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newsletter

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Executive Compensation FAR 31.205-6(p) Statutory Limit

Although the statutory limit or "cap" has been around since 1995 for DoD contracts and 1998 for all government contracts, the application of statutory cap and FAR 31.205-6(p) is anything but crystal-clear. The first interpretation is that of identifying the contractor employees to which the cap applies. Those employees include the CEO and the four other most highly compensated employees in management positions at the headquarters and each home office and segment. FAR 31.205-6(p)(2)(iii) does provide a definition of "headquarters" as the highest organizational level from which executive compensation costs are allocated to government contracts and FAR 2.101 defines a "segment", but we ultimately must turn to CAS 9904.403-30 for the definition of a home office. Similarly, employees in a "management position"

are not otherwise defined, thus leaving room for interpretation.

Although it is an unintended consequence, a very large, totally self-contained business segment will minimize their exposure to the statutory cap (five positions) in contrast to an organization with multiple home offices and business segments with five caps at each. At one point during the evolution of the statutory cap, the DoD Inspector General (IG) took note of the fact that in its analysis and interpretation the DoD-IG concluded that one such large contractor had at least 55 executives in management positions. In that case, the issue wasn't the definition of a "management position", but the fact that only the top five of the 55 were subject to the cap while 50 were not subject to the cap.

After interpreting the number of home offices and segments and management positions to which the statutory cap applies, the next interpretation is the definition of compensation within 31.205-6(p)(2)(i); "the total amount of wages,

salary, bonus, deferred compensation and employer contributions to defined contribution plans for the fiscal year, whether paid, earned or otherwise accruing, as recorded in the contractor's cost accounting records for the fiscal year". To make government contracting more interesting, this definition of compensation is not the same as the general definition of compensation in FAR 31.001, nor is it all that clear what DCAA intends with respect to reporting executive compensation on its Schedule 2 of the Supplemental Model Incurred Cost Proposal Information (referenced in FAR 42.705-1). This schedule (also identified as Schedule T in DCAA's "ICE" model) appears to be designed with respect to 31.205-6(b), the overall reasonableness criteria; however, it has been routinely misapplied to the statutory cap (total compensation as defined by FAR 31.001 is typically a larger amount than the compensation subject to the cap).

Lastly, the statutory limit is less than clear with respect to its application to fiscal

year contractors which are other than calendar year contractors. The statutory cap is published annually, the most recent having been published in the Federal Register May 21, 2009, Volume 74, Number 97, page 23893. As published, the benchmark compensation (statutory cap) is for “contractors’ fiscal year (FY) 2009 and the amount is for contractors’ fiscal year 2009 and subsequent contractor fiscal years unless and until revised by OFPP”. But the notice then adds, “The benchmark compensation amount applies to contract costs incurred after January 1, 2009” which is clear for contractors with a calendar year, but not so clear for contractors with a fiscal year ending other than December 31. For a “fiscal year contractor” the amount for the contractor’s fiscal year 2009 is not the same as the amount applied to contract cost incurred after January 1, 2009 because the amount for the contractor fiscal year would include amounts applied before January 1, 2009.

In terms of DCAA’s Contract Audit Manual (CAM), it makes no reference to the full context of the regulation, but only mentions that the benchmark for any given year is for costs incurred after January 1 of that year and for years subsequent until the cap is subsequently revised. Of more than passing interest, DCAA makes no reference to the “contractors’ fiscal year” in spite of the fact that the published rule makes two references to the “contractors’ fiscal year”. Additionally, DCAA’s CAM goes into great detail regarding blended rate calculations for 1995-1997, but nothing with respect to average or blended ceilings that would logically apply to a fiscal year (non-calendar year) contractor if a fiscal year statutory cap only applied to costs after January 1.

There is no case law which would otherwise provide an interpretation; however, there is one other source to find an answer and that is DAU’s (Defense

Acquisition University) “Ask a professor”. In mentioning this “other source”, it is with caution (see our separate article on Questions and Answers to Government Contracting Questions). In fact, Ask a professor did address this question pertaining to a contractor with a March 31, 2007 year-end (question posted August 29, 2008, in reference to the 2007 benchmark). In answering the question, the “professor” advised that “the law, the federal register and the FAR all refer to Fiscal Year; however, the Federal Register is clear that the benchmark applies to costs incurred after January 1, 2007”. According to the “professor” the maximum that this March 31, 2007 fiscal year contractor could apply is to pro-rate the statutory cap which (in this case) would apply 75% to the 2006 cap (\$546,689) and 25% to the 2007 cap (\$597,912). Hence, a blended cap not otherwise addressed anywhere in the regulations, DCAA CAM, or elsewhere.

This particular answer from the “professor” stating that the Federal Register is inconsistent with the Law and otherwise introducing the concept of a blended cap unintentionally reinforces the “Ask a professor” disclaimer (information is not official policy and cannot be construed as official policy in any way). In providing answers, one cannot simply dismiss the obvious regulatory inconsistencies and defer to the Federal Register as opposed to the Law without the absolute disclaimer which in this case should have stated that this information should not be construed as government policy or any policy for any purpose.

Questions and Answers to Procurement Questions

Noting that the preceding article was slightly critical of an answer given by “Ask a professor” led us to read additional Q&A postings at the DAU website. In fairness to DAU, the disclaimers and notices are quite obvious; nonetheless, there would

be no reason to have such a website unless its owners made a reasonable attempt to provide reasonably accurate answers. With that introduction, let’s review a few of the Q&As.

T&M Subcontracts, in this case the posted question (posted on 10/24/2008); “Can salaried employees (paid a fixed salary) record and bill their time for all hours worked on a T&M contract?” The professor’s answer was an absolute “no” based upon FAR 52.232-7(a)(5) that vouchers shall be substantiated by evidence of actual payment. Unfortunately, this answer is absolutely wrong based upon the fact that FAR 37.115, “Uncompensated Overtime”, clearly anticipates that uncompensated overtime maybe proposed on T&M contracts (although FAR 37.115 does indicate that uncompensated overtime is not encouraged).

Equally disconcerting, the “Ask a professor” has at least two additional postings for the same basic question on uncompensated overtime vis-à-vis T&M contracts and the answers are not consistent. As posted on 9/8/2009, the professor provides a much more expansive response with different regulatory references (including FAR 31.201-4 and 52.237-10) and without a simple “yes” or “no” answer. Perhaps the “non-answer” leaves the questioner on his/her own, but the professor correctly stated that the question did not provide sufficient information upon which to answer the question.

Related to a CAS question (Cost Accounting Standards) posted 2/5/2009, the question pertained to the requirement for a CAS Disclosure Statement based upon the contractors receipt of a modified CAS covered contract, value greater than \$650K and the contractor has less than \$50MM in annual government sales. In response the “professor” provided an answer (without any regulatory

reference), when in fact the “professor” should have suggested that the contractor might be well served to re-evaluate its assumption of modified CAS coverage and by referring to 9903.201-1(b)(7), which pertains to the \$7.5MM trigger contract for modified coverage. The point, modified CAS coverage does not initially apply based upon a contract value greater than \$650K; there must first be a \$7.5MM trigger contract.

We are further concerned by the professor’s answer because of recent experiences where DCAA auditor “helped” the client with defining CAS applicability. In two cases, a relatively senior DCAA auditor advised the client that you simply add-up the value of your contracts in excess of \$650K and when the aggregate exceeds \$7.5MM, you now have modified CAS coverage. Absolutely wrong because there must first be a single \$7.5MM trigger contract, but in both cases the contractor initially relied on the DCAA interpretation.

There are other “Ask a professor” questions and answers for which the answer is at best an interpretation or an opinion, some with regulatory references, others without any references. Those answers without any regulatory reference are of dubious value; those with a regulatory reference may or may not provide all applicable/relevant regulatory references. Although, “Ask a Professor” may not always provide a reliable answer, it does have some value by virtue of providing regulatory references albeit with no assurances that it has provided all relevant regulatory references.

Ultimately, “Ask a professor” is in the same league as many other internet sources; use with caution and do not assume that the information is accurate. For good reason, “Ask a professor” provides a very clear disclaimer (actually three different disclaimers, one of which is stated twice).

DCAA “In the News”

As was announced earlier this month, DCAA has a new Director and for the first time in its 44 year history, the DCAA Director is not home grown (with the exception of the very first director, all DCAA directors came from within DCAA).

The incoming director, Patrick Fitzgerald, had been the director of the United States Army Audit Agency (AAA) which is essentially an internal audit function focused upon Army internal operations and financial management, but with some coverage of acquisition and procurement. In trying to gain some “intel” on Mr. Fitzgerald, the first consideration is that his arrival will not immediately change DCAA audit operations because it will be a massive undertaking and quite likely accomplished on a piecemeal basis.

One source for gauging the eventual changes is AAA’s Strategic Plan (published on its website). Noting that DCAA has been told it needs a strategic plan (or a new strategic plan), it is logical to assume that AAA’s strategic plan will influence DCAA’s future strategic plan. The AAA Strategic Plan for 2007-2012, dated 29 September 2006, indicates that the AAA plan will be updated every two years. Based upon our count, the two year update slipped or it has not been posted. Assuming its issuance date has slipped, that one year (and counting) slippage will fit perfectly with current DCAA audit execution wherein numerous audits seem to have slipped into a state of perpetual delay.

The AAA Strategic Plan has three categories; Valued Service, Professional Workforce and Organizational Effectiveness and Efficiency which are coincidentally quite similar to DCAA’s existing Strategic Plan. In drilling down to specific goals, we believe the following have implications for crossover application to DCAA:

- Goal 1.2.1, Identify formal and additional monetary benefits in at least 20 percent of our audits and achieve a return on investment (ROI) of \$20 to \$1 (of note, DCAA’s ROI is about \$7 to \$1 and the GAO reports its ROI at about \$95 to 1).
- Goal 1.2.2, Confirm through follow-up that at least 80 percent of our recommendations fixed the problem and realized at least 75 percent of the report benefits.
- Goal 3.1.2, issue draft reports on or before the date agreed to at the 60 percent review for at least 70 percent of audits in FY07 increasing to 90 percent by 2011.
- Goal 3.1.3, complete audits within staff days agreed to at the 60 percent review for at least 70 percent of audit engagements in FY07 and for at least 90 percent by 2011.
- Goal 3.1.7, Continue to emphasize adherence to Government Auditing Standards and take prompt corrective action and follow-up on identified weaknesses.

Of the five we’ve listed (and others not listed above), the goal which should be of most interest to contractor’s subject to DCAA audits is goal 1.2.1. DCAA does have a FY2009 goal of issuing 45 percent of its audits with tangible findings (compared to 20% for AAA); however, DCAA’s ROI is embarrassing in contrast to AAA (and “beyond embarrassing” in contrast to the GAO assuming any of the ROIs were reliable/valid). Regardless of the precise accuracy of the ROIs (DCAA vs. AAA), one might expect the new DCAA director to focus on higher ROIs for DCAA. In order to achieve a higher ROI, an optimist would hope that DCAA significantly reduces its staffing (hence its cost of operations) and focus on the high risk-high payback audits. Perhaps DCAA would become more focused if it could more predictably determine which audits will be high-payback; unfortunately it

probably cannot predict high-payback audits with the exception of DCAA's Economy and Efficiency or Operations' Audits.

DCAA Operations' audits ostensibly evaluate the reasonableness of Contractor operations (FAR 31.201-3) with some of the earliest dating back to the 1970s oil embargo when energy efficiency was important not only from a cost avoidance perspective, but more so because of the scarce resources. Those 1970s audits, with at least some legitimacy and validity, have been replaced by audits which all-too frequently defy legitimacy or validity.

Recently, the media announced that DCAA had issued an audit report which concluded that the Government could save \$193MM if a contractor in Iraq would downsize its Iraq Operations at the same relative pace as the military was downsizing its forces. Unfortunately, that contractor is held to perform to its government contracts which probably aren't directly tied to the military force strength. In other words, even "if" the contractor could save \$193MM by linking its support services directly to the military forces in Iraq, the contractor doesn't have the freedom to unilaterally deliver services at less than those stated in the relevant contracts.

Based upon the Army's reaction to the DCAA audit, it is all too obvious that DCAA performed and issued this audit with little or no coordination with the Army. It is overly simplistic to link this contractor's (or any other in-theatre contractor) "should cost" budget to the changes in the military forces without first determining the contractual requirements. Further, it is disingenuous to link contractor "should cost" budgets to the military headcount when that headcount is declining while avoiding such simplistic comparisons when the military forces were increasing disproportionately faster

than the support contractors (such as during the surge in Iraq). Rest assured that a DCAA audit would never recommend that defense contractors need larger contract budgets merely to maintain pace with rapidly increasing military forces. No doubt, that would be viewed by DCAA as an over-simplification.

Other than agitating both the contractors and the contracting officers, what is DCAA's end game in issuing these operations audits? Originally, to identify potential savings such as those identified in the 1970s energy audits. Now, the objective is to issue the report in hopes that the contractor will actually begin to accelerate the reduction of its support services in which case DCAA will take credit for saving \$193MM notwithstanding the fact that in reality DCAA's audit will have had no cause and effect. If the contractor begins to accelerate the reduction of their services in Iraq or elsewhere, it will be a function of the changing scope of their contracts having nothing to do with DCAA's recommendation.

DCAA is not alone in terms of using simplistic logic to extrapolate non-causal recommendations into huge cost savings (cost reductions or cost avoidance). Whether represented by jobs saved with stimulus funds or cost avoidance (ROI) achieved by government audit and oversight agencies, the odds are that the amounts are not easily verifiable, but more than likely overstated. The "sanity check", if anyone believed that the GAO achieved a \$95 to \$1 ROI, why isn't the GAO a much larger organization covering substantially more government programs and expenditures? The answer should be obvious.

Geren v. Tecom – Federal Circuit Court Denies Petition for Re-hearing on Legal & Settlement Costs

The U.S. Court of Appeals for the Federal Circuit on October 2, 2009, denied Tecom, Inc.'s petition for reconsidering a previous May 19, 2009 decision in *Geren v. Tecom, Inc.*, which specifically held that legal fees and settlement costs resulting from an out-of-court decision with a Tecom employee should not be reimbursed by the government.

The court denied the petition, leaving in place the previous decision that the "defense and settlement costs are allowable only if the contractor can show that the plaintiff in the Title VII suit had very little likelihood of success". The court implicitly concluded that Tecom had not adequately demonstrated "very little likelihood of success" by not carrying the legal process far enough (perhaps to judicial verdict).

Tecom legal fees were incurred in addressing an employee civil suit, under Title VII of the 1964 Civil Rights Act, which alleged sexual harassment and retaliation. Tecom settled the complaint out of court without admitting any wrongdoing, thus avoiding a longer term legal process, which would have obviously resulted in incurrence of more legal expenses. Thereafter, Tecom sought to recover the legal and settlement costs from the government via charging the legal fees as indirect, and the settlement costs as direct to the government contract under which the complainant was working.

An initial ASBCA hearing found in favor of Tecom; however, after the Government appealed, the Federal Circuit overturned the ASBCA decision. The Federal Circuit reasoned that costs were unallowable by virtue of having breached a contract

provision, specifically for not being able to demonstrate compliance with flow-down contract clauses addressing Equal Opportunity requirements.

Although FAR 31.205-47 does not address civil complaints of this nature, the court chose verbiage (“very little likelihood of success”) that is almost identical to that used as a standard to gage allowability of legal fees where a Qui Tam suit (False Claims Act) was filed by a third party, and in which case the government chose not to enjoin such a suit. Moreover, the only provisions of FAR 31.205-47 which render costs expressly unallowable, or unreasonable, by virtue of consent or compromise pertain only to government initiated proceedings, or those related to the False Claims Act. And the only scenario whereby the “very little likelihood of success” criteria is applied under this FAR cost principle is a third party action under the False Claims Act, which obviously is not applicable to the Tecom case circumstances.

Nonetheless, the Tecom decision now holds government contractors to an arduous standard for demonstrating the allowability of legal costs associated with a private employment discrimination law suit. The court’s decision essentially penalizes a contractor for exercising good business judgment in utilizing a compromise settlement approach which would lessen the litigation process and reduce legal expenses.

Instead of reinforcing the use of prudent contractor judgment in settling private lawsuits, the court’s decision effectively forces contractors to carry the litigation process to a final decision with the goal of a successful judicial outcome in order to recover its legal fees, although legal costs for such civil actions are not addressed within the FAR cost principles, and therefore are not expressly unallowable.

Teknowledge Case Decision: When Are Costs Allocable to Government Contracts?

The U.S. Court of Appeals for the Federal Circuit affirmed in its November 3, 2009 judgment an earlier decision, submitted in January 2009, that Teknowledge Corporation was not entitled to reimbursement from the government of software development costs because those costs were not considered “allocable to the government, and therefore not allowable”. (Case No. 06-CV-310).

Teknowledge incurred costs for developing TekPortal software, a customer financial information system intended for use by government as well as commercial customers, and allocated these costs as indirect charges to both government and commercial contracts, with government contracts absorbing approximately 31% of those costs. The research and development costs were initially accumulated within its commercial segment overhead pool before those costs were allocated over all company contract work.

The court decided that allocability of such costs to the government did not meet the provisions of FAR 31.201-4, which state in part that costs must be assignable or chargeable to cost objectives on the basis of benefits received or other equitable relationship as direct or indirect charges, or such costs are necessary for the overall operation of the business. The January 2009 court decision states that these costs are not allowable “because the Government never purchased TekPortal, and any potential benefit to the Government is purely speculative”.

The court’s November 3 decision affirms this position with the statement, “Given that Teknowledge’s costs resulted from

work done in anticipation of acquiring government purchase orders and contracts, the Claims Court properly found that any benefit from the development of the TekPortal software to any government work would be remote and insubstantial”.

Such a conclusion was drawn because, at the time the costs were incurred and amortized, the government had not purchased the software for specific contract use, there were not any existing government contracts using the software, and future use by the government was only “speculative”. Consequently, there was no demonstrated “nexus” of the software cost to a government contract. The decision also dismissed the premise that “allocability” should consider potential future benefits to government work and to the company as a whole, and thus summarily concluded that the contractor could provide no evidence that software development costs would bring in new business or keep the company afloat—e.g., no demonstration that the costs were necessary for the overall operation of the business (FAR 31.201-4(c)).

Notwithstanding Teknowledge’s perceived weak arguments in several areas, the court’s decision raises the standard for contractors to demonstrate a direct link (nexus) between the incurrence of indirect costs, specifically independent research and development, and the benefits that such costs provide to the government. The court standard reinforces a prior decision (Boeing N. Am., Inc. v. Roche) whereby a test of allocability is a clear beneficial relationship of a cost and the government.

Moreover, the court’s decision reinforces that “allocability” does not exist for indirect costs incurred in a current cost accounting period where the future benefits of those costs to government customers cannot readily be measured prospectively (“speculative”). One must

then consider whether other costs that are incurred and allocated to government contracts in a given fiscal year should be considered non-allocable. The benefits to the government of bid and proposal, independent research and development, selling and marketing, market planning, and directly associated costs are often not measurable until long after those costs are incurred in prior accounting periods. And in many cases, no specific benefit accrues to the government for selling and B&P costs when no sales or awards result from these selling efforts.

Finally, the decision places more pressure on government contractors to be cautious regarding the allocation of costs associated entirely, or partially, with non-government products, projects, or other endeavors. Given the government's continued fixation that a "nexus" between a cost and a government contract must be readily transparent, any indirect cost, whether necessary for business operations or not, that is incurred in part for commercial work could be rendered as non allocable.

Whitehouse Issues More Guidance to Procurement Heads on Acquisition Reform

In a October 27, 2009 Whitehouse news release, the Office of Management and Budget (OMB) notified the general public that new acquisition reform guidance has been issued to senior procurement executives, specifically targeting improving the acquisition workforce capability and capacity, and better structuring contracts to maximize results.

Two separate memorandums were issued, one covering each of these subjects, and both are a continuation of

previously issued guidance with a goal of saving \$40 billion annually through acquisition reform. The guidance for better structuring contracts specifically addresses steps for avoiding high-risk contracts and improving competition among government contractors, with emphasis on increasing fixed price and reducing cost reimbursable contract awards.

The memo issued for improving the civilian agency acquisition workforce includes a recommendation to hire at least 5% more acquisition personnel to meet the demands related to increases in contract spending and complexity. In supporting the need for additional and more highly qualified government procurement personnel, the memo points to a disproportionate growth in qualified contracts specialists during FYs 2000 and 2008 (24%) when compared to the growth in acquisition dollars for the same period (56%).

This guidance memo focuses on several areas regarding workforce capability, to include improving workforce training & development, management infrastructure, effective use of interns, and an annual workforce planning process.

The memo related to better structuring contracts takes aim at avoiding non-competitive contracts and discouraging use of sole-source and flexibly priced contracts. The memo addresses three "key questions", as follows:

1. Maximize effective use of competition and select the right contract type

Principal highlights include focus toward clear solicitation requirements and collaborative efforts in enhancing interest of more companies to bid on acquisitions. Other efforts toward

gaining a broader interest of companies to bid on government opportunities would include the use of strategic sourcing, extending consideration for small business awards, and using performance based acquisitions. As to choosing the "best contract type", the guidance verbiage is direct: avoid cost reimbursable contracts when possible and shift toward FFP contract types.

2. Mitigate risk when noncompetitive, cost reimbursement, time and materials, and labor hour contracts are used

Acquisition personnel should consider limiting length of contracts, improving price reasonableness analysis techniques, and ensuring accurate contract monitoring is in place. Proposed actions regarding use of flexibly-priced contracts include maintaining adequate oversight of contractor accounting system and cost controls; link payment to performance on CPAF contracts, and; use FFP contract types for commercial items.

3. Create opportunities to move to more competitive or lower risk contracts

Procurement agencies should maintain an active dialogue with leading contractor sources regarding best practices for encouraging more companies in bidding on competitive solicitations. Also discussed is the use of contract review boards, peer reviews, or contract type advocates for making it easier to award lower risk contracts, and; award of contracts that provide agencies options in selecting contract types, to include those with "hybrid" contract arrangement terms.

The complete text of both memorandums can be found within the internet website, www.whitehouse.gov/omb/news_10272009_contracting_guidance/



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December 8-9 – Las Vegas, NV

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Beason & Nalley, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Sandra Baker at sbaker@beasonnalley.com, or at 800-416-1946.

Reader Inputs for Future Newsletters

Beason & Nalley, Inc. develops its topics based upon recent regulations, information, publicly accessible Government policies and our experience in assisting clients with regulatory compliance. However, we are also interested in the ongoing compliance experiences of our readers; hence, we invite your input in terms of suggestions for topics based upon your compliance experiences. Suggested topics along with any background information (i.e., your experience) should be sent to lmiller@beasonnalley.com.

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