

Pacific Northwest Consultants, LLC

## Special Interest Articles

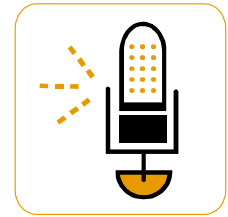
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## Evaluating Your Cost Structure

It is critical for companies to continuously evaluate all aspects of the business organization in order to maintain their competitive edge. This would include an evaluation of the direct/indirect cost structure and comparisons on how it stacks up against cost trends in your industry.

A growing trend in Government contracting is the development of service centers or shared services. By taking traditional G&A type functions like human resources, security, and payroll and allocating it over a different base, such as headcount, a company

can effectively move costs from the G&A pool to overhead thereby lowering the G&A rate.

Why is lowering the G&A rate desirable, important, or necessary? Because in many situations, the G&A rate really matters. It could affect your profit. For example, some DoD profit guidelines do not allow profit on G&A but do allow profit on overhead. Perception is sometimes important. Even though bottom line costs may be the same, in a competitive situation, a company with the lower G&A rate might prevail. Thirdly, if the base for G&A is total cost input, it's more

palatable to mark up travel and subcontracts with a 15% G&A rate than with a 30% rate.

Contractors have considerable discretion in deciding how costs should be allocated to contracts. So long as direct costs are assigned and indirect costs are allocated on an equitable basis, the Government will not object to the allocation methodology.

A word of caution however, evaluations of cost structures must also consider the impact on your existing contract backlog and your forward pricing rate structure.

## Incurred Cost Proposals due Soon

For Government contractors with cost reimbursable contracts and fiscal years ending December 31<sup>st</sup>, the June 30<sup>th</sup> deadline for submitting annual incurred cost proposals will be here before you know it. DCAA has developed "ICE" (Incurred Cost Electronically), an Excel version of the Model Incurred Cost Proposal found in Chapter 6 of DCAA Pamphlet 7641.90. This electronic tool and the DCAA pamphlet can be downloaded from DCAA at <http://www.dcaa.mil>.

ICE provides contractors with a standard submission package to assist them in preparing adequate incurred proposals in accor-

dance with FAR 52.216-7, "Allowable Cost and Payment". Contractors who have not used the model previously, are encouraged to contact their local DCAA office. DCAA will not prepare the claim but can offer some limited assistance in using the model. In addition, many DCAA offices provide free training from time to time in setting up and using the ICE model.

Our staff has extensive experience in working with ICE and can assist you in preparing and supporting an adequate claim. We can help ensure that all allowable, allocable, and reasonable costs are con-

sidered and can help avoid pitfalls caused by inadvertently including unallowable costs in your submission to the government.

Timely submission of your annual incurred cost proposal is not only critical to the annual settlement of your incurred costs on flexibly-priced contracts, but is also a high priority with DCAA and the Contracting Officers. DCAA has initiatives to settle many of these incurred cost claims within 12 months and to promote electronic, rather than paper, submissions.

Contact Paul Cederwall at [Cederwall@pacificnwc.com](mailto:Cederwall@pacificnwc.com) for more information.



Many Cost Accounting Standards have been incorporated into the Federal Acquisition Regulations.

## Cost Accounting Standards

In our past two newsletters, we discussed various aspects of CAS. We discussed the thresholds for coverage (exempt, modified and full coverage) and the standards applicable to modified coverage; 401, 402, 405, and 406. Previous newsletters are available for downloading from our website. Beginning with this issue and extending for the next few issues, we will discuss the CAS standards

that are applicable to fully covered CAS contracts.

Some CAS standards or parts of standards have been incorporated into the FAR. Take the four standards discussed below; 404, 409, 414, and 417. CAS 414 and 417 have been fully incorporated into FAR 31.205-10, Cost of Money.

Under the Depreciation cost principle, FAR 31.205-11, contractor with con-

tracts subject to CAS 404 and 409 can elect to adopt the standards for all other contracts.

Companies should not be concerned over the prospect of becoming CAS covered. CAS simply builds on GAAP (Generally Accepted Accounting Practices) which already serve as the basis for the accounting systems used by Government contractors.

### CAS 404 and 409 – Capitalization and Depreciation

CAS 404 – Capitalization of Tangible Assets. The standard requires contractors to maintain written capitalization policies that include minimum service life criterion that does not exceed two years (but may be shorter), minimum acquisition cost that does not exceed \$5 thousand (but may be smaller), the identification of "asset accountability unit, and establishment of minimum dollar amounts for the capitalization of original complements of low cost equipment and for betterments and improvements.

Acquisition cost includes the purchase price and all costs necessary to prepare the asset for use including initial inspection and testing, installation, and similar expenses.

CAS 409 – Depreciation of Tangible Capital Assets. This standard provides criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and for allocating such costs in cost objectives within such periods in an objective and consistent manner. The depreciable cost of a tangible asset shall be its capitalized

cost less its estimated residual value. The estimated service life will be used to determine the cost accounting periods to which depreciation will be assigned. The estimated service life must reasonably approximate the actual period of usefulness and must be based on recorded past experiences if possible. The standard requires contractors to maintain adequate records to determine past service lives. The method of depreciation selected must reflect the pattern of consumption over the life of the asset.

### CAS 414 and 417 – Cost of Money

CAS 414 – Cost of Money as an Element of the Cost of Facilities Capital. This standard recognizes the cost of facilities capital as a contract cost and provides criteria for measuring and allocating an appropriate share of these imputed costs to contracts using those facilities. The calculation involves determining the average net book value of facilities for each indirect expense pool,

multiplying that by the cost of money rate established by the Secretary of the Treasury, and dividing the product by the corresponding allocation base. The base must be compatible with the bases used for applying indirect costs. Contractors must maintain adequate records to support net book values. Normally, contractors must use the CASB-CMF Form to compute

the costs.

CAS 417 – Cost of Money as an Element of the Cost of Capital Assets Under Construction. This standard applies the same principles discussed in CAS 414 to a contractor's investment in capital assets being constructed, fabricated, or developed for a contractor's own use.

## Random Musings

More than half of government contractors reported that their revenues increased in 2006 over the prior year according to the 12<sup>th</sup> Annual Grant Thornton Government Contracting Survey. The survey also noted that management and support headcount decreased from 16.2 to 13.8 percent of total headcount, overhead rates continued the downward trend from prior years while rates for fringe and G&A held steady, revenue from cost-reimbursable contracts increased sharply and executive compensation remains the most frequent cost challenged by government auditors. Go to [www.govinfo.bz/6777-100](http://www.govinfo.bz/6777-100) to download the highlights brochure.

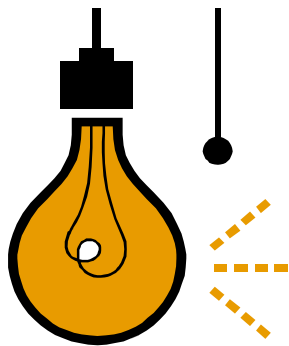
The cost of money rate to be used in computing the cost of money factors as determined by the Secretary of the Treasury is 5.25% for January – June 2007.

DoD issued a final rule on March 27, 2006 requiring contractors to submit payment requests in electronic form while establishing a few exceptions (Case 2005-D009)

The Defense Department has developed a competence modeling tool for 26,000 people to help gauge the capabilities of its acquisition workforce and determine what areas need strengthening or realignment. Hope they solicit input from customers.

The Federal Funding Accountability and Transparency Act of 2006 requires the existence and operation of a searchable website that provides public access to information about Federal expenditures. The FFATA specifically requires that a pilot program be established to test the collection and accession of subcontract award data. As a result, subcontracts awarded and funded with Federal appropriated funds will be disclosed to the public in a single searchable website. This will undoubtedly require additional effort from prime contractors.

The Office of Federal Procurement Policy (OFPP) set the 2007 cap amount for compensation at \$597,912. Amounts in excess of this will not be reimbursed by the Government.



## Professional and Consulting Costs

The Government continues to treat Professional and Consulting costs a high risk area for audit oversight. Their focus is to determine whether contractors are maintaining adequate supporting data to demonstrate the purpose and reasonableness of professional fees and that such fees do not contravene laws or regulations.

In evaluating the contractors internal controls over consulting costs, the auditor will review purchasing department specifications for purchased services, the independence of the purchasing department to the organization receiving the services, written policies

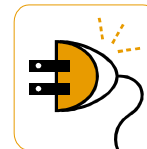
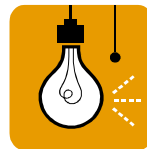
explaining prohibited activities by purchasing agents, complete history files for purchased services, procedures requiring competitive acquisitions of consulting services, and whether consultants are used to engage in unlawful lobbying activities.

Typically, the following forms of documentation will be requested for each consultant cost being audited; consulting agreement, consultant's work products and billings, correspondence between consultants and the contractor, travel vouchers and trip reports, internal audit reports providing coverage in the particular area, any other documents which

provide evidence of the nature and scope of the services furnished and the reasonableness of the amounts charged, and access to the vendor listings and IRS Forms 1099s.

Of special concern will be those types of agreements where scopes are broadly defined. These sometimes include lobbying and political activities, broadly targeted advertising, and organizational expenses – all generally unallowable under various FAR cost principles.

Contractors should, at a minimum, ensure that they maintain proper documentation required by FAR 31.205-33.



## Allowable Costs – Legal Fees



The U.S. District Court recently ruled on December 15, 2006 that a government contractor is not entitled to recover legal costs that it incurred in an unsuccessful defense of a citizen's suit for violating the Clean Water Act (*Southwest Marine Inc. v. United States, S.D. Cal, No. 05-CV-1189*).

The court ruled that \$3 million in legal costs are unallowable under FAR 31.204 because they are similar to those disallowed under FAR

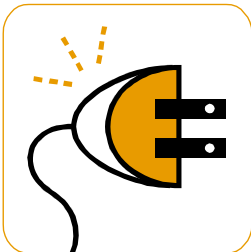
42-205-47(b)(2) making unallowable the legal costs incurred by a contractor in connection with a civil proceeding brought by a government entity for violation of law resulting in the imposition of a monetary penalty.

FAR 31.204(d) states that "Section 31.205 does not cover every element of costs. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be

based on the principles and standards in this subpart and the treatment of similar or related selected items.

The contractor argued unsuccessfully that FAR did not intend to disallow costs incurred in defending private party lawsuits in which the government had no involvement and did not finance both sides' legal costs.

## You Need Written Policies/Procedures



It is important for all companies, large and small, to have written policies and procedures that address key government regulatory requirements. Any time a government auditor comes in to assess an internal control system, such as floor checks, one of the first things requested is a copy of the documented policies and procedures covering that area. The lack of documented policies and procedures is an internal

control deficiency and could, under certain circumstances, disqualify contractors from winning a contract, hold up contract payments, or subject the company to increased oversight.

The primary procurement areas for which policies and procedures are crucial are:

- Timekeeping and labor distribution

- Job cost accounting and cost segregation
- Accounting for unallowable costs
- Indirect cost pools and bases
- Billing and Invoicing
- Compensation including incentive compensation
- Contract and subcontract administration

## Pension Protection Act of 2006 – DoD Guidance

In our October - December 2006 newsletter (available as a download from our website), we reported that the Director, Defense Procurement and Acquisition Policy (DPAP) instructed all services, pending formal guidance, to clear all requests for increased pen-

sion costs resulting from the PPA through their organization. On December 22, 2006, DPAP issued its long overdue guidance on the implementation of the PPA.

When contractor propose increases using current CAS rules, contracting officers are required to contact the

cognizant ACO and DCAA office for assistance in reviewing the costs before negotiating the contract price.

Contracting Officers cannot negotiate any increase in contract prices for forward pricing rate agreements related to a poten-

tial CAS change or include a re-opener clause addressing such costs.

The entire guidance memorandum is available on our website at [www.pacificnwc.com/paaguidance.pdf](http://www.pacificnwc.com/paaguidance.pdf).

## Financial Condition Risk Assessments

In our January – March 2006 newsletter (available as a download from our website), we discussed the reasons why a government contractor needs to have adequate financial resources to perform a contract “in the near term” and the Government’s program to continuously assess a contractor’s financial capability. Since then, we’ve received a number of inquiries as to what the Government specifically looks at in assessing a company’s financial viability.

Generally, the government performs a financial condition risk assessment each year at contractors with government sales in excess of \$1 million. For contractors with sales in excess of \$15 million, the gov-

ernment performs a “full” risk assessment every three years and a “modified” risk assessment in the intervening years. For contractors with sales between \$1 and \$15 million, the government will perform a modified risk assessment every year in conjunction with other field visits.

A “modified” risk assessment has one subjective and two objective steps. First, the auditor will ask the contractor to identify any significant events that have occurred since the last risk assessment such as sale of a division, loss of a contract, large layoff, new contract, plant expansion, etc. The auditor will make an assessment as to whether any of these events would significantly affect a contractor’s

financial status. Second, the auditor will analyze financial statement trends including profit/loss, sales, cash flows, working capital, net worth, and long term liabilities. Thirdly, the auditor will determine if a contractor is paying its payroll taxes on a timely basis.

A “full” risk assessment adds steps to review internal controls over cash management and financial planning, financial ratio trends (in addition to financial statement trends), off balance sheet arrangements, related party transactions.

Any significant negative indicators found during a risk assessment will be pursued in a “full-up” financial capability audit where the key step is analyzing a cash flow forecast.



*“... the Government performs a financial condition risk assessment each year at contractors with Government sales in excess of \$1 million.”*

## Directly Associated Unallowable Costs

The Federal Acquisition Regulations (FAR) requires that unallowable costs and directly associated costs be identified and excluded from any billing, claim, or proposal applicable to a Government contract. FAR 31.201-6 defines directly associated costs as any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

FAR also establishes a materiality criterion for directly

associated costs. It states that one needs to consider the significance of the actual dollar amount, the cumulative effect of all directly associated costs in a cost pool, and the ultimate effect on the cost of Government contracts.

In reviewing incurred cost proposals, auditors will generally perform tests to determine whether contractors have appropriately excluded directly associated unallowable costs from their incurred cost claims. Some of those tests include comparisons of voluntary deletions with prior years, analysis of voluntary deletions to determine whether the contrac-

tor has identified and excluded directly associated unallowable costs, and review of questioned costs to determine whether the contractor incurred any directly associated costs that should be questioned and removed.

Examples of directly associated unallowable costs include (i) collection fees and legal costs associated with bad debts, (ii) show or sporting event tickets, meals, transportation, lodging and gratuities related to entertainment, and (iii) travel and administrative support cost related to unallowable lobbying activities.

*When an unallowable cost is incurred, its directly associated costs are also unallowable.*



Is this a good time to buy that airline ticket or will fares drop in the near future?

## Smart Stops on the Web

### **Air Fare Predictions** <http://www.farecast.com>

This website (still in beta but available to anyone) tries to predict whether it's a good time to buy a ticket. When we inquired about a trip from Seattle to Boston to begin 15 days from then, Farecast told us to wait because the lowest fares were expected to drop by \$39 within the next 7 days.

When Farecast predicts a price, it also determines a confidence level – a measure of how accurate the result will be. Typically, the confidence levels range from 60 to 90 percent. On the Boston trip, the confidence level was estimated at 70 percent. Farecast's self-reported track record, the accuracy of past predictions, ranges from 70 to 75 percent.

This website, if used consistently, could be a useful tool for companies looking to save a few dollars. It helps take some of the guesswork out of wondering whether it's a good time to buy that ticket or to wait awhile.

Currently, Farecast has data for 75 cities, and is regularly adding more cities to its database.

## Interesting Software – eFAACT

**PNWC does not endorse or recommend products. However, from time to time, we come across software, that is worth taking a look.**

eFAACT (Electronic Federal Auditing and Contracting Tool) from Innovative Business Solutions in Glen Allen VA integrates with Quickbooks to help streamline contract administration, cost accounting and reporting. It supports the

government contract life cycle with a DCAA compliant web-based timecard system that integrates with Quickbooks payroll, produces period reports, generates Government invoices, calculates interim and final indirect rates, and prepares schedules to support the annual incurred cost submission.

It is not versatile because it works only with Quickbooks

but it is flexible in that it provides for user defined controls for contract definition, contract loading, and cost pool allocations.

The cost is \$2,800 for stand-alone version or \$275 per month for online version. On-line is good for companies without their own server.

<http://www.efaact.com/efaact/index.html>

## 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 one and two days. Our training qualifies for CPE in most states. PNWC's training modules include:

*Truth in Negotiations (TINA)*

*FAR Allowable Costs*

*Billing Systems*

*Labor Systems (includes Timekeeping)*

*Estimating Systems*

*Ethics for Government Con-*

*tractors*

*Terminations and Claims*

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

Please contact [training@pacificnwc.com](mailto:training@pacificnwc.com)



## Contractor Code of Ethics

The Civilian Agency Acquisition Council and the Defense Acquisition Regulation Council recently proposed to amend the Federal Acquisition Regulations (FAR) to address Contractor Code of Ethics and Business Conduct and the display of Federal agency Office of the Inspector General (OIG) Fraud Hotline Poster.

This proposal would amend FAR to establish a policy regarding contractor code of ethics and business conduct, responsibility to avoid improper business practices, procedures for displaying Fraud Hotline posters.

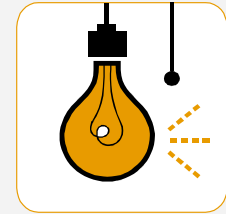
Contractors performing contracts valued in excess of \$5 million will be required to display a hotline poster in common work areas within the business segments performing the work.

Contractors performing contracts valued in excess of \$5 million and with a performance period in excess of 120 days must also have a written code of ethics and business conduct within 30 days after contract award and shall establish an employee ethics and compliance training program and an internal control system with 90 days after contract award.

The training program and control system must be suitable to the size of the company and its involvement in Government contracting. The internal control system must facilitate timely discovery and disclosure of improper conduct in connection with Government contracts and ensure corrective measures are promptly instituted and carried out.

The proposed FAR clause lists several components that must be included in the internal control system.

1. Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the Contractor's code of ethics and business conduct;
2. An internal reporting mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports
3. Internal and/or external audits;
4. Disciplinary action for improper conduct.
5. Timely reporting to Government officials and full cooperation with Government agencies for either investigation or corrective action.



*Contractors ... must have a written code of ethics and business conduct.*

## Ethics – Client Tips

Many allegations of fraud and abuse among Katrina-related procurements and Iraqi reconstruction efforts have increased the attention paid to Government contractor standards of conduct and the adequacy of policies and procedures to prevent, identify, and report potential noncompliances.

Last fall, the Justice Department launched a National Procurement Fraud Task Force to focus re-

sources at all levels of government to increase criminal enforcement in areas of procurement fraud. More than 50 inspectors general from across all government departments and agencies also are actively pursuing thousands of investigations.

In addition, newly installed Democratic committee and subcommittee chairs in Congress are launching dozens of oversight investigations of alleged contractor abuses.

This heightened sensitivity is bound to continue, regardless of whether the proposed FAR change is adopted or changed significantly in its final form.

With all this attention, every contractor should have in place, an effective compliance program that includes standards of conduct and mechanisms for investigation potential violations and for taking prompt and appropriate remedial steps if violations are found.

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*From left, Ron Sabado, Paul Cederwall, Bill Vermie, and Terry Nuzzo.*

## 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.

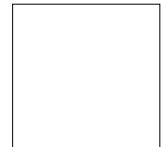
## Our Staff

Pacific Northwest Consultants, LLC was formed in January 2006 by four individuals who decided to combine their various expertise and interests into a full-service Government consulting group. Com-

bined, PNWC's consultants and trainers have over 120 years of Government contracting experience with the Defense Contract audit Agency. Two of the four are licensed CPAs in Washington State, two hold

graduate degrees and all have had teaching experience at the collegiate level.

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**We're on the Web!**  
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[www.pacificnwc.com](http://www.pacificnwc.com)