

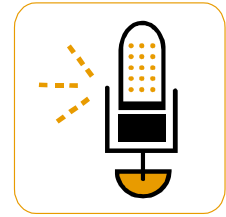
Pacific Northwest Consultants, LLC

Special Interest Articles

Contract Terminations. See Page 2.

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Statistical Sampling to Identify Unallowable Costs

FAR 31.201-6, Accounting for Unallowable Costs, was revised effective October 31, 2005 to specifically allow contractors to use statistical sampling as a method of identifying and segregating unallowable costs.

This is great news for many contractors, said one industry observer, especially those medium to large firms with thousands of transactions every month. It should achieve tangible savings in the cost assurance processes now in

use by those firms while maintaining a high degree of confidence that unallowable costs do not end up on billings to the Government.

Where statistical sampling is used, FAR requires that the sample be unbiased, that it represent the universe, that large dollar and high risk transactions be separately reviewed and that the process permits audit verification.

FAR also provides sound advice, recommending

that the sampling process be the subject of an advance agreement with the administrative contracting officer because without an advance agreement, the burden of proof is on the contractor to establish that its methods meet the aforementioned criteria.

We can help you develop a plan and obtain an advance agreement. Contact Terry Nuzzo at 206-508-1849 or e-mail Nuzzo@pacificnwc.com

Internal Controls and Small Companies

A fundamental step to any audit, be it the annual financial statement audit or a review by a Governmental agency is to assess a company's system of internal controls. This assessment is part of an overall risk assessment and will influence the amount of transaction testing that auditor will need to perform in order to render an opinion.

Generally speaking, there is an inverse relationship between the adequacy of

the internal controls and the amount of testing that needs to be performed.

Often times, the internal controls at very small companies are non-existent or ineffective. This is not surprising nor of paramount concern to an auditor. It basically means that the risks of say, unallowable cost charged to the Government, is higher than if there were adequate controls over identifying and segregating unallowable costs.

The auditor will compensate for the lack of internal controls by examining more items.

Having stated that, there is one system that DCAA is unyielding when it comes to implementing adequate internal controls – labor charging when companies have flexibly priced (e.g. cost plus fixed fee) contracts. No amount of transaction testing can validate the accuracy of a labor charge made months or years earlier.

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"... When a contract is terminated, a contractor is entitled to all the reasonable costs of the terminated work, termination costs, settlement expenses, and a reasonable profit."

For More Information:

For additional details on Terminations please see Terry Nuzzo's article on our website at <http://www.pacificnwc.com/article0001.htm>

Terminated Contracts

The Government has the right to terminate a contract for its own convenience or for default. This article focuses on terminations for convenience. We will discuss terminations for default in a future newsletter.

The Government's right to terminate a contract is provided for in a standard contract clause that allows it to terminate work in whole or in part.

When a contract is terminated, a contractor is entitled to all the reasonable costs of the terminated work, termination costs, settlement expenses, and a reasonable profit. On a fixed price contract, the total, exclusive of settlement expenses, cannot exceed the total contract price. If the contract was in a "loss" position, the projected loss will be reflected in the final settlement.

Cost type contracts, on the other hand, are not subject to settlement limits or loss ratios. However, cost type contracts can be constrained by the limitation of loss and the limitation of funds clauses.

For more information, contact Terry Nuzzo at nuzzo@pacificnwc.com.

Allowable Termination Costs

FAR 31.205-42 includes eight types of allowable termination costs.

a. Common items. Items purchased for the contract but cannot be reasonably used on other work.

b. Cost continuing after termination. Costs that cannot be immediately discontinued upon the effective date of the termination are allowable so long as they are not attributable to the

negligent or willful failure of the contractor to stop work.

c. Initial costs. Costs spent on preparation and startup costs that haven't been fully amortized.

d. Loss of useful value. These costs are usually associated with special tooling and test equipment.

e. Rental costs. Contractor must mitigate them and period cannot exceed the

initial period of performance.

f. Alterations of leased property. Cost to restore leases to original condition if required.

g. Settlement expenses. These include accounting, legal, and clerical costs for the preparation and presentation of the settlement proposal.

h. Subcontractor claims. Subs must follow prime rules

Settling a Termination Claim

Normally, prime contractors have a year to submit their settlement claims to the government. This includes claims submitted by any subcontractors. Extensions are usually available.

After the TCO (Termination Contracting Officer

receives the proposal, he will need to develop a negotiation objective and most likely request an audit of the claim. Historically, audit risk areas include (i) the use of the correct form (termination basis vs. total cost basis); (ii) contractor efforts to mitigate costs; (iii)

costs continuing after termination; (iv) settlement expenses; and (v) potential for loss contract.

The process is lengthy and your chances of "fast-tracking" the settlement is slim. Take time to ensure that you get all the costs that you're entitled to,

SBA's 8(a) Business Development Program

The SBA's 8(a) business development (BD) program was created to help small disadvantaged businesses compete in the American economy and access the federal procurement market.

To qualify for the program, the firm must be a small business, unconditionally owned and controlled by one or more socially and economically disadvantaged individuals having good character and US citizenship, and must demonstrate a potential for success. See www.sba.gov/8abd for details of these criteria.

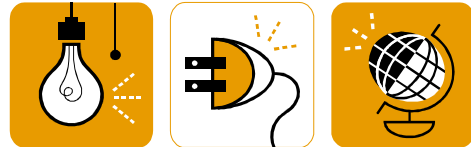
Once qualified, companies can get a wide range of support from the SBA including sole-source contracts up to \$3 million (\$5 million for manufacturing).

Companies wanting to apply to the 8(a) program do not need to pay PNWC or any other consultant to prepare its application. SBA designed the forms (either paper or online) to make that process easy and

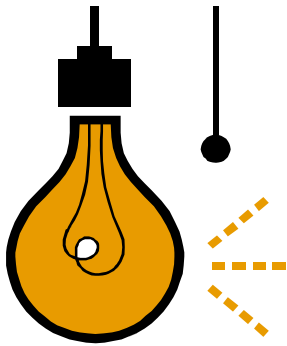
representatives are available to provide whatever assistance might be needed.

While most of the qualifying factors are objective, the SBA exercises a good deal of judgment in assessing whether the firm has demonstrated a potential for success. The SBA will consider (i) technical and managerial experience, (ii) the firm's operating history (two years is preferred), (iii) ability to access credit and capita, (iv) financial capability, (v) record of performance, and (vi) requisite licenses.

Once the application is complete, a final decision regarding eligibility takes place within 90 days.



The Pre-Award Survey



FAR requires contracting officers to make affirmative determinations of contractors' responsibility prior to contract award.

Awards based on price alone would be false economy if there were subsequent defaults, late deliveries or unsatisfactory performance.

To be determined "responsible", a contractor (or subcontractor) must (i) have adequate financial resources to perform the contract or the ability to obtain them, (ii) be able to comply with the required or proposed delivery or

performance schedule, (iii) have a satisfactory performance record, (iv) have a satisfactory record of integrity and business ethics, (v) have the necessary organization, experience, accounting and operational controls, and technical skills, (vi) have the necessary equipment and facilities, and (vii) be otherwise qualified and eligible to receive an award.

If the contracting officer does not have sufficient information on-hand to make a determination of responsibility, he will conduct or request a Preaward Survey. Standard Forms 1404 through 1408 help guide the Government through the Preaward Survey process

(visit our Website to see copies of these forms). Government auditors are typically requested to provide information on financial capability, credit needs, and the suitability of the accounting system for the particular type of contract contemplated.

Since contractors must be considered "responsible" as a condition to obtaining a contract, the Preaward Survey process should be taken seriously and any potentially negative or adverse issues should be resolved straightway.

For tips on preparing for a Preaward Survey, visit our website at www.PacificNWC.com.

Uncompensated Overtime



The Fair Labor Standards Act requires employers to compensate hourly workers for hours worked in excess of 40 hours per week but does not require employers to pay overtime to salaried employees.

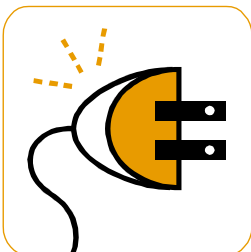
Because most accounting systems account for labor based on a 40 hour week, the hours worked in excess of the 40 hours is referred to as uncompensated overtime.

In some contracting situations such as those requiring professional or technical services acquired on the basis of the number of hours to be provided, FAR 52-237-10, Identification of Uncompensated Overtime, requires companies to have accounting procedures that account for uncompensated overtime and to provide those procedures to the government.

In other cases, CAS 418, Accounting for Direct and Indirect Costs, and FAR 31.201-4, Determining Allocability, will influence whether accounting systems should be modified in order to accurately account for uncompensated overtime.

Either way, if your firm has significant uncompensated overtime, you need to assess the risk of labor mischarging.

....as the Government sees it.



This area has often become contentious. Under some conditions, there can be a serious risk of mischarging costs to Government contracts. Obviously, if employees or management can pick and choose which final cost objectives benefit from uncompensated overtime, the risk that mischarging can occur increases.

For example, suppose an exempt employee works 5

hours on a fixed price contract and 5 hours on a cost-type contract. Since he is compensated for only 8 hours, he could charge 5 hours to the cost-type contract and 3 hours to the fixed price contract. The Government views this as a risk and would recommend system revisions to distribute the paid hours proportionately to the time actually spent.

Companies that refuse to

adopt uncompensated overtime policies, often find themselves with added auditor presence. The auditors will determine whether uncompensated overtime is significant. If so, guidance tells them to issue reports citing noncompliance with CAS 418 and FAR 31.201-4.

The key is to accurately assess the risks and ensure that auditors understand your point of view.

Accounting Methods for Uncompensated Overtime

You don't have to redesign your accounting system to record uncompensated overtime. Accounting may be accomplished by a variety of methods as;

a. Computing a separate average labor rate for each labor period, based

on salary paid divided by the total hours worked during the period and distributing the salary cost to all cost objectives worked on during the period based on this rate.

b. Determining a pro rata allocation of total hours

worked during the period and distributing salary cost on the pro rata allocation.

c. Computing an estimated hourly rate for each employee for the entire year based on the total hours the employee is expected to work during

the year and distributing salary costs to all cost objectives worked on at the estimated hourly rate. Variances could be charged to overhead.

Contact Paul Cederwall at Cederwall@pacificnwc.com for more information.

Advance Agreements Help Avoid Misunderstandings and Costly Audits

When it comes to determining allowability of costs under Government contracts, the cost principles at FAR Part 31 are not always specific or precise enough for a particular situation. That's because the principles were written broadly to cover many accounting systems in varying contract situations.

To avoid possible subsequent disallowance or dispute based on unreasonableness, unallocability or unallowability under specific cost principles, FAR encourages contractors

and contracting officers to seek advance agreement on the treatment of special or unusual costs (FAR 31.109(a)).

An advance agreement, of course, is not going to make an unallowable cost become allowable. The contracting officer is not authorized to agree to a treatment of costs that is inconsistent with the cost principles.

A major advantage of having advance agreements for both the contractor and the government is quicker negotiations and

settlements. Sensitive, unusual, or contentious cost issues that might bog down a forward pricing negotiation or finalizing indirect rates, have already been resolved.

Make certain that your advance agreements are easily understood by third parties. We've seen some so poorly written to be unintelligible.

Make certain that all relevant information is included. Don't rely on memories or other documentation.

Cancel agreements that are no longer needed.



...a major advantage ... is quicker negotiations and settlements.

Advance Agreement Examples

Our lead article discussing the new FAR provision that allows contractors to use statistical sampling to identify and segregate unallowable costs is a case where FAR specifically recommends the use of an advance agreement.

Other coverage is not so direct however FAR lists some examples for which advance agreements may be particularly important. In most cases, the issues deal with "reasonableness" of costs, not allowability or allocability issues.

1. Compensation, especially allowances for off-

site pay, incentive pay, location allowances, hardship pay, and cost of living adjustments.

2. Use charges for fully depreciated assets.
3. Deferred maintenance costs.
4. Precontract costs.
5. Travel and relocation, especially related to special or mass movements.
6. Cost of idle

facilities or idle capacity.

7. Professional services
8. Public relations and advertising
9. Training and education.

For a complete listing, refer to FAR 31.109(h).

Sometimes you need to "sell" the idea to your contracting officer. The process for the ACO can sometimes be cumbersome and the cost/benefit to them may not be obvious.

"Sometimes you need to "sell" the idea to your contracting officer."



"...quick access to
...contracting laws and
pending legislation,
current and proposed
regulations ..."

Smart Stops on the Web

Where in Federal Contracting?

www.wifcon.com

Wifcon serves the federal acquisition community by providing quick access to acquisition and assistance information such as contracting laws and pending legislation, current and proposed regulations, guidance, courts and boards of contract

appeals, bid protest decisions, contracting newsletters, selected analysis of federal acquisition issues, and more.

It claims to be independent and not affiliated with any government or private organization. It is updated each week-day (excluding holidays).

This site contains a huge amount of content but it is well organized and relatively easy to find what you need. By scanning the "what's new" page, you can keep you up-to-date on current events affecting the contracting community.

Wifcon also contains an impressive array of links to other websites (600+ links).

Interesting Software

PNWC does not endorse or recommend products. However, from time to time, we come across software, that may provide value to our clients.

IndirectRates.com is a web-based application to help Government Contractors easily calculate their indirect rates and obtain indirect reporting information for both internal management and

government review and audit purposes.

IndirectRates.com also offers a desktop version with the same functionality.

Users of QuickBooks, Peachtree, MYOB, and Simply Accounting can use their current accounting system data to produce indirect reports.

This program is definitely for small contractors with a

limited number of indirect rates and pools. Additionally, it requires that you don't stray too far from the default chart of accounts produced by the accounting software.

If you can live with these limitations, this program should save a lot of time and provide management with current rate information. See it at www.IndirectRates.com

Need Training?

PNWC provides specialized training in a variety of government contracting areas. Our standard training modules generally take 3 to 4 hours while our extended training modules are designed for two days. Both qualify for CPE. PNWC's training modules include:

Truth in Negotiations (TINA)

FAR Allowable Costs

Billing Systems

Labor Systems (includes Timekeeping)

Estimating Systems

Ethics for Government Contractors

Terminations and Claims (coming soon)

PNWC can modify any of these packages or develop additional training modules to fit your specific needs.

Please contact training@pacificnwc.com



TINA – What Data must be Submitted

This is the second article in our series on TINA. In the last issue we discussed the characteristics of cost or pricing data.

Fundamentally, all reasonably available current, complete, and accurate cost or pricing data must be disclosed to the Government. However, the term "reasonably available" can sometimes be very subjective. It often depends on the accounting and estimating systems, and closing and cutoff dates.

If cost or pricing data were known to someone (reasonably high) in the company, the data falls into the reasonably available category. Its not necessary that the negotiator didn't know about it – the contractor is responsible for having an estimating system that ensures all cost or pricing

data gets to the negotiating table.

"Submission" of cost or pricing data should be viewed as a continuous process. It starts when you submit a proposal and continues through the date of agreement on price (or an earlier agreed-to cut-off date.

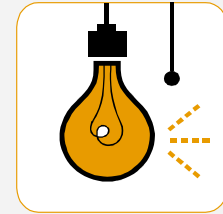
Cost or pricing data must be submitted to the contracting officer or a designated representative who is substantially involved in the proposal evaluation or negotiation (e.g. DCAA).

The Government must be clearly advised or have knowledge of the cost or pricing data. Merely making books and records available to the Government does not suffice. It must be made in such a way that the Government is on equal footing with the contractor.

Contractors required to submit cost or pricing data must also obtain cost or pricing data from their subcontractors if over \$550 thousand. In addition, if the subcontract exceeds \$10 million or 10% of the prime, the subcontractor cost or pricing data must be submitted along with the prime data.

The chances are very good that the cost or pricing data will be audited by a Government Agency, depending on the customer. In addition, the pricing action could be audited after award, depending on various risk factors (to be discussed in subsequent issues).

For a more in-depth look at this area, please see the article posted on our website at <http://www.pacificnwc.com/article0002.htm>



...all reasonably available current, complete, and accurate cost or pricing data must be disclosed to the Government.

Don't Wait Until the Auditors Ask For It

Most companies have systems and processes to collect and organize cost and supporting data for financial reporting and other representations.

Why is it then that we often scramble around to find support for the "auditors?"

FAR is very specific on the kinds of support necessary for certain costs.

Professional fees require agreements, detailed

invoices, and work product.

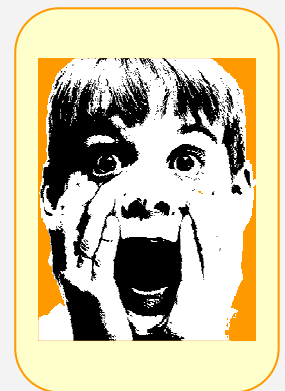
Travel requires date, place, purpose, and names.

Losses on a cafeteria require documentation to show "unusual circumstances" to be allowable.

Lost discounts require documentation to show it was not the fault of the contractor.

Some companies, to save time, effort and costs, forgo the documentation requirements hoping to develop or find the support when and if the auditors ask.

This could be more costly in the long run. Records get misplaced, people leave, memories fail and the ability to create or recreate data that will support the cost can fall short of satisfying FAR requirements.



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Bill Vermie and Terry Nuzzo holding their plastic fish on Washington's Skykomish River.

Pacific Northwest Consultants, LLC

PNWC is dedicated to providing Government contract consulting, litigation support, and training services. We provide affordable consulting and training services to help Government contractors grow their business, increase profits, and comply with

Government contracting rules and regulations.

PNWC's consulting and training services include forward pricing, incurred cost, terminations and equitable adjustments, cost accounting standards and defective pricing allegations. We assist in developing

adequate internal control systems and company-wide ethics programs.

PNWC staff has extensive teaching experience. They have developed and presented training classes covering all aspects of Government contracting.

Meet our Staff

Terry S. Nuzzo, CPA is a part-time instructor in Financial and Managerial Accounting at Highline Community College. He graduated from Myers College in 1974 and his professional career includes

the Boeing Company, Alaska Airlines, and 32 years for the Defense Contract Audit Agency.

With DCAA, Terry specialized in highly complex operations,

defective pricing, termination, and equitable adjustment audits.

In addition, Terry developed and delivered training classes for DCAA.

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We're on the Web!
See us at:
www.pacificnwc.com