrotechnic Specialties, ASBCA No. 57890);* a contractor is entitled to an equitable adjustment for government's inadequate or negligent estimates *(Agility Defense & Gov Svcs, vs US, 847 F.3d 1345)*; defective government solicitation documents misled bidders so contractor was entitled to costs of removing and replacing unsuitable riprap *(Magnus Pacific Corp. v US, Fed. Cl. 640)*; contractor not entitled to REA when it was required to assume costs for importing backfill material *(Senate Builders vs US 131 Fed. Cl 719)*; entitled to expenses related to accelerating orders *(IAP Worldwide, ASBCA No. 59397)*; successor contractors not entitled to REA for increased vacation costs under a union agreement it inherited where contractor is responsible for increased costs under its fixed price contract *(SecTek CBCA No. 2862)*; government was liable for labor inefficiency because it was responsible for factors requiring the subcontractor to change its plans *(Turner Const., CBCA 2862)* and; the government bears

the burden to substantiate deductive changes for deleted work *(Yates-Desbuild JV, CBCA No. 3350)*.

Termination settlement costs. Termination for convenience of a fixed price contract has the effect of converting the contract into a cost reimbursable contract. Where the government never issued notice to proceed construction costs are not reimbursable but costs incurred in preparing to perform, standby labor costs and three months of costs for assembling a start-up team in preparation for performance were reimbursable as well as G&A and profit on those costs *(Pro-Built Const., ASBCA 59278)*. Termination costs must be reasonable and no recovery for materials purchased before the government approved purchases and standby costs without documentation were not reimbursable *(American Boys Const., ASBCA 60515)*. Contractor not entitled to CLIN prices because CLIN prices are based on price whereas T of Cs are based on costs *(Atlas Sahil Const., ASBCA No. 58951)*. Reasonable costs paid to subcontractor were reimbursable but no recovery for G&A and profit on those costs *(Dream Mgt CBCA No. 5571)*. Despite lack of documentation, contractor was correctly paid according to percentage of work completed plus its sole invoice (*Rhodes Research, ASBCA 59414)*. Under the Commercial Item clause, no recovery for software license costs was allowed because they were "perpetual and valid" and thus usable on other contracts *(ESC Gov, ASBCA No.58852)*. Cannot use termination settlement cost principles to settle breach of contract disputes where no termination occurred *(Paradise Pillow, cbca No. 5179)*. We addressed conditions for allowability of pre-contract costs in the last GCA REPORT where additional issues were addressed in the case where the Board rejected several assertions by the government: (1) the "entire contract" was not in a loss position where no profit and reduced settlement costs would be justified because the "entire contract" would not have a loss but only the base period was at a loss because it absorbed $68 million of in-transition costs where it would have turned profitable in the second and third option years (2) it was unreasonable to expect AGHP to eliminate its staffing, office space and IT services immediately following its stop-work order (3) the contract close out and settlement costs were not unallowable legal costs to promote prosecution of its claim but was rather allowable costs of the Contract Dispute Act process of a claim which encourages the exchange of information between the CO and contractor (4) severance costs were not unallowable because there was no legal obligation of AGHP to pay severance where FAR 31.205-6(g) states they are allowable if there is an established policy that constitutes, in effect, an implied agreement to pay it and (5) G&A was an applicable cost on the severance costs since they should be considered other direct costs and thus burdenable with G&A *(Phoenix Data Sltns, ASBCA No 60207)*.

Cost reasonableness. The government's disallowance for reasonableness of subcontractor security costs in Iraq were found to be allowable since the government breached its contract to provide contractual force protection *(Kellogg Brown & Root, ASBCA N. 56338)*. The Board upheld numerous costs related to several cost plus fixed fee task orders for hurricane relief work. Award of CPFF subcontracts were required because KBR was unable to award fixed price subcontracts due to the contingency nature of the work; the percentage markup on labor and equipment rates did not create prohibited cost-plus-percentage-of-cost subcontracts because overhead and profit were applied to fixed hourly and equipment rates, not actual costs; oral subcontract modifications were valid where there was evidence of the oral mods; the contractor was not required to obtain certified cost or pricing data because the subcontract was for commercial item dining facilities; it was appropriate for the foreign subcontractor to use federal per diem rates to show reasonableness and; it was appropriate to pay a 15% markup on a second tier subcontractor's labor and a markup for equipment rental costs for subcontractor owned equipment when it was shown such markups were normal practices in the industry *(Kellogg, Brown & Root (ASBCA No. 58081)*.

Expressly unallowable costs. Though the Board found that stock option costs based on the "Black-Scholes" model were unallowable because they were based on changes in the price of corporate securities they were not expressly unallowable because due to the complexity of the issue, there could be reasonable differences of opinion regarding the costs and hence they were not expressly unallowable *(Luna Innovations, ASBCA No. 60086)*. Some costs were expressly unallowable when lobbying and associated salary costs were shown to be claimed while other costs were not expressly unallowable when it was shown no law or regulation specifically addresses unallowable costs for fractional lease costs or the government failed to meet its burden of proving that unallowable consultant costs were expressly unallowable *(Raytheon Co., ASBCA No. 57743)*. The Board ruled that contractor's compensation costs were expressly unallowable when it showed it was based on securities price changes and dividend payments and entertainment costs *(Exelis, ASBCA No. 58966)*.

Cost allowability. The government (DCAA) improperly disallowed costs asserting the contractor had failed to

"manage" its subcontractors by failing to initiate audits where the Board ruled for Lockheed stating this duty was "non-existent" and hence the government had relied on a nonvalid legal theory *(Lockheed Martin Integrated Systems, ASBCA No. 59508).* After the parties were unable to agree on a quantum the Board dismissed the case ruling the government suffered no damages for the noncompliance with a section of the compensation cost principle at FAR 31.205-6(o). The Board held the contractor's deferred compensation was not unallowable under the compensation cost principle because the government's refusal to make contract payments until DCAA approved its indirect cost rates compelled the contractor to defer paying a salary to its founders ruling the deferred payments was unavoidable and unforeseeable *(Quimba Software v US, 132 Fed. Cl. 676).* The contractor asserted DCAA had so changed its approach by questioning costs it had not previously questioned arguing government was precluded from disallowing the costs by the doctrine of retroactive disallowance. One judge agreed with the contractor while four others sided with the government saying retroactive disallowance, like equitable estoppel, is no longer a valid theory to challenge audits since both principles require a showing of "affirmative misconduct" by the government *(Technology Systems, ASBCA No. 59577).* Though the government agreed the contractor's legal fees were allowable it claimed contractor expensed them in the wrong future year while the Board ruled FAR 31.205-47(g) precluded reimbursement of legal fees while an investigation was still pending and it was reasonable to wait until all documents were received to ensure it was certain the investigation was complete *(Technology Systems, ASBCA No. 59577).* Following a prior Bill Strong Enterprises case holding that contract administration costs are allowable while costs prosecuting a claim were unallowable, the Board ruled that costs, including corporate overhead markup and profit incurred in furtherance of a mediation were allowable administrative costs *(Yates-Desbuild JV CBCA No. 3350)* and a contractor is entitled to pursue negotiation before submitting a formal claim where the costs are considered allowable contract admin costs *(Foxy Constr., CBCA 5632).* On a CAS case, the Board rule that disputed lease costs did not violate CAS 404 because the building lease costs were considered an operating lease, not a capital lease, and hence was not covered by CAS 404 which applies only to tangible assets having a physical substance whereas an operating lease is "intangible" because it is a legal right to use and occupy the building and has no "physical substance."

TRAVEL & RELOCATION

(Editor's Note. We have provided some recent Board decisions on travel and relocation costs addressing the Joint Travel Regulation affecting government employees. Though only three parts of the JTR provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidental and justifying payment of up to 300% of per diem rates – many government contractors choose to follow the FTR and auditors consider them to represent "reasonable" travel costs.)

No Reimbursement for TDY Travel to a Different, Cheaper PDY

Lauren was on temporary duty (TDY) in Washington DC and rather than return to his permanent duty station (PDY) in Dallas, he received permission from his supervisor to travel to New Orleans after receiving quotes that showed the New Orleans trip costed less than Dallas. Despite the permission, Lauren's agency demanded he reimburse it for the New Orleans travel, after deducting permissible lodging and per diem expenses which he would have been entitled to if he went to Dallas, The Board ruled against Lauren citing the Federal Travel Regulation that allowed for round trip expenses and lodging and per diem "when periodic return travel home is justified" for TDY assignment and then quoted the comparable section of the FTR (30-11.23) that prohibited reimbursement of transportation expenses to a different location than its PDY. The Board stated the supervisor who granted permission had no authority to do so because to do so would be to violate the Appropriations Clause of the Constitution which proscribes reimbursement of expenses without authority *(CBCA 5742-TRAV).*

Must Receive Prior Authorization for Second Bag

Martin sought reimbursement for checking a second bag on the airline that charged him since it allows only one free bag. The agency refused to reimburse Martin for the second bag citing FTR 301-12.2(d) that allows reimbursement for only one bag which is the default where an agency may reimburse an employee for more than one bag when the agency "determines those fees are necessary in the interest of the government" where the time to make such a determination is "prior to commencing travel." Martin offered several reasons for two bags – not knowing the "dress code" he packed a suit and casual wear as well as workout attire in the two bags – where the Board agreed

with the agency it could have been avoided with better planning or cited the need to request for prior agency authorization *(CBCA 5844-TRAV)*.

Fly America Act Not Violated for Portion of Trip Using a Foreign Air Carrier

Louise's agency rejected reimbursement for part of her trip because the portion from Calgary, Canada to Houston was with Air Canada rather than US domestic United Airlines which violated the Fly America Act (FAA) requirement for travel being funded by the US government must fly only US domestic airlines. The agency noted although United operated the flight it was ticketed using a flight number of a foreign carrier (Air Canada) where both the boarding pass and itinerary showed Air Canada. The Board sided with Louise stating all evidence showed travel services were provided by United - the agency acknowledged United actually operated the flight, the tickets were issued on United ticket stock, the itinerary identified both United and Air Canada, United considered the entire trip to be one continuous trip for purposes of fare calculation and United received the revenue from the government *(CBCA-5834-TRAV)*.

Meaning of "Customary" When Reimbursing Customary Closing Costs

As part of his transfer from Fort Lee to Ohio, William submitted expenses related to the sale of his Fort Lee home that included $8,250 for a portion of the purchaser's closing costs. The Navy refused reimbursement asserting he had not shown the payment was customary in the place the home was sold. William provided (1) a letter from a local real estate agent asserting that a 3% closing cost concession was a normal and customary concession to defray costs to allow purchasers to buy property with little money down and (2) an electronic mail message from the local housing authority stating sellers may contribute up to 6 percent of the sales price toward origination fees and other closing costs. The Board agreed that the FTR does provide for real estate transaction expenses that are reasonable and "customarily" charged to the seller. The issue here was whether the fee was customary where the Board states the seller has the burden of proving by a preponderance of the evidence that such costs are customary in the locality of the sale. The Board cited Charity Hope Marini *(CBCA 4760-RELO)* as determining what did and did not constitute adequate evidence. Examples of adequate evidence included (a) state law requires it (b) preprinted settlement form calls for seller to pay a specific cost (c) letters from a real estate broker confirming a particular cost is invariably paid by the seller (d) extensive sales data on similarly-priced properties showing that 93 percent of sellers contributed to the closing costs or (e) letter from real estate broker confirming that 90 percent of sales transactions included the expense. A "bald assertion" that that many sellers paid the closing costs is not sufficient, where even though a practice may be common it is not enough to rise to the status of "customary." The Board ruled William did not meet the burden of establishing the closing costs paid were customary. It stated the letter from the real estate agent did not provide supporting data or other information showing the expense was customary and the local FHA letter only shows that a seller may pay some of the closing costs where nothing in the message showed it was customary *(CBCA 5641-RELO)*.

22-Year-Old Daughter is Not Considered a Family Member

Maria accepted a position to relocate to Vancouver, British Columbia from San Diego. She was accompanied by her 22 year old daughter who was pursuing her education and was a dependent. Both a relocation counselor and director of field operations authorized the daughter's relocation and temporary quarters subsistence allowance (TQSA). Maria's agency realized they made a mistake in reimbursing her for her daughter's TQSA and asked to be repaid while Maria said they should not be reimbursed because her daughter was a family member and she received preapproval. The Board stated the FTR provides that employees and their immediate family are entitled to per diem when relocating from inside the US (CONUS) to outside (OCONUS). Under the FTR, only children "who are unmarried and under 21 years of age" or who are physically or mentally incapable of self-support" are included in the definition of "immediate family" so since she was over 21 and not incapable of self-support she was not a member of Maria's immediate family and hence not entitled to reimbursement. The Dept. of State Standardized Regulations (DSSR) has the same definitions. Though the agency did erroneously advise Maria it is settled law that a government official many not obligate the government to spend money in violation of statutory or regulatory entitlements *(CBCA-5646 RELO)*.

Two-Year Limit on Reimbursement of Real Estate Costs With No Exceptions

Chase relocated to Bridgeport, WA and when he could not find a house within one year of his relocation he asked

for and received an extension of the one year provision to a second year. His agency refused to reimburse him for his real estate expenses because they were incurred later than two years after he relocated while Chase asserted he was entitled to it since he had difficulty locating a suitable house and the closing was delayed through no fault of his own. The Board cited several provisions of the FTR that limited reimbursement of real estate expenses to one year plus only a one year extension where the FTR stated "there was no authority to extend the two years limitation under any circumstance" (FTR 5908-C.8). The Board concluded though the sale was delayed through no fault of Chase, it nonetheless had no authority to extend the time limit *(CBCA 5731-RELO)*.

Lower ME&I Amount Not Justified Without Prior Authorization

Michael received travel orders to attend a training academy for a month in a half where there were no notifications of per diem reimbursement for less than the amounts authorized by the JTRs. While attending the academy Michael was provided lodging at no expense and dining facilities were available at a daily cost of $11.55 ($2.45 for breakfast and $4.55 for lunch and dinner). Michael was reimbursed at a daily rate of $11.55 and sought the per diem amount totaling $2,011 which was the difference between the full per diem amount and the $11.55 daily amount he received. The Board ruled in favor of Michael, quoting the FTR (301-11.200) which stated an amount lower than the FTR rates can be justified when it is shown that lower rates are available but only when such an arrangement is "requested and authorized prior to the travel." Here there was no such prior authorization or notification *(CBCA 5409-TRAV)*.

Case Study…

RESULTS OF BENCHMARKING INDIRECT COST RATES

(Editor's Note. We were asked to benchmark a client's proposed indirect cost rates against published rates we could find. We have decided to include our highly edited report because it demonstrates how companies can compare their rates with competitors and also shows the need to compare "apples and apples" where comparing numbers must be adjusted for how companies and surveys compute their benchmarked rates. We also think our report can be useful for suggesting ways to alter practices to generate more competitive rates. We have disguised the identity and actual rates of our client but have provided accurate rates we found in our research. The following is a highly edited version of our report where we have omitted numerous exhibits provided. Also, one of the sources we used was proprietary so we disguised the name as "XXX Foundation.")

Fringe Benefit Rate. Contractor computes its fringe benefit rate by including many normal fringe benefit costs in its pool (e.g. payroll taxes, health insurance) except for paid time off and bonuses and uses total payroll in its base. Contractor's projected fringe benefit rate of 33.5 is lower than most surveys' respondents. Whereas the Gauge Report and XXX Foundation did show a minority of respondents were at a similar level of 31%, 75% were noticeably higher, between 36-40%. A major reason for Contractor's lower rate is the fact that its fringe benefit pool does not include the same costs that are in the FB pools of most surveyed companies (PTO costs). In addition there is uncertainty of whether bonus costs are included in surveys' FB pools. Except for the XXX Foundation survey, all fringe benefit pools do include all PTO costs. By adding the PTO costs to its fringe benefit pool, the resulting FB rate is 42% which is at the high end of all the surveys.

Overhead Rate. Contractor uses what it calls a value added base (e.g. direct labor, fringe benefit costs, other direct costs except subcontracts) in computing its overhead rate. Its overhead rate is 32% which is significantly lower than all of the surveys. It is difficult to accurately confirm this since the surveys do not specify whether the overhead bases consist of only direct labor or direct labor plus fringe benefit rates. However, it is safe to say Contractor's rate of 32% is at least the same or likely lower than most surveyed companies since last year, we reported the Grant Thorton survey did show an average 33% overhead rate where the base consisted of direct labor plus fringe benefit costs.

However, the major reason for these favorable results seems to lie in the overhead base used to compute the rate. The results of the XXX Foundation not withstanding, the overhead base is almost always direct labor costs or direct labor costs plus associated fringe benefits. Use of a value added overhead base which includes significant amounts of non-labor direct costs results in a higher base (denominator). If this significant non-labor factor – supplies – was eliminated to produce a comparable overhead rate, the resulting overhead rate would be 45%, a rate higher than the other surveys. The use of these adjusted higher overhead and fringe benefit rates along

with the proposed G&A rate generates a multiplier much higher than the Grant Thorton survey.

General & Administrative Rate. Unlike Contractor's fringe benefit and overhead rates that have unique characteristics, its G&A rate structure is not unusual. Its G&A rate consists of G&A pool costs and its base is value added (all costs except for subcontract costs). Its G&A rate is 21% compared to 13% last year while survey results are 15% for G&A. The increase of its G&A rate from 13% to 21% does place its rate from solidly below survey results to one that is a bit higher than comparable results. Fortunately, there are some options worth considering to lower the rates and even help its pricing options.

Material/Subcontract (M&S) Rate. Contractor's rate of 1.5% is significantly lower than survey results of 4-6%. A brief analysis of the M&S pool and base indicates that inclusion of only subcontract administration costs in the pool is rather small while inclusion of all subcontract costs (material costs are very low) in the base may be excessive. The stakes are significant where doubling the M&S pool would allow an increase in the rate to more comparable levels and a corresponding decrease in either the overhead or G&A rates can be achieved by transferring some M&S base subcontract costs to the G&A base. Contractor should consider changing the costs included in both its M&S pool and base. For example, the pool could also include purchasing and QC costs along with allocated shares of facilities costs and administrative functions. The M&S base could be reduced by including only high dollar subcontract costs (above $25K is common) while transferring lower cost subcontract costs to the G&A base.

Changes worth considering. If Contractor does desire to lower its overhead and G&A rate, there are several options that can be considered. First, movement of some overhead and G&A costs to the material and subcontract (M&S) pool can lesson some of its G&A pool costs. Second, movement of some of its M&S subcontract base costs to the G&A base can have the effect of lowering Contractor's G&A rate (higher denominator) while their inclusion in the base would allow it to have a higher add-on amount for some subcontract and intracompany transfer costs if it desired since they would be using the higher G&A rather than lower M&S rate. Third, there may be the opportunity to shift certain home office allocations from the relatively high G&A pool to a relatively lower overhead pool. The rules provide great flexibility in making these decisions about what costs are overhead versus G&A where, for example, certain home office costs that reside in the G&A pool may be transferrable to the overhead pool if the functions are more related to overhead rather than G&A functions. Though not CAS covered, it is probable that these accounting changes would need to be disclosed but there would likely be justifications for the changes (e.g. costs relate more to project support than the company as a whole).

Advantages/Disadvantages. The lower rates you are proposing have the advantage of appearing low. However, applying both a G&A and Overhead rate to certain significant dollar ODCs has the advantage of high recovery but the disadvantage of having a non-competitive price or even being rejected with the assertion "I don't care what your rates are, I am not going to accept a 66% add on to direct supplies"(45% overhead, 21% G&A).

Comparison of Multipliers

The relative shortage of credible surveys required us to apply another way of comparing indirect cost rates – estimating and comparing multipliers. Though lacking precision, such an approach can yield some results that can be used to compare companies. We computed a multiplier for Contractor by starting with average base rates for a selected sample of labor categories and then added its proposed indirect cost rates plus a 10 percent profit rate to compute a fully burdened cost. In order to be able to compare Contractor's multiplier, we estimated the same for certain companies who have won the GSA's Alliant IT professional services contract (which is similar to Contractor's business) whose fully burdened costs are published on line. We selected three companies who are competitors of Contractor as well as a median list of all companies and listed their burdened rates for the similar labor categories we selected for Contractor. We are assuming that most companies have roughly the same base rates for similar labor categories to be competitive where the multiplier represents the difference between calculated results for Contractor and those published by GSA. The results are a 2.2 multiplier for Contractor's proposed rates, which is comparable to the 2.1 multiplier found in the Grant Thorton survey. However, applying the adjusted rates we found resulted in a 2.5 multiplier which is on the lower end of 2.1-4.3 for the median multiplier found in the GSA rates. Reasons can vary for the higher GSA rates such as fees higher than the 10% we are assuming, companies may be offering market based rates rather than cost build up ones or their base rates may be higher. This estimate does indicate that Contractor's multiplier is at lower or at least comparable levels to some of its competitors whereas its adjusted rates are higher.

Knowing Your Cost Principles…

TAXES

(Editor's Note. Recent cases focusing on allowability and allocability of various taxes have made accounting treatment of taxes for contract costing purposes a hot issue. We have used the most recent editions of various texts including Mathew Bender's Accounting for Government Contracts, prior articles in the GCA REPORT addressing new developments and DCAA's Contract Audit Manual (DCAM).

Cost Allowability

The following taxes are unallowable contract costs in accordance with FAR 31.205-41(b):

1. Federal income and excess profits taxes.
2. taxes related to financing, refinancing, refunding operations or reorganizations.
3. taxes for which exemptions are directly or indirectly available. These are exemptions available not to the contractor but to the federal government. For example, a contractor might claim an indirect tax exemption for property owned by the government but in contractor's possession even though the federal government is exempt from state and local taxes even if in the contractor's possession. However, if the CO determines obtaining an exemption is too great an administrative burden, the tax is allowable.
4. special tax assessments on land to pay for capital improvements.
5. taxes on real and personal property not used in connection with government contracts.
6. taxes related to funding deficiencies and prohibited transactions under deferred compensation plans.
7. tax accruals to recognize the difference between taxable income and pretax income recognized in the financial statements.

Generally, taxes not declared unallowable by the FAR are allowable if recorded in accordance with generally accepted accounting principles (GAAP).

- **State and Local Taxes**

Though recent IRS changes may affect treatment of state and local taxes there have been no changes thus far to accounting rules affecting government contractors. State and local taxes, including property, franchise and income taxes are allowable costs. However, if the taxes are paid late or in error, any penalty or interest assessed by the state or local government is unallowable unless the contractor followed direction from the contracting officer.

Sometimes disputes arise over applicability of state and local taxes levied on inventory in the contractor's possession to which the government has legal title because state and local taxes cannot be levied on the federal government. However, the government's title to property that is obviously in possession by the contractor may be disputed by the local taxing authority. In such cases, the contractor should not pay the tax before asking the CO's advice.

Tax accruals arising from differences between state and local taxable income and the expense reported for financial purposes are not allowable. The government accepts only those taxes reflected on the tax return – taxes actually paid. In addition, a contractor cannot allocate state and local taxes to government contracts in excess of taxes actually paid. In *Physics International Company (ASBCA No 17700)* the board held though the contractor paid a minimum tax of $100 due to losses at a commercial division, the taxes allocable to the profitable government division based on the taxes that would have been due had it been a separate entity were unallowable.

Some states like New Mexico and Washington impose on the seller revenue based state taxes that are computed by multiplying the total revenues received from doing business by the applicable rate. Unlike many state sales taxes, the seller is not exempt from paying these revenue based state taxes. Though allowable, DCAA has imposed certain allocation restrictions. Since the revenue-based state taxes are levied on the contractor's revenue from doing business in the state, which generally comprise many contracts, these costs are not identifiable to specific contracts and hence not a direct charge. Even though these taxes are overall costs of doing business and hence akin to G&A expenses, DCAA asserts these taxes, if they are material, should not be included in the G&A pool. Because the usual base of allocation of overhead and G&A are normally costs rather than revenue, they should be allocated to contracts on a different base than cost. Furthermore, DCAA states these revenue based state taxes should be included in the total cost input base for G&A allocation.

- **Other Taxes**

When a contractor performs work in a foreign country the host country commonly imposes taxes on the contractor and since they are analogous to state or local taxes they are considered allowable contract costs. When a contractor has paid an income tax to a host country it can claim a foreign tax credit against its federal income tax resulting in a reduction in federal income tax by the full amount of the foreign credit. DCAA considers this a duplicative recovery of a foreign income tax expenditure – first as a contract cost and then as a reduction in its federal income tax liability. In 1991 the FAR was revised to require contractors to credit government contracts for foreign tax credits claimed on US income tax returns when these allowable foreign income taxes are claimed on contracts. Even for fixed price contracts, FAR 52.229-6(h) requires that if a contractor receives a reduction in its US tax because of any tax or duty which was included in a contract price, the amount of the reduction shall be paid or credited to the government.

The ability of a state government to tax a federal government contractor for purchases related to the contract has been a controversial matter and the outcome depends on the state involved. For example, Missouri courts have ruled the state cannot tax a contractor that is using purchased items in direct contract performance *(US v. Benton, DC WD Mo. No. 89-0608).* In California and Arizona, the courts have held that even indirect materials may be exempt from state taxes based on a reasonable allocation of these materials to contracts. On the other hand, Colorado courts have permitted imposition of state use and regional transportation taxes on special tooling equipment used by a contract when it is delivered to the government at the close of contract performance. As recognized in FAR 29.401-6 the New Mexico state courts have held that certain state taxes are applicable to services provided under federal contracts and until the federal government gets a ruling, any state taxes paid to New Mexico are allowable. One court has ruled that a county may tax a contractor for the beneficial use of government furnished property in its possession *(DC Ne. No CV-S-94-687).* In another decision the court was unmoved by the argument that the property belonged to the federal government and was used exclusively for government work *(US v NY county, 178 Fed 1080).*

When sales tax refunds are made, the government's share is dependent on the type of contract and specific terms and conditions in the contract. The government is entitled to a share of any refund allocated to a cost reimbursable contract. However, for fixed price contracts, any government share is dependent on two contract clauses – progress payments based on costs and property title provisions. If a contract does not contain a progress payments clause and the contractor purchased property does not become government property when purchased, the government will not receive a share of such refunds under fixed price contracts *(ASBCA No. 49339).*

Cost Allocability

Because tax exemptions might exist for government-owned inventory held by a contractor special rules on the allocation of taxes have been developed. Taxes on property used solely for government work must be allocated only to government contracts and taxes on property used solely for non-government work must be allocated only to non-government work. If property taxes are insignificant or if separate allocations do not differ significantly from a combined allocation, then separate allocations are not necessary. If property is used for both government and non-government work, taxes should be allocated to all work based on relative use of the property.

Refunds of allowable taxes, fines or penalties have to be credited ratably to the government to the extent the government participated in the original cost. Contractors should expect refunds will be carefully reviewed to assure that proper credit is given to the government. Normally, refunds can be credited in the year the refund is received but this may not be acceptable to the government if the mix of contractor business has substantially changed from the time the tax was charged *(Hercules Inc. v US 49 Fed Cl 80).*

State and local income and franchise taxes are allowable costs. However, the allocation of state and local taxes to business units and ultimately to government contracts is one of the most controversial tax issues in government contracting. The DCAA Contract Audit Manual (DCAM) cites three possible allocation methods: the first is to allocate taxes to organization units based on the income of each unit as determined by the books and records of each unit. The second method, which DOD recommends, is based on a formula that uses three elements to allocate total income: payroll, revenue and assets. The third method is to allocate the income based on specific identification, which is just a combination of the other two methods.

Allocable to government work. The primary emphasis of DCAA guidelines in Chapter 7-1403 of the DCAM

is to make sure that taxes are allocable to government work. The guidance stresses any taxes leveled on non-government work (e.g. inventory, real property, personal property) is unallowable because it is not allocable to government work. The exception to this is if the amounts involved are insignificant or if comparable results would otherwise be obtained.

Erroneous computations of taxes. The guidance indicates auditors need to be alert for whether there are questions about how claimed taxes were computed, whether there were illegal acts or simply errors. The amounts of the errors are to be identified and reported and if the error is subsequently confirmed a credit or refund should be pursued. Auditors are to follow up to assure that a proper share of credits or refunds received by the contractor are passed on to the government.

Penalties. Penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. However, FAR 31.205-41(a)(3) provides a specific exception to the disallowance of penalties when incurred as a result of following the contracting officer's direction or permission not to pay taxes assessed by a state or local government.

Interest. Generally interest associated with an intentional (i.e. intentionally paying less than is reasonably estimated to be due) underpayment of state or local taxes is unallowable per FAR 31.205-2 because the interest is considered to be "interest on borrowings." However, interest associated with an underpayment of taxes where the contractor's intent to borrow cannot be shown is allowable. Also, if the contractor's underpayment was directed or agreed-to by the CO, FAR 31.205-41(a)(3) allows any resulting interest. Interest incurred as a result of late payments (e.g. not paying financial obligations by the due date) is considered "interest on borrowings" and is therefore unallowable per FAR 31.205-20.

Oldie but goodie…

WAYS FOR GOVERNMENT CONTRACTORS TO IMPROVE CASH FLOW

(Editor's Note. As all firms know, the ability to generate cash is a critical key to success. All successful businesses have found their own unique ways to expedite cash generation. Our work with a wide variety of government contractors has led us to the conclusion there are common factors that are fairly unique to government contractors' efforts to improve cash flow no matter what type of product or service the firm sells to the government. This article summarizes some of our experiences and insights from experts.)

Collections

While most contracts contain the prompt payment clauses prescribed by FAR 32.9 each government activity proceeds at its own speed. Time for reviewing invoices can vary widely and reasons for rejecting invoicing can challenge the imagination. Client A may review and approve invoices in 14 days while Client B may take 60 days. The Prompt Payment Act requires government to pay interest on late payments at a rate set every six months but the current 3.5% rate may offer little help on a 90 day receivable. Consequently, contractors need to work with their clients up front to ensure invoices are processed quickly. The terms of the contract need to be well known and requirements of 52.232-25, Prompt Payment memorized.

If invoicing is based on delivery, attach evidence of the government's acceptance. If invoicing is based on percent of completion, ensure both parties are in agreement about what the percentage is. Even a 1% disagreement will result in delay. When submitting a cost reimbursable invoice, be prepared to have every backup document clearly marked, coded and attached to the invoice such as timecards, expense reports, subcontractors' invoices, materials reports, etc. If it is the client's practice to request only an invoice, have back up documents handy. Have the invoice formats and required information established well in advance – contractor kick-off meetings should address invoice requirements or a short pre-invoice meeting is recommended. At these meetings, find out if bi-weekly or even weekly billings are allowed rather than the customary 30 days. Strive to work on the basis of electronic invoicing and electronic payments to save the several "in the mail" days.

Paying Vendors

Speeding up collections are half the battle – timing of contract payment is equally essential whether you are a prime contractor/upper tier subcontractor or are the lower tier subcontractor/vendor. Helping subcontractors get paid is important on all types of contracts but is critical on cost-type contracts. The subcontractor's invoices must be consistent with contract terms and sufficiently detailed to satisfy the client as well as government auditors. It

must be clear with enough detail what was purchased, delivered and accepted, unit prices with backup and any other relevant information. Subcontractors and vendors need to know when invoices will be submitted by the prime contractor – if they submit an invoice the day after the prime contractor invoices its client, their invoice will not be sent to the government for another 29 days. To eliminate this time, establish a fixed date each month (or more often) in subcontracts and purchase orders. Let vendors know, for example, if the invoice to the client goes out on the 15th of each month, their invoices need to be received no later than the 10th, providing time to review and approve the invoice, request additional backup and submit the invoice with that month's voucher.

Timing of Payment. The question of when do I pay a vendor can depend on what state you are in, the agency you are working for and the type of contract. While "Net 30" or "Net 60" is clear certain terms may be "Pay When Paid" (vendor will receive payment when payment is received from prime contractor). The changes to the Paid Cost Rule made in recent years have simplified matters – large businesses under cost type contracts used to have to certify that vendor invoices had been paid before they were entitled to payments but the change has eliminated this requirement allowing large businesses to bill the government for invoiced goods and services when the cost is "incurred" rather than having to be physically paid.

Similar to non-government contractors, prime and subcontractors need to consider prompt payment discounts. Such discounts are stated in the purchase order or vendor's proposal and should be carried over to the resulting subcontract. Early payments are usually expressed as a percentage with a time period – e.g. "2 percent/10" meaning a 2% discount if invoice is fully paid within 10 days. The decisions on whether to offer discounts are similar with all companies but government contractors need to be especially sensitive to the efforts to review subcontractors' work. While discounts may make sense for commodity supply contracts which are easy to administer contractors may not want to put on additional time burdens on top of the normal review cycle of complicated cost type contracts.

Tax Exemptions. On many government projects the issue of tax exemptions arise, particularly state and local sales tax exemptions. The prime or upper tier subcontractor must clearly address the issue with their subcontractors and vendors. Subcontractors may assume the exemption and provide quotes and bids based on the assumption. If the exemption does not go through, the subcontractor will seek reimbursement sometimes up to 8 or 9 percent of the price. The contractor will either bear the cost or seek a change order from the client. The increased cost can also call into question the contractor's purchasing processes – for example, if the vendor was evaluated assuming the tax exemption, would they still be the lowest responsible bidder if the exemption does not apply. When seeking bids from vendors, the contractor should state in the solicitation whether the price quote will include taxes, fees, permits, etc. so bids can be evaluated equally. Contractors need to let their vendors know how to obtain tax exemptions - just because the last contract they worked on had an exemption does not mean the new one will. Also, contractors need to clarify in the subcontract documents that in the event an exemption from any tax is obtained, a change order or other mechanism will be issued requesting a credit. Be aware that under non-competitive circumstances, FAR 52.229-4 may apply which allows contractors to recover any after-imposed federal, state or local taxes if they exempt them from the proposals or similarly, require them to provide the government a credit if the contractor did not have to pay the tax or received a refund.

Relations with Subcontractors. Though the government does not have a legal relationship with a subcontractor (lacks "privity") normal disputes between the contractor and subcontractor may result in subcontractors calling the government representatives directly with complaints of not being paid. Since such actions can provide big headaches to the contractor, they need to minimize these occurrences. If a subcontractor wants to contact the client, the contractor should not react negatively but should educate the subcontractor on the likely outcome of such a call. If it believes a subcontractor is likely to make a call, it should contact the CO first and explain the situation to avoid surprises and one-sided accounts told by the subcontractor. Prime contractors should also ensure their subcontract agreement and purchase order terms and conditions restrict the subcontractor's ability to communicate directly with the client. Though it may not prevent the subcontractor from breaching those terms, it will provide some ammunition if the dispute ends in litigation. There is usually no better means to avoid escalating problems than to communicate frequently with the subcontractor.

Second Tier Contractors

Sometimes the prime contractor may receive inquiries from one of its subcontractor's vendors (known as second tier subcontractors). While the prime may have more options

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than subcontractors they are still essentially in the same position and need to follow the guidance in FAR 32.112, Payment of Subcontractors. When it comes to money, things don't tend to get better with age so there is a need to act quickly before the party's next call is to the client, bank, congressman, news media, etc. The prime should gather enough information to have a reasoned discussion with the first subcontractor but do not take sides or give the second tier subcontractor reason to have unrealistic expectations. There are things that can minimize the effect of second-tier subcontractors not being paid:

1. Have the first-tier subcontractor provide payment bonds. Under the Miller Act, a payment bond will provide protection in the event a subcontractor does not pay their subcontractors, employees or certain vendors. While the Miller Act applies to government-prime relationships, the prime can require its subcontractors to provide payment bonds anytime – the principles are the same. Though payment bonds are required on fixed price construction projects, clients will often be happy to pay for bonds of second-tier subcontractors on cost type prime contracts of any scope due to the benefits of decreased project risk.

2. Run a pre-award credit check. Dun and Bradstreet and other sources will provide invaluable information about a subcontractor's current financial status and payment history so eliminating non-responsible subcontractors can preempt future payment problems.

3. Require interim releases and payment certifications. These documents should accompany all invoices submitted by the first tier subcontractor and they should certify that all vendor, employees and subcontractors have been paid or will be paid. Though a prime cannot prevent false certifications, such documents should limit potential liability.

4. Have a dispute outlet for subcontractors before a situation escalates.

Finally, prime contractors should not pay second-tier subcontractors. In certain circumstances a subcontractor will ask for an assignment of debt and this is acceptable with proper legal review or an agency like the Labor Department or the IRS may direct the contractor to garnish or withhold payments. But direct payments to a second tier subcontractor can put contractors in jeopardy of paying twice – if the first tier-subcontractor files for bankruptcy the prime will be at risk for any "offset" receivable.

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