

Pacific Northwest Consultants, LLC

## Special Interest Articles

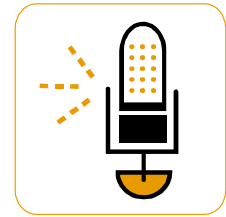
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## Equitable Estoppel

“Equitable Estoppel” is a legal doctrine that government contractors can sometimes use to prevent the Government from retroactively disallowing costs or retroactively disapproving cost accounting practices when the contractor detrimentally relied on the Government’s acquiescence or approval.

The Federal Circuit courts, the ASBCA, and other jurisdictions have consistently applied estoppel against the Government when the course of conduct or representation on which the contractor relied was by an officer or agent of the U.S.

acting within the scope of his or her authority and the contractor established four elements of estoppel: i) the Government knew the facts, ii) the Government intended that its conduct be acted upon or acted in such a way that the contractor had a right to believe the Government so intended, iii) the contractor was not aware of the true facts, and iv) the contractor detrimentally relied upon the Government’s conduct.

Typically, estoppel is applied in contractual matters where the Government is acting in its “proprietary” rather than “statutory” ca-

capacity. Therefore, a person or company cannot use estoppel to bar the government from enforcing federal law, to pay money in violation of a statute, or grant a public benefit contrary to statutory eligibility criteria.

Recent court cases have seemingly invoked a fifth criterion that contractors must establish to invoke estoppel. In addition to the traditional elements of estoppel, the contractor must also show “affirmative misconduct” on the part of the government’s agents. It is unknown whether these decisions will withstand appeals.

## Elements of a Code of Business Ethics

In our last newsletter, we discussed the proposed FAR change that will require contractors to maintain a written code of ethics, an employee ethics and compliance training program and an internal control system. The period for public comment has ended and as we perused those comments, we noted that they were overwhelmingly positive. It’s likely that it will become a final rule.

A code of ethics is an open disclosure on the way your organization operates and it provides visible guidelines for behavior. It is intended to promote ethical and law-abiding conduct within your organization and

should clearly communicate to employees what is expected of them and the consequences for violations.

Following are a few of the elements we believe are important for an effective Code of business ethics.

- Commitment by the organization’s directors and top management to abiding by the Code.
- Applicability to all levels of the organization.
- A letter from the CEO communicating the organization’s commitment to following the code.
- Standards of conduct that communicate

what issues employees should be aware of and what to do whenever confronted with any such issue

- A mechanism for employees to report suspected violations.

Standards of Conduct usually covers topics such as EEO, nondiscrimination, environmental, safety and health, drugs and alcohol, conflicts of interest (outside employment and personal financial interests) gifts and entertainment (including bribery and kickbacks, and government personnel), communications and records, antitrust policy, claims, statements and certifications.





CAS 408 requires that the cost of compensated personal absences be charged to the period earned.

## Cost Accounting Standards

In our past three 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. In the last issue, we discussed four standards that have been incorporated into FAR in whole or part: CAS 404, 409, 414, and 417 dealing with capitalization, depreciation

and facility capital cost of money.

In this issue, we are going to discuss a couple of standards that deal with employee compensation; CAS 408, Accounting for the Cost of Compensated Personal Absence and CAS 415, Accounting for the Cost of Deferred Compensation.

Like many other CAS standards, CAS 415 has been

incorporated into FAR (FAR 31.205-6(k)) so even if your company is not covered by CAS, the provisions of CAS will apply if you have deferred compensation plans.

No company should fear CAS coverage. CAS standards simply build upon GAAP (Generally Accepted Accounting Principles) which already serve as the basis for the accounting systems used by Government contractors.

### CAS 408 – Compensated Personal Absence

The purpose of CAS 408 is to improve and provide uniformity in the measurement of costs of vacation, sick leave, holiday, and other compensated personal absences in order to ensure that measured costs are allocated to the proper cost objective.

This standard requires that the costs of compensated personal absence shall be assigned to the cost accounting period or periods in which the entitlement was earned and that the costs for an entire cost accounting period

be allocated pro-rata on an annual basis among the final cost objectives of that period.

Most small companies assign the cost of compensated personal absences to the period in which the vacation or sick leave is taken. That would not comply with CAS 415. CAS 415 would require companies to estimate liabilities and set up accruals. Every entitlement plan is different and the plans would have to be evaluated to determine the proper accrual. Other factors to consider in estimating liabilities include forfeitures

when employees leave the company, use or lose rules, or payments for unused vacation.

The application of this standard is beyond the scope of this article. Some illustrations of hypothetical situations can be found in FAR 9904-408-60. However, illustrations go only so far and each company will need to assess its own situation and develop a reasonable methodology for estimating cost in the year of entitlement.

### CAS 415 – Deferred Compensation

Deferred compensation means an award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods prior to the date of the receipt of compensation by the employee. This definition specifically excludes year-end accruals of wages and bonuses that are paid with a reasonable period of time after the

end of a cost accounting period. Also, stock option plans that meet certain criteria are excluded from this standard

CAS 415 requires that the cost of deferred compensation shall be assigned to the cost accounting period in which the contractor incurs an obligation to compensate the employee. And, to really complicate things, the measurement of the amount of the

cost of deferred compensation shall be the present value of the future benefits to be paid by the contractor.

Sometimes, the terms of the award require the employee to perform future service as well. In those cases, the cost will need to be appropriately assigned to the current and future service.

## Random Musings

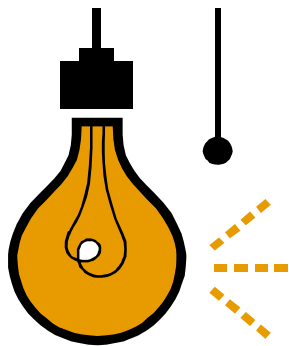
If you have Government property, you need to pay attention to FAC 2005-17. The revision implements a policy that improves the management of Government property while fostering efficiency, flexibility, innovation and creativity by adopting property practices typically used in the commercial arena while continuing to protect the Government's interest.

The prompt payment interest rate for the second half of 2007 is 5 ¾ percent.

On May 22<sup>nd</sup>, DPAP (Defense Procurement and Acquisition Policy) published its assessment of public input on systemic issues related to contract closeouts. Surprisingly, not a few comments railed at some of the initiatives designed to speed up the process, like CACWS (cumulative allowable cost worksheets) and submitting final indirect rate proposals in a timely manner. We have this report linked to our home page at [www.pacificnwc.com](http://www.pacificnwc.com).

On May 4<sup>th</sup>, the U.S. Court of Federal Claims upheld the Navy's termination for default on a contract with McDonnell Douglas and General Dynamics for the A-12 stealth attack aircraft. The contract was awarded in 1988 but terminated in 1991 because it was substantially over budget and behind schedule. After 16 years of litigation, the contractors will be required to return to the government, payments of \$1.3 billion plus interest of about \$1.3 billion.

According to statistics published by the Association of Certified Fraud Examiners, fraud is consuming 6% of all business revenues in this country or an average of \$4,500 per employee per business. Further, 80% of all frauds are committed in the absence of internal controls or when internal control measures are ignored. The average small business fraud carries a price tag of \$98,000. Here are some simple things to do. Implement user IDs and passwords and limit access to those who need it. Most accounting software has the capability to establish audit trails. Turn the feature on. Prepare meaningful budgets and periodically review actual-to-budget comparisons.

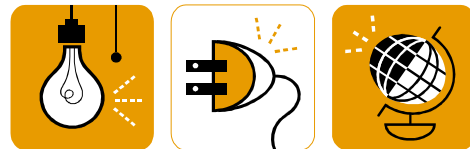


### How to Determine Whether a Cost is Reasonable

FAR 31.201-3 considers a cost to be reasonable if in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

From the Government's perspective, it is the contractor's responsibility to establish that each cost is reasonable. There is never a presumption of reasonableness.

There are four questions that you should consider as you decide if a particular



cost is reasonable.

Is the type of cost generally recognized as necessary in conducting business? The purchase and up-keep of an ocean-going yacht for exclusive use of the company president is not a necessary cost of doing business.

Is the cost consistent with sound business practice, law, and regulation, and are purchases conducted on an "arms-length" basis? To pay a premium price for materials on a Government contract while receiving a bargain price for the same materials on a commercial contract may not be consistent with sound practices.

Do your actions reflect a responsible attitude toward the Government, other customers, owners, employees, and public at large? Excessive salaries to executives and unconscionable retainers for retired executives as consultants are not acting responsibly toward owners and employees.

Are your actions consistent with established practices? If your established practice has always been to perform design work in-house but for some reason you decide to out-source it at a higher cost (and you had available capacity), it would be unreasonable to do so.

## Enhancing Competition



According to OMB, competition is the cornerstone of the Federal acquisition system. It believes that competition saves money for the taxpayer, improves contractor performance, curbs fraud, and promotes accountability for results.

In a May 31<sup>st</sup> letter to senior procurement executives, OMB expressed concern that the government was not taking full advantage of competition. It cited recent reviews by GAO and the IGs

of missed opportunities.

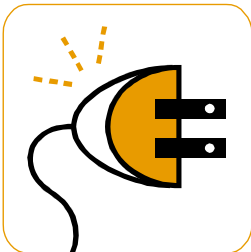
Those reviews found that inadequate planning, insufficient market research, and poor coordination among program and acquisition offices lead to ill-defined requirements, lack of head-to-head competition for task-specific solutions and pricing and the absence of meaningful performance standards to measure results.

In order to reinvigorate the use of competition in the

acquisition process, OMB is requesting every agency to self-evaluate the strength of their competition practices and to develop plans and goals for maximizing competition.

In addition, OMB is proposing changes to the FAR that will remove some obstacles to competitive procurements and make it painful for those who award contracts on some other basis.

## Excessive “Pass-Through” Charges



DoD added an interim rule to DFARS to ensure that pass-through charges on contracts or subcontract are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor.

DFARS 252.215-7004 defines an excessive pass-through charge as one that adds no or negligible value to a contract by the contractor and represents indirect cost or profit on work performed by the subcontractor.

“No or negligible value” occurs when the contractor cannot demonstrate to the contracting officer that its effort added substantive value to the contract in accomplishing the work performed under the contract. The contracting officer (CO) will make the determination whether excessive pass-through charges exist, and such charges are unallowable.

How will the CO do that? The provision requires that

offerors identify in their proposals, the percent of effort it intends to perform, and the percent expected to be performed by each subcontractor. If more than 70% is expected to be subcontracted, the offerors must also identify the amount of indirect costs and profit applicable to the work to be performed by the subcontractor and a description of the value it adds to the work performed by the subcontractor.

## What is WAWF? (Its got nothing to do with wrestling)

WAWF has got to be the most convoluted, uninspired, and unimaginative name the government has ever devised. Wide Area Workflow is simply an online tool that allows vendors to electronically submit invoices and get paid (it has some other functions as

well but billing is the main one for most contractors). Why couldn't they have named it “eBilling” or “Quickpay” or something more descriptive?

WAWF came about after a 2001 law that required all vendors doing business with DoD to use an electronic

method for submitting invoices and supporting documentation. WAWF was developed in response and in 2003, DFARS was amended to require the use of WAWF.

With WAWF, your company can submit invoices and receiving reports, get paid

in a timelier fashion, and have good visibility of the status.

Despite its name, WAWF is surprisingly easy to use. For new users, we suggest you begin with WAWF's web-based training site; <http://www.wawftraining.com>.

## When “Adequate” is the Best You Can Be

Many times during our years as Government auditors, we would sit down with contractors after finishing an audit of one or more of their internal control systems and proclaim that their system was “adequate”. “Adequate, only adequate?” they would decry. “We’ve done this and we’ve done that, we have great policies and procedures, we have superb controls with internal reviews and other checks and balances. How can you say they’re only adequate?”

We would then explain that “adequate” was as good as it gets. Under Generally Accepted Governmental Auditing Standards (GAGAS), an internal control system is declared adequate when no

significant deficiencies are found. The alternative opinion is “inadequate” or “inadequate in part” depending upon how much of the system was affected. If the deficiencies were so significant that the entire system was unreliable, the system would be declared “inadequate”.

Sometimes audits disclose conditions that do not materially affect the adequacy of the system but if corrected, would enhance the system of internal controls. These would be reported as “Suggestions to Improve the System” rather than deficiencies and would not affect the overall opinion.

Some internal control audits are required by FAR (e.g. purchasing system and esti-

imating system) while others are based on areas where the perceived risk to the Government is greatest (e.g. accounting system and labor system). Generally, contractors should not fear the internal control audit. Fundamentally, the goals and objectives for both contractors and the Government are the same. Good internal controls are fundamental to good business practices and provide the government with some assurances that its procurement dollars are well spent.

The audit programs that DCAA and other governmental audit agencies use to assess the adequacy of contractor internal controls are available on DCAA’s website, [www.dcaa.mil](http://www.dcaa.mil).



*“Adequate” is when there are no significant internal control deficiencies found.*

## Internal Control Deficiencies – What Are They?

The AICPA, GAO (GAGAS) AICPA, PCAOB, and OMB are fairly consistent in their definitions of internal control deficiencies. It is important to know these definitions and to know which ones are reportable.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, detect, or correct errors in assertions made by management on a timely basis.

A deficiency in design exists when a control necessary

to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective is not met.

A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

Generally, only significant deficiencies and material weaknesses are reportable. A significant deficiency is one that adversely affects

the entity’s ability to initiate, authorize, record, process, or report data reliably in accordance with the applicable criteria or framework such that there is more than a remote likelihood that a misstatement of the subject matter that is more than inconsequential will not be prevented or detected.

A material weakness is a significant deficiency that results in more than a remote likelihood that a material misstatement of the subject matter will not be prevented or detected.

The distinction between the two lies in the significance of the deficiency.

*A significant deficiency is one that adversely affect the entity’s ability to initiate, authorize, record, process, or report data reliably.*



*Business.gov – the official resource to help business quickly find compliance information, forms, and contacts from the government*

## Smart Stops on the Web

### **One Stop for Compliance Resources** <http://www.business.gov>

The SBA recently launched a new website that provides business with a resource that searches other Government agencies for information on taxes, immigration laws, workplace safety, environmental requirements, and other regulations that are often

challenging to small and even medium-sized businesses.

The website provides compliance information, forms, and points-of-contact. Companies can search for information by topic and/or by industry from all major federal agencies regulating or serving businesses.

The topics that are covered

in this site include advertising and marketing, business law, emergency and disaster planning, environmental compliance, finance, **government contracting**, hiring and managing employees, and many more.

The industries covered include aerospace and defense, construction and facilities, services and much more.

## Interesting Software – Adagio FX

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

If you use QuickBooks, Microsoft Small Business Accounting, or Simply Accounting and find yourself limited by the standard reports available through the software, take a look at Adagio FX by Softrak. Adagio FX is a report writer

and provides a way to create presentation quality financial statements, run comparatives by year, and produce consolidated statements.

We found it a little tedious to set up but once that was accomplished, it was relatively easy to use. Its uses a drag and drop method to quickly create financial reports but it also contains all the calculating power of

a modern spreadsheet to create just about any report you would ever need.

To find out more about Adagio FX, visit [www.softrak.com](http://www.softrak.com). You can download an evaluation copy and a .pdf of the user manual and view sample reports. The cost is \$200 for the standard version and \$95 per year after that if you want or need the updates

## 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 Contractors*

*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)



## The CAS Board is Back

After nearly a two-year hiatus, a newly reconstituted CAS board is once again functioning. The five member board is chaired by the Administrator of the Office of Federal Procurement Policy (Paul Dennett) with two other government members and two members from outside the government.

Most of their initial effort will concentrate on unfinished business from the previous CAS Board. Including;

CAS 412 and 413 and the Pension Protection Act of 2006. The Board will identify any issues between CAS 412/413 and the newly passed Pension Protection Act. The Board established a working group to develop a discussion paper by May 29th. In the meantime, DoD has advised its contracting officers to disallow any increased costs

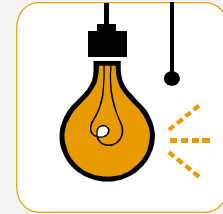
arising out of the PPA.

Computing Cost Impacts resulting from Accounting Changes. Another issue the Board is taking up has to do with computing cost impacts when there are changes in cost accounting practices. In 2005, the staff presented a paper to the Board describing the opposing views of Government and contractor representatives on the interpretation of "increased costs in the aggregate". The Board established a working group to evaluate whether any revisions or interpretations to the Board's rules and regulations are needed and to specifically consider how increased costs in the aggregate are computed when a contractor makes multiple accounting changes that take effect on the same date. The staff briefing is scheduled for the June 2007 meeting. The thorny issue here is whether accounting

changes that decrease the allocation of costs to firm fixed price contracts constitutes "increased costs to the Government."

Employee Stock Option Plans (ESOPS\_CAS does not explicitly discuss ESOPS and there has been inconsistent treatment for Government contracting purposes. Sometimes they have been treated as deferred compensation and other times like pension costs. The Board's 2003 position (as discussed in an ANPRM - Advanced Notice of Proposed Rulemaking) was to treat all ESOPs as deferred compensation.

CAS 403. The Operating Revenue Threshold at CAS 403-40(c)(2), used in determining whether a contractor must allocate residual expense using the three factor formula, has not been revised in the 33 years since the standard was promulgated.



*The CAS Board will initially concentrate on unfinished business from the previous CAS Board.*

## The Pre-award Accounting System Survey

FAR requires that contracting officers make affirmative determinations on prospective contractor's responsibility. One aspect of that determination is whether the accounting system is adequate for the type of contract contemplated. The accounting system must follow GAAP and provide for

- Proper segregation of direct costs from indirect costs.
- Identification and accumulation of direct costs by contract.
- A logical and consistent method for allocating indirect costs to

intermediate and final cost objectives.

- Accumulation of costs under general ledger control.
- A timekeeping system that identifies employees' labor by intermediate and final cost objectives.
- A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.
- Interim determination of costs charged to a contract through routine posting of books of account.
- Exclusion of costs

which are not allowable in terms of FAR 31, Contract Cost Principles and Procedures, and/or other contract provisions.

- Identification of costs by contract line item or by units, if required.
  - Segregation of preproduction costs from production costs.
  - Financial information required by contract clauses concerning limitation of cost (FAR 52.232-20 and 21) or limitation of on payments (FAR 52.216-16).
- How does your system measure up?

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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.

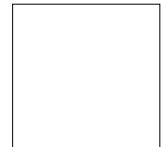
## Our Staff

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 and hold a variety of other ad-

vanced degrees and certifications. All have had teaching experience at the collegiate level.

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**We're on the Web!**  
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