GCA Digest

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Knowing your cost principles and cost accounting standards…

CAS 403

(*Editor's Note. Like many of the cost accounting standards, CAS 403 is applicable to contractors whose contracts are covered by CAS as well as those who are not. We have used numerous texts as the basis for our discussion, most notably Mathew Bender's Accounting for Government Contracts, Cost Accounting Standards. The section of "Practical Considerations" is based solely on our own consulting experiences working with government contractors where our conclusions are our own.*)

Cost Accounting Standard 403 is the first standard we have examined that deals with the issue of allocating specific costs to contracts. The standard sets criteria for allocating an organization's home office expenses to business segments. The basic philosophy of CAS 403 is that there is not an amorphous mass of costs that needs to be allocated to segments in one particular way. Rather there are many different kinds of home office expenses that are caused by particular segments in different ways and so they should be allocated to the segments appropriately. As a result, the purpose of the standard is to establish criteria which ensure the allocation of an organization's home office expenses is "to the maximum extent possible" allocated to receiving segments properly – what the standard refers to as there being a "beneficial or causal relationship" between the costs being allocated and the receiving segment.

CAS 403 applies to allocating home office expenses to segments. There is no mention of how those costs, once assigned to a segment should, in turn, be allocated to cost objectives. Those issues are addressed by other standards (e.g. CAS 410, allocating G&A expenses, CAS 418, allocating direct and indirect costs, CAS 420, allocating IR&D/B&P costs).

A Few Definitions

First, a few words about definitions would be helpful. "Home office" is defined as "office responsible for directing or managing two or more, but not necessarily all, segments of an organization." The home office typically establishes policy and provides guidance to the segments in their organization and usually performs management, supervisory, administrative and/or service functions for the segments. It is important to realize there may be multiple "home offices." A home office is not just what is considered "corporate headquarters" or "corporate offices" but may also be intermediate levels such as a group. Consequently, such an intermediate group may be both a segment receiving expenses from a higher level home office as well as a home office in itself.

"Segment" is defined as "two or more divisions, product departments, plants or other subdivisions of an organization reporting directly to a home office." It is usually identified with responsibility for profit and/or producing a product or service line. The term can also include a Government-owned contractor-operated (GOCO) facility, joint ventures and subsidiaries (both domestic and foreign) where the organization has a majority ownership or if ownership is in the 20 to 50 percent range then it is considered a segment if the home office exercises "significant guidance or control."

Though the standard refers to "homogeneity", when referring to homogeneous cost pools, it does not define it. Bender refers to the May 1992 Statement of Objectives, Policies and Concepts that defines homogeneity as meaning "the costs of functions allocated by a single base having the same or similar relationship to the cost objectives for which the functions are performed and that the grouping of such costs in homogeneous pools for allocation to benefited cost objectives results in a better identification of costs with cost objectives." Such a rather nebulous definition of this essential criteria for adequate pooling of costs provides great flexibility for contractor actions but also a broad basis to challenge contractor choices if the government believes the choice is not advantageous.

Basic Requirements

The standard describes three broad categories of home office expenses and how they should be assigned to the segments in descending order of preference:

(1) Expenses incurred for specific segments that can be directly assigned to the segments. Direct assignment of costs to specific segments is considered the preferred method and such direct allocation should be made "to the maximum extent possible."

(2) Expenses though not incurred for a particular segment have clear relationships to two or more segments that are "measurable with reasonable objectivity." These costs are to be grouped into logical and homogeneous pools to be allocated to segments on the basis of beneficial and causal relationships.

(3) Everything else where those expenses have no clear measurable relationship to the segments. These so-called residual expenses are to be allocated to all segments.

♦ Direct Allocation

The CAS Board (CASB) believed that ideally each cost should be allocated to the cost objective (i.e. contract, subcontract, task or delivery order) that was intended to benefit from or caused a cost to be incurred. In the case of home office expenses, this ideal could best be accomplished by direct assignment of home office costs to specific segments to the maximum extent possible.

♦ Nondirect allocation

Those home office expenses not directly allocable to two or more segments but where an "objective measurable relationship" exists should be grouped into logical homogeneous expense pools and allocated on a basis reflecting the relationship of the expenses to the benefiting segment. Most of the standard addresses these types of costs.

The standard does not state how many grouping should be established nor how those groupings of costs should be allocated to segments but it does provide quite specific guidelines. The standard states "the number of grouping will depend primarily on the variety and significance of service and management functions performed by a particular home office" and as a rule "each service or management function will have to be separately identified for allocation by means of an appropriate allocation technique." Several categories of groupings are common:

1. *Centralized service functions.* They are considered to be functions performed by the home office that if it did not exist would be performed or acquired by some or all of the segments individually. In the case of these types of functions the CASB felt the need to provide definitive criteria for allocating these pools of costs to segments by including a hierarchy of allocation methods. In descending order of preference these were:

a. Measure of activity (resource consumption). In this case, a single unit of measure can represent the consumption of resources used in performing the activities represented by the pool of costs. The standard states it is common for supporting functions to be labor oriented, machine oriented or space oriented and hence the costs of the functions can be allocated as a rate per labor hour, rate per machine hour or cost per square foot.

b. Output measure. When the measure of activity (resource consumption) is not available or is impractical to ascertain, the standard's next preference is to use "a measurement of the output of the supporting function." In this case output becomes a substitute measure for the use of resources. For example, the labor spent in a printing center may not be a good measure of the cost of service provided so number of printed pages may be best, purchasing orders processed may be good for the purchasing department or number of hires for the employment office.

c. Surrogate for consumption. When neither activity (resource consumption) nor output can be practically measured, a surrogate may be used to allocate the centralized service function. To identify a surrogate you look at the central services being allocated to the segment and then look for something related that can be used as a reasonable surrogate. For example, a reasonable surrogate for personnel services may be number of personnel in the segment, labor hours or dollars incurred by the segment receiving the service.

The standard provides examples of various centralized services functions and illustrative allocation bases: centralized personnel administration (headcount, labor hours, payroll), data processing (machine time, number of reports), purchasing and subcontracting (number of purchase orders, number of items purchased), centralized warehousing (square footage, value of material, volume of material), central telephone service (usage costs, number of instruments) and company aircraft (actual or standard rate per hour, mile, passenger mile).

2. *Staff management activities.* These include centralized management or policy guidance over certain functions that may be performed for all or some segments. Examples of such staff management activities and

illustrative allocation bases include personnel management (headcount, labor hours, payroll, number of hires), manufacturing policies that may include quality control, industrial engineering, production, scheduling, tooling, inspection and testing (manufacturing cost input, manufacturing direct labor), engineering policies (total engineering costs, engineering direct labor, number of drawings), purchasing policies (number of POs, value of purchases) and marketing policies (sales, segment marketing costs).

3. *Line management.* These include management or supervision of one or a group of segments as a whole. Line management expenses may commonly apply only to some segments and the allocation of these costs to the relevant segments should be based on that segment's "total activity." Total activity is not defined but other standards suggest it be measured by a cost input base.

4. *Central payments.* The standard defines this as payments or accruals which if there were not two or more segments would be paid by individual segments. Consistent with the two preferred methods, CAS states such central payments may be allocated directly to segments or indirectly to segments on a base "representative of the factors on which total payment is based." However, the standard provides greater flexibility by permitting a contractor to opt for allocating costs using a logical pool of costs allocated on an appropriate base even if costs could be directly assigned to segments. Examples of central payments and illustrative allocation bases include: pension or group insurance expenses (payroll or other factor on which total payment is based) and state and local income taxes and franchise taxes (measured by the same factors used to determine taxable income for that jurisdiction).

♦ Residual Expenses

Residual expenses - the remaining expenses after using the direct and nondirect method to allocate home office costs – are those for managing the organization as a whole that have no measurable relationship to segments. Examples listed by CAS 403 include the chief executive, the chief financial officer and any staff not identifiable with specific activities of segments. Residual expenses are allocated to all segments of the home office which include both foreign and domestic subsidiaries. It is not uncommon for contractors to negotiate an agreement as to how the allocation is to be made to them.

There are three methods of allocating these costs:

a. Three factor formula. If the dollar threshold requirements are met, residual expenses must use the following formula: arithmetic average of (i) percentage of the segment's payroll dollars to the total payroll dollars of all segments (ii) percentage of the segments operating revenue to total revenue of all segments and (iii) percentage of the average net book value of the sum of the segment's tangible capital assets plus inventories to the total of all segments.

The thresholds are as follows: 3.35 percent of the first $100 million; 0.95 percent of the next $200 million; 0.30 percent of the next $2.7 billion; 0.20 percent of all amounts over $3 billion. The threshold amount applies to the contractor's previous fiscal year and must be net of unallowable costs (as determined by DCAA) as well as any IR&D or B&P costs that might be allocated on the same base as the residual expenses. So, in effect, if the residual pool is $3,350,000 or more, the three factor formula must be used. If it is less, the three factor formula may still be used as a measurement of "total activity." Interestingly, these percentages were established in the early 1970's and have not been adjusted for inflation since.

b. Total activity. If the amount of residual expenses does not meet the threshold amounts, the base used to allocate them to business segments must be one "representing total activity" (which is basically the same base that would apply to non-CAS covered contracts). We have seen numerous examples of such total activity bases such as total cost input, cost of sales, head count or even combinations of certain bases. We have even seen "sales" accepted as an adequate base but keep in mind such a base usually raises a red flag with auditors and the burden would fall on the contractor to demonstrate the sales base does represent total cost activity and does not result in a significant difference from more established methods. It should also be noted that the total activity measurement selected need not be consistent with the "cost input" base used to allocate a segment's G&A Costs (covered by CAS 410).

c. Special allocation. The standard provides for use of a special allocation of residual expenses "where a particular segment receives significantly more or less benefit from the residual expenses that would be reflected" using one of the two methods discussed above. The standard provides some guidance as to when such a special allocation might apply: for example, if a segment, unlike others, performs on its

own many of the functions represented by the residual expenses or if a comparatively large segment receives little or no costs using one of the other methods. When a special allocation is needed then the special allocation amount is removed from the residual expense pool and the base data (e.g. cost input) is also excluded from the base used to allocate the remaining amount of residual expenses.

Practical Considerations

1. Resist the tendency to create many pools and especially many bases to allocate costs to various segments. Though the guidance indicates multiple pools and bases are preferable because they tend to result in more precise cost assignments, such practices commonly create more problems than the added precision gained. First, pooling costs and especially identifying the base elements used to allocate them require administrative effort, sometimes considerable effort. Second, if it turns out the basis is not accurate (e.g. number of pages produced, computer time, square footage, etc.) you are vulnerable to assertions your methods for allocating costs are not accurate which can (and frequently does) call into question the adequacy of your accounting system. However, be prepared to show how a less precise method would not result in a materially different allocation.

2. Surrogate measurements for allocating centralized service functions are very common. Though very specific ways of allocating multiple cost pools can be devised, it is quite common to use very few bases (e.g. head count and square footage). For example, rather than use number of computers, purchase orders and vendors to allocate IT, contracts and accounting cost centers, respectively, use of head count is frequently used and commonly accepted, especially when it can be demonstrated that the one method is logical and more precise methods yield similar results.

3. Pooling most and even all home office costs into a residual pool is common. Though the standard indicates that pooling corporate expenses into a residual pool is the least preferable method, keep it mind it is also the most prevalent method. That is, it is very common for companies to pool either the majority or even all corporate expenses into a residual pool. If you choose to do so, you may need to defend your decision to auditors. For example, you may want to claim a total activity basis is the most appropriate basis to allocate those costs or demonstrate a different method yields similar results without having to complicate the practice.

4. Conduct a sensitivity analysis for determining the best method of allocating residual pool costs. For allocating residual expenses, if the mandatory 3-factor formula threshold is not met, it's a good idea to consider various methods to see which one yields the most favorable result. Three factor formula, cost of sales, total costs of business segments are all commonly accepted bases and a sensitivity analysis could determine which method produces the most favorable results.

5. Special allocations are time consuming to finalize. Though it may be necessary to use a special allocation to produce an acceptable result, keep in mind that approval of special allocations can be difficult and time consuming to obtain because approval from various levels of DCAA and administrative contracting offices must often be secured. Such delays can adversely delay pricing actions needing quick resolution.

ORGANIZATIONAL CONFLICT OF INTEREST AND TOOLS TO MITIGATE IT

(*Editor's Note. Though we have either worked or consulted for large companies in the past where organizational conflict of interests were frequent concerns needing to be addressed, we are seeing more and more smaller companies being faced with potential harm of loosing business due to real, potential or even perceived conflicts of interest. The issue is certainly becoming more prevalent due to the high number of mergers, acquisitions and consolidations not to mention increased use of teaming arrangements and the tendency for the government to outsource more and more services. The problems are increasing rapidly because of non-uniform policies at various agencies as well as uneven levels of experience and training by contracting representatives. In response to requests to address this issue we have found it has become more widely discussed in the literature. We used a fairly new text, Government Contract Awards, edited by Steven Feldman for insights into the basics of the rules and review of recent decisions and an article by Diane Whitmoyer, VP of Contracts at BAE System in the June 2006 issue of Contract Management for some excellent practical methods of mitigating organizational conflicts of interest that correspond to our experience in helping firms find appropriate tools to minimize potential allegations of conflict. We recommend distributing this article to project managers and personnel involved in preparing proposals so potential conflict can be identified and minimized quickly.*)

The rules are pretty simple. FAR Subpart 9.5 requires contracting officers to avoid, neutralize or mitigate potentially significant (not remote or insubstantial) organizational conflicts of interest during acquisition (which can include conflicts with consultants.) Both the FAR Subpart 9.5 and relevant cases point to three broad categories of situations where organizational conflict of interest (OCI) may arise:

1. Unequal access to information. This may occur when a firm has access to nonpublic information as part of its performance of a government contract and that information is not available to all competitors in later competition for another government contract.

2. Biased ground rules. This situation may occur where in some sense the firm has set the ground rules for one contract when performing another.

3. Impaired objectivity. The concern here is of the firm not providing the government with impartial advice because of its relationship with the firm who is being evaluated.

Though not an inclusive list, an OCI is most likely to occur in contracts involving management support services, consultant or other professional services, contractor performance of or assistance in technical evaluations or systems engineering and technical direct work performed by a contractor not having overall contractual responsibility for development or production. The regulations focus on four circumstances that most commonly create OCIs:

1. When a contractor provides system engineering and technical direction but does not have overall responsibility for its development, integration, assembly or production then it is prohibited from competing for a contract to supply that system as either a prime or subcontractor

2. When the contractor prepares specifications or work statements it generally may not compete for contract awards for that requirement. However there are notable exceptions. First, for specification of development items the OCI rules do not apply to either (a) contractor's furnishing specs or data at the government's request for products they provide or (b) situations where the contractors are acting as industry representatives provided their assistance is supervised and controlled by the government. Even for contractors whom the exceptions do not apply, a contractor may both assist in preparing work statements and compete for that work if they are a sole source provider, participated in the development and design work or was one of multiple contractors who prepared the work statement.

3. The contractor that provides evaluation services to the government cannot evaluate their own proposals or those from their market competitors without proper safeguards to ensure objectivity to protect the government's interests.

4. When the contractor obtains access to proprietary information and can use that as leverage to compete that is considered to be an unfair competitive advantage unless certain restrictions are imposed.

An OCI can apply to prime contractors, subcontractors, suppliers or consultants. An OCI must be distinguished from circumstances where the firm merely has other contracts with the procuring agency or where an individual employee changes companies and supplies proprietary information concerning his old firm. If an issue arises during an acquisition concerning a potential OCI the CO's decision must be formally documented.

The contracting agency has responsibility for determining whether an actual or apparent COI exists. The CO is tasked with identifying potential OCI as early in the acquisition process as possible so necessary steps can be taken to "avoid, mitigate or neutralize" the OCI. If an OCI cannot be avoided or at least mitigated then contract award will be withheld. The CO is required to notify the contractor before taking this later action to give reasons for the proposed withholding and to allow a reasonable opportunity to respond. (However, court decisions have held that a failure to give a contractor this opportunity does not affect an otherwise valid determination.) Potential offerors need to know up front about possible OCI because such a conflict will affect its business decisions should a mitigation plan not be accepted. For example, the company may decide not to merge or acquire a company or go through the expense of preparing a proposal. Or, for example, a company may decide not to bid on less profitable initial work and instead focus on long-term more profitable implementation phases.

Recent Cases on OCI

A review of numerous cases of OCI indicates some general principles.

1. The GAO will not overrule the agency's determination of OCI absent clear unreasonableness.

2. Even where no actual OCI exits several cases have supported an agency in taking corrective actions (e.g. rejecting a proposal) if the agency reasonably concludes that an appearance of OCI is present. However other cases have ruled that unless the agency has a clearly supportable reason for excluding a prospective offeror because of an OCI, the firm cannot be excluded on the mere basis of a potential or theoretical OCI.

3. A protester that alleges an agency erred in its OCI determination must affirmatively prove its case. In addition, when a protester alleges the agency improperly made the award to a firm with an OCI the protesting firm must further demonstrate prejudice e.g. it was next in line for the award.

4. When a protester alleges an OCI because the firm had obtained disclosure of confidential information the GAO will examine the reasonableness of the agency's decision to withhold a recipient from competition in light of such factors as (a) whether the disclosure was inadvertent and (b) the likely effect that exclusion would have on the degree of competition.

Mitigating OCI

We have used both Ms. Mitover's and our own experience to put forth several techniques that can be used to prepare mitigation plans.

1. *Disclosure of relevant information.* Though they vary widely, most goverment agencies have generally increased requirements to disclose all information relative to OCI determinations. This increased discussion requirement implies that companies need to have systems in place to be able to screen both new work and new solicitations against existing contracts that might conflict. The larger the company the more complex the system should be.

2. *Firewalls.* The written agreement between conflicted entities relies on a combination of procedures and physical security to establish "firewalls" to avoid potential, real or perceived, OCI from affecting either party. Organizational separation in an OCI plan should be at a level low enough in the contractor's organization to not deprive the government of valuable products and services merely because they are included in a business unit that performs work that may potentially be OCI.

3. *Confidentiality agreements.* Employees should execute special confidentiality agreements that prevent any person not working on the contract from acquiring information or influence of the work. Inquiries should go through high ranking corporate officials, employees should receive training and harsh penalties for non-compliance should exist.

4. *Separation of personnel.* Eliminating communication between personnel from conflicted organizations can eliminate potential of bias. Of course, potential for bias can exist merely because an organizational relationship exists.

5. *Separate company.* A new company, for example what is often called a "proxy company," can be created with a separate board of directors. Certain forms of divestiture can be considered but only when other means of resolving OCI are unsuccessful.

6. *Removal of conflict.* Sometimes staff members have supported a particular government program or agency for most of their careers and the program could experience dire consequences if they were removed. In these cases the affected individuals might be hired by another, non-conflicted entity to perform the same work. Alternatively, the offeror may be allowed to propose exclusion or revision of those parts of the statement of work that causes a conflict. For example, if the purpose of a contract is to test products produced by a sister unit, then one possible mitigation would be to have only the conflicted company perform the actual tests while another entity (even the government) could perform the analysis and evaluation of the tests.

7. *Work-switch.* Depending on where the conflict is, work may be shifted between the prime and subcontractor. Or when the prime is simply passing through work to the subcontractor and is providing little or no added value then it may be possible for the government to provide needed oversight rather than prime contractor.

DISPUTE ON DIRECT VERSUS INDIRECT CHARGING: A CASE STUDY

(Editor's Note. The following represents an edited position paper we prepared for a client in response to a DCAA assertion that certain consulting and in-house costs related to a certain law suit should not be included in its G&A pool but should rather be charged directly to the individual commercial project that generated the need for the costs. Some of the arguments we put forward are similar to a position paper we presented years ago

addressing legal expenses but we thought it would be worth risking repetition because similar disputes on direct versus indirect charging of different types of expenses occur all the time.

Background

The contractor is a mid-sized architecture firm that works on commercial, local/state agencies and federal government contracts and subcontracts. Because of the high cost of insurance the contractor did not insure itself against third party law suits alleging professional negligence and hence had to incur the defense-related costs to fight the suits. These law suits are common in the industry and typically occur years after architect plans are complete and the structure is built where some third party might be injured and their lawyers sue everyone involved in the project. DCAA reviewed both timesheets and consulting invoices and identified costs of in-house labor and consultants who were involved in providing technical help against the third party lawsuit. The lawsuit in question happened to be related to a commercial contract of the firm that was completed several years before the questioned costs were incurred. Like most of its non-direct labor and consulting costs not incurred for a direct project, the contractor charges these costs indirectly in the period they are incurred. The contractor does not have a disclosure statement because none of its contracts are CAS covered but it does have written government accounting policies and procedures where criteria for charging direct and indirect charges are addressed and the manner of charging many (but not all) expenses are discussed.

DCAA Position

In its draft audit report and subsequent discussions DCAA did not assert the legal costs are *unallowable*. Neither the in-house effort nor consulting activities met any of the FAR cost principles prohibitions against the types of costs in dispute and all requirements for allowable consulting costs were present (e.g. consulting agreement, clear work product, need for the outside expertise, etc.). Rather DCAA's position is these costs are not *allocable* to government contracts because (1) the expenses are related to a specific contract and hence they should be charged directly to the contract that caused the lawsuit or (2) in any case, they should not be charged to the government. In defending their position, DCAA cited the following regulations and court case:

1. FAR 31.203(a). Indirect costs. This section defines an indirect cost as a cost not directly identified with a single final cost objective (e.g. contract) but rather with two or more cost objectives. Since the costs in question should be charged to the commercial contract related to the lawsuit, they cannot be charged indirect.

2. FAR 31.201-4, Determining allocability. This section identifies three conditions for a cost to be allocable to a government contract: (a) incurred specifically for the contract (b) benefits both the contract and other work and can be allocated on a reasonable proportion basis and (c) necessary for the overall operation of the business. DCAA asserts neither the second or third condition applies, and hence the cost should be a direct cost of the commercial contract that gave rise to the lawsuit.

3. *FMC Corp Northern Ordnance Division (FMC Corp), ASBCA No. 30130.* This FMC case is put forth as support for DCAA's position since it rules that supporting costs of litigation in a specific contract were attributable solely to that contract and not to the contractor's G&A pool. (*Editor's note. We have seen DCAA cite this case several times in similar disputes – it is apparently a favorite of theirs.*)

Response

Our client and I met with DCAA several times and we responded in writing that the disputed costs were properly charged to the indirect cost pool and hence should be allocated to all contracts including federal cost type contracts and subcontracts. The reasons put forth are as follows:

1. *Consistent with established practices and written policies and practices.* Since the contractor has always charged costs related to third party lawsuits as indirect, it has an established practice. In addition, the contractor's written policies and procedures identify specific costs that are considered direct (e.g. labor, materials, rental equipment) and the type of costs in dispute (e.g. indirect labor, consulting costs not used for a direct on-going job) are not included in this category. Though "consulting" costs are not specially identified as indirect costs, "professional services" are one of the categories identified as indirect and the type of effort in support of the lawsuit certainly qualifies.

2. *Consistent with the contractor's own definitions of direct versus direct cost.* Though it is possible, with enough time and effort to identify any cost with a final cost objective, the contractor, like most others, recognizes such precision is not worth the effort. Instead, it limits direct charges to those costs that "add value" while charging remaining costs indirect. Hence, consulting

and in-house labor are direct costs only when the costs are in direct support of contract performance.

3. *Contractor's practice is consistent with CAS 418.* Though not CAS covered, CAS standards are instructive because they explicitly address the issue in question here – appropriate allocation of costs to government contracts. To ensure the contractor's decisions are reasonable CAS 418 establishes two criteria: (1) the classification of whether a cost is direct or indirect must be made "pursuant to a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied" and (2) a cost is either direct, which is defined as any cost identified to a particular final cost objective, or it is indirect. The contractor is provided extensive flexibility in determining how to treat a cost and is instructed to make their decision applying the above definition reasonably and in a written statement of policies and procedures. The contractor's written procedures distinguishing direct versus indirect costs and its prior consistent practices certainly meet the requirements of this standard.

4. *Disputed costs are immaterial.* CAS 418 allows immaterial direct costs to be charged indirectly. In the Preamble to CAS 418, a contractor should be required to make an accounting change only if the result has a "materially different cost impact on a government contract." In all years, the costs in question represent an immaterial amount of the total indirect costs (less than 2 percent) and hence there would be an immaterial impact on the government contracts

5. *Case law provides it is reasonable to charge the disputed costs indirectly when incurred after physical performance.* Our client does not argue the disputed costs *must* be charged indirect but only that it is *reasonable* to do so, which meets the criteria of CAS 418. There are several cases that hold essentially similar costs in dispute that are incurred after physical performance have no direct bearing on either performance or administration of the contract and thereby are indirect costs. In *Singer Corp.*, the court ruled the professional fees incurred for the submission of a request for equitable adjustment (REA) after performance of a contract did not have a "sufficient nexus to the successful completion of the contract" to be allowed as a direct contract cost (*The Singer Company, Lobrascope Div. V. United States. 568 F. 2d*). In *Gulf Contracting*, professional fees expended for preparing an REA that were directly charged to the contract were ruled unallowable costs to the contract because only costs "related to performance or administration of an ongoing contract" can be considered direct and that expenses incurred after completion "bear no relation to performance or administration" (*Gulf Contracting Inc., & Hughes Masonry Co., Inc. v United States*).

6. *The FMC case is not relevant.* In the case DCAA cited for its position, the court ruled FMC should charge costs direct to a subcontract when that subcontract was still open and FMC's disclosure statement stated professional services "are charged direct when specifically related to a contract task." In the FMC case, though the subcontract was physically complete it was still administratively open and the disclosed practices clearly stated the costs should be direct. In addition, the lawsuit itself was between the actual contracting parties intended to untangle their respective contract rights and not part of a third party lawsuit where the party had nothing to do with the original contract.

7. *The costs in question are really indirect, period costs in the year it is incurred. In Stanwick Corp., ASBCA No 18083*, the board ruled costs may never be assigned to years prior to when the cost was incurred. This is logical since even though occurrence of a prior event may give rise to the need for professional services, there is no means at the time to estimate and hence accrue the costs prior to when they were incurred. According to FASB No. 5 a cost exists either when there is a binding liability or the expenditure of cash, whichever occurs earlier. The costs in question cannot be assigned to an earlier period since it is impossible to know what the legal liability is or even if there will be one. Such "costs" in an earlier period would be unrecognizable contingencies and not costs. A cost assigned to a fiscal year may be a direct cost only if it is identifiable specifically with a final cost objective in existence during that year; in any other circumstance, it is an indirect cost.

8. *The costs in question are similar to environmental remediation costs.* Like the costs questioned here, environmental remediation costs are usually incurred long after the full performance of the contract that caused the contamination. Under DCAA's own guidance (DCAA Policy Memorandum, October 12, 1992) environmental remediation costs caused in prior years will "generally be period costs" and should be allocated to "residual G&A costs." DCAA clearly recognizes these costs to be "period" costs to be expensed in the current fiscal year and that they should be allocated indirectly because there is no specific cost objective in that year that benefits from or exclusively caused the costs.

9. *DCAA's Position Violates Consistency Requirements.* FAR 31.202 and 31.203, like their cost accounting standards counterparts at CAS 401, 402 and 418, essentially require contractors to distinguish between direct and indirect costs and once the decision is made, to treat the costs consistently. If DCAA's position is followed, the consistency principle would be violated because (1) the contractor would select a single type of cost from its indirect cost pool and reassign it in a manner inconsistent with its disclosed written policies and historical accounting practices and (2) it would require direct cost treatment of the same cost that needs to be treated indirectly for pricing purposes. The inconsistent treatment for pricing and costing purposes occurs because for proposal purposes the costs can only be treated indirectly because there is no way to accurately estimate future third party suits for a given contract. Very few if any customers would ever reimburse a contractor directly for the possibility of future third party suits so recovery would need to be limited to estimates of indirect cost making charging those costs direct in violation of the consistency requirements of FAR.

10. *Disputed costs are G&A type costs.* DCAA challenged the allocation of the questioned costs to government contracts even if it was appropriate to charge them indirectly. The questioned costs were incurred to defend the contractor from a corporate liability. Whether it is from a commercial, local or federal government contract, defense against third party suits that generated the costs benefits the company as a whole by protecting the company against potentially catastrophic damages and it is appropriate that government contracts share the burden. FAR 31.204-4(c) quoted above requires that an allowable expense that benefits the entire business should be allocated equitably to all of the business customers.

The above response was communicated to DCAA and we requested it be included in the "Contractor Comments" portion of the DCAA final report. DCAA did not reverse their position and then we asked for a meeting with the cognizant administrative officer before a final audit report was issued to discuss this and other questioned costs. We asked the ACO to review our position paper. The ACO, along with his legal and price analysts at the meeting, rejected DCAA's questioned costs. It must be said, in a spirit of cooperation, that other questioned costs were agreed to by my client in order to arrive at an overall settlement everyone could feel they benefited from.

Classic Oldie…

ENTERTAINMENT VERSUS EMPLOYEE MORALE AND WELFARE COSTS

(*Editors Note. Increasingly we are seeing not only DCAA but also state audit agencies questioning costs that are incurred for the benefit of employees as unallowable entertainment expenses. These days most of these costs are labeled as "social" and hence unallowable "entertainment" expenses. Though some "social" costs may clearly be unallowable according to the FAR, DCAA has taken the initiative to further expand certain "social" costs as unallowable entertainment even though the FAR is silent on these specific costs while other such costs are clearly related to employee morale, health and welfare purposes which are allowable. In researching this issue we remembered an article we printed several years ago addressing "Entertainment (Unallowable) Versus Employee Morale and Welfare (Allowable) Costs" and were struck at how pertinent it is today so we have recreated it here with a few modifications.*)

Are such common costs as picnics, holiday parties, Friday get-togethers, sporting team events, recreation activities, etc. allowable costs under FAR 31.205-13, Employee morale, health, welfare, food service and dormitory costs and credits or unallowable costs under FAR 31.205-14, Entertainment costs? As consultants, we frequently encounter instances of the government challenging costs as being unallowable entertainment costs that contractors believe are allowable employee morale expenses. Many times contractors have legitimate claims because the regulations are not really clear but choose not to fight auditors' conclusions because the amount is too small to press the issue either by appealing to the CO or litigation. In this article, we intend to identify those types of costs that clearly fall under one of the two categories and then identify those costs that, in our experience, are less certain and how auditors are likely to view these uncertain costs.

FAR 31.205-13, the so-called employee morale and welfare cost principle explicitly cites such costs related to improving working conditions, employee-employer relations, employee morale and employee performance as allowable. It offers several examples such as house publications or newsletters, health clinics, recreation activities, employee counseling services and food and dormitory services. FAR 31.205-14, Entertainment, provides that costs of amusement, diversion, social activities and any directly associated costs of those activities such as tickets to

shows or sports events, meals, lodging, rentals, transportation or gratuities are unallowable. The cost principle also states that costs specifically unallowable under this cost principle are not allowable under another cost principle even if it is called, for example, employee morale and examples are included such as social dining or country clubs or other organizations having the same purpose.

Both contractor and government auditors and COs have been very inconsistent in whether certain costs are allowable under the employee morale and welfare criteria or unallowable under the Entertainment principle. Courts have been asked to settle many of the questions. For example, *Cotton & Co.* (DOE BCA No. 426-6-89) ruled certain challenged expenses allowable such as (1) a $100 gift certificate to an employee hosting a company picnic (2) three birthday luncheons (3) luncheon and dinner parties with key personnel for career counseling and (4) occasional Friday afternoon pizza parties. Effective October 1, 1995, the government amended the FAR to explicitly state that unallowable entertainment costs cannot be deemed allowable under another cost principle. In addition, gifts were made explicitly unallowable unless they are part of compensation or part of an established plan to recognize employee achievement and recreation expenses were made unallowable with the explicit exceptions of costs of employee participation in company sponsored sports teams or employee organization to improve company loyalty, team work or physical fitness.

The Defense Contract Audit Agency has interpreted the rather broad 1995 changes to make numerous costs unallowable. Even when court decisions issued before 1995 allowed many activities (e.g. picnics), DCAA interprets the 1995 changes as making such events as picnics, holiday dinners and retirement parties unallowable. Unless such events are designed to improve employee loyalty, morale or fitness they will be questioned. Though auditors are now generally consistent in their views about allowability of the above events, their guidance stresses that such costs should be reviewed for reasonableness and materiality. In our experience, many auditors will not question such costs if they are not "material" while other auditors will attempt to identify such events and question the amount no matter how significant the dollar expenditures are. Though several commentators have taken issue with DCAA's more aggressive position since 1995, the low dollar amount of questioned costs makes expensive challenges doubtful for now.

AWARD FEES

(Editor's Note. There has been a flurry of recent legislation proposals in response to numerous media reports criticizing payment of award fees to contractors for substandard work. A recent commentary in the Nov. 15 issue of Government Contractor written by David Gallagher of the Sheppard, Mullen Richter and Hampton law firm highlights the developments of this "hot" issue.)

Historically, a contractor could count on getting the award or incentive fees on cost type contracts that it had bargained for. So long as it had met certain minimum requirements spelled out in the contract and in negotiated award fee agreements, it could earn a certain amount from the available fee pool. However, new legislation threatens to undermine this practice. Now the new Congress has sent a message that states the government will no longer pay award fees for merely satisfactory performance. Rather award fees will be reserved for circumstances in which the contractor "truly deserves it" and when the contract requirements are clearly exceeded. The author believes such a policy is "two-faced: potentially allowing the government to underperform on its contractual promises while requiring a defense contractor to overperform to earn an award fee."

Recently the Defense Department and Industry have come under fire from numerous sources criticizing the use of award or incentive fees for merely "satisfactory" or substandard performance. In December 2005, the GAO issued a report stating that paying award fees for "acceptable, average, expected, good or satisfactory" performance was "undermining the effectiveness of fees as a motivational tool" and was a "waste of taxpayer funds." GAO was critical of DOD payment fees when total program costs or schedules had slipped past the baseline. GAO stated that rather than focusing on acquisition outcomes such as delivering fielded capability with established cost or schedule baselines, DOD placed emphasis on less important things like responsiveness of contractor management to feedback from DOD, quality of contractor proposals or timeliness of contract data requests. Consequently, GAO recommended that DOD tie fees in new award and incentive fee contracts to acquisition outcomes.

DOD largely agreed with GAO's recommendation but also took the position that it is fair to pay a portion of award fee for "satisfactory" performance. In March 2006 Deputy Undersecretary of Defense James Finley issued a memo encouraging DOD to structure its new

award-fee contracts in ways that would focus the government's efforts on both meeting or exceeding cost, schedule and performance requirements as well as "achieving desired program outcomes." Finley indicated that unsatisfactory work should not be rewarded with a fee, satisfactory work should receive "some" fee while excellent performance should earn more. In testimony Undersecretary of Defense Kenneth Krief testified on April 5 that award fees should recognize exemplary performance but also serves two other purposes: (1) to give DOD access to the best resources and technologies, the department must ensure its contractors make "a reasonable return on DOD contracts" and (2) shares the risk of contract performance when there are numerous variables affecting contract performance. He also warned against tying award fees to undefined terms – if the government does not define what is "satisfactory" then it is not a good idea. Kreig's testimony was followed by GAO head David Walker who stated that continuing to award "some" fee for satisfactory performance was "indicative of DOD's resistance to change."

Congress has enacted legislation that basically ignores Krief's counsel in both the 2007 Appropriation Act and the 2007 Authorization Act that contains provisions prohibiting award-fee payments for unacceptable contract performance and leaves open the issue of whether award fees are appropriate for satisfactory performance. Section 814 of the Authorization Act required DOD to issue guidance, with detailed implementation instructions on the appropriate use of award and incentive fees. Examples of what the guidance should include are:

- Ensure new contracts using award fees are linked to acquisition outcomes which will be defined in terms of program cost, schedule and performance.
- Provide guidance on circumstances where a contractor's performance will be judged as "excellent" or "superior" and the percentage of available fee to be paid for such performance.
- Establish standards for determining the percentage of available fee, if any, to be paid for "average", "expected", "good" or "satisfactory."
- Provide direction of circumstances, if any, when award fees not earned in one period can be "rolled over" to another.

Though there is nothing inherently objectionable about these requirements – in fact most contractors would probably agree as long as award-fee conditions are spelled out in the contract – the author expresses concern over how these guidelines are implemented. He asks what does "satisfactory" mean and how far above "satisfactory" must a contractor perform to earn fee? If satisfactory means meeting expectations, then the contract must spell out carefully what they are rather than relying on arbitrary expectations of a CO. He expresses concern that though the legislation allows payment of fees for satisfactory work, it creates an opening for COs to deny awards for merely "average" work. He states that "satisfactory" is not a bad word, especially if the term is intended to reflect achieving basic contract requirements. If the legislation is misused to force contractors to perform above and beyond contract requirements, it is bad policy because it may impose unreasonable burdens on a contract when such requirements exceed levels spelled out in a contract. He fears that Congress and the public, in their fear of "greedy defense contractors bilking the public," may forget that a viable defense base must make a profit to provide a reasonable return on its assets, cover inevitable financial risk and recoup normal business expenses that may be unallowable under FAR cost principles. Otherwise there may very well be unintended consequences of having only a small roster of companies providing only satisfactory work and all other companies pursuing more profitable investment opportunities elsewhere.

CAPITAL VS OPERATING LEASES

(*Editor's Note. We have received several questions recently on whether the monthly payments contractors pay for certain assets can be written off as rental expenses or whether they must be capitalized and treated as ownership assets. In response to these inquires we thought it would be a good idea to address (1) the government accounting distinctions between rental costs and costs of ownership and (2) the financial accounting distinction between operating leases and capital leases. We have used our experience as the basis for this article.*)

Under FAR 13.205-36, rental costs are generally allowable, including those costs "under operating leases." The amount of monthly payments for the operating lease would normally be those charged by the leasor and paid by the contractor. Assets not rented or leased are owned by the contractor. Though no specific cost principle addresses treatment of these owned assets, several do address elements of the costs of these assets (e.g. depreciation, cost of money, gains and losses on disposition, maintenance and repair). Expenses related to these assets are normally referred to as "costs of ownership." These costs are normally

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allowed and typically include depreciation, taxes, facilities, repair and maintenance and cost of money (where interest costs are unallowable).

Operating leases and capital leases are concepts common in the world of financial accounting as opposed to government accounting where generally accepted accounting principles in FASB No. 13 addresses the two types of leases. There are basically two ways to account for a lease: the operating method or the capital method. An operating lease is a regular rental of property. As payments become due, rent expense is charged. The lessee normally does not report anything on its balance sheet. The lessee uses a capital lease if *one* of the following four conditions are met:

1. the lessee obtains ownership to the property at the end of the lease term.
2. a bargain purchase option exists where either the lessee can buy the property at a nominal amount or renew the lease at minimal payments.
3. the life of the lease is 75% or more of the life of the property.
4. the discounted value of minimum lease payments at inception of the lease equals or exceeds 90% of the fair market value of the property. Minimum lease payments exclude costs paid by the lessee to reimburse the leasor for its costs of maintenance, insurance and property taxes.

In most cases, operating leases are equivalent to rental costs. The government accounting rules recognize an exception if the leasor of an operating lease is "related" (e.g. officers, owner or owner's family) to the lessee in which case the allowable costs would be limited to ownership costs. Though many contractors believe a "related" party arrangement should be treated like any other operating lease when the lease costs and terms are similar to those found in the local marketplace, the government disagrees saying given the opportunity to manipulate those costs, they should be limited to costs of ownership.

Though the term "capital lease" infers a lease component, there is the presumption that the asset is owned by the lessee and the proper amount of costs to recognize for government costing purposes are the ownership costs of that asset. Payments under a capital lease may be the same as ownership costs but may also be different in which case the contractor must separately compute the ownership costs and charge only those costs to the government. Hope that clears that up.

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