

Pacific Northwest Consultants, LLC

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Determining Cost Reasonableness

This is the second of our two-part series on determining cost reasonableness.

A cost is generally considered 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 (FAR 31.201-3).

There is no presumption of reasonableness. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative (e.g. DCAA), the burden of proof shall be upon the contractor to establish that

such cost is reasonable.

Reasonable will depend upon a variety of considerations and circumstances including;

1. Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or contract performance;
2. Generally accepted sound business practices, arm's length bargaining, and Federal and state laws and regulations;
3. The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
4. Any significant deviations

from the contractor's established practices.

A determination that costs are reasonable for allowability purposes in an overall conclusion based on consideration of all the factual circumstances relating to incurrence of the costs including the amounts incurred. FAR 31.201-3 expressly refers to the "nature and amount" of the cost in assessing reasonableness. In a recent ASBCA case involving war insurance, the Board ruled that while the contractor had supported the reasonableness of the "nature" of the expenditure, it had not satisfactorily supported the reasonableness of the "amount".

Ethics and Procurement Integrity

Federal employees involved in the procurement process ascribe to a very strict code of ethical conduct. It is important for Government contractors to know what these prohibitions and limitations are in order to avoid situations that might compromise the integrity of the procurement process, place the Government employee in a potentially embarrassing situation or avoid administrative, civil or even criminal penalties.

A government employee may not work on a matter that would affect his financial interest or where his impartiality is called into question.

A Government employee may not solicit or accept gifts so you should not offer any. Exceptions include modest food and refreshments such as coffee and donuts that are not offered as part of a meal or gifts valued at \$20 or less per source or occasion not to exceed \$50 per year. Its better if you avoid gifts altogether.

Government employees may not disclose contractor bid or proposal information or source selection information before the award of a contract, so don't ask.

There are significant restrictions on employment dis-

cussions. The rules are quite broad and apply well before you and a potential employee actually negotiate specific terms and conditions of employment. There is generally a one-year ban on employing anyone who has been involved in the award of a contract.

Government employees are permanently barred from representing another person before the Government on the same matter as he worked while a Government employee.

For more information, refer to the Ethics and Procurement Integrity pamphlet issued by the U.S. Office of Government Ethics linked to our website.



CAS 411 requires contractors to accumulate and allocate according to written statements of accounting policies and procedures.

Cost Accounting Standards

This newsletter continues our coverage on Cost Accounting Standards. In past newsletters, we've discussed 10 standards. In this issue, we take on two more, CAS 407, Use of Standard Costs for Direct Material and Labor, and CAS 411, Accounting for Acquisition Cost of Material. Past newsletters are available on-line at www.pacificnwc.com.

CAS applies to negotiated

contracts over a certain threshold (currently \$650 thousand). There are certain exemptions including one for small businesses. There are two levels of coverage, modified and full. Modified coverage requires compliance with Standards 401, 402, 405, and 406. Full coverage requires compliance with all applicable standards.

Regardless of exemption or coverage, many of these

standards or in some cases the essence of the standards, have been incorporated into FAR cost principles which apply to all contractors.

As we've stated previously, there is not need for contractors to fear CAS coverage. CAS simply builds upon GAAP (Generally Accepted Accounting Principles), the basis for your existing accounting systems.

CAS 407 – Standard Costs

The purpose of CAS 407 is to provide criteria under which standard costs may be used for estimating, accumulating, and reporting direct material and labor costs and criteria relating to the establishment of standards, accumulation of standard costs, and disposition of variances from standard costs.

Contractors are not required to set up a standard costing system. It is the contractor's option. However, if they do establish a standard cost accounting system, then they

must comply with this standard. In practice, there are relatively few government contractors that use a standard costing system.

A standard cost accounting system must meet the following criteria.

- Standard costs must be entered into the books of account.
- The practices with respect to the setting and revising of standards, use of standard costs, and disposition of variances must be stated in writing and consistently followed.
- The standard costs and related variances must be appropriately accounted for at the level of the production unit. A production unit is a grouping of activities

which either uses homogeneous inputs of direct material and direct labor or yields homogeneous outputs such that the cost or statistics related to these inputs or outputs are appropriate as bases for allocating variances.

CAS 411 – Acquisition Cost of Materials

CAS 411 provides criteria for the accounting of acquisition costs of material, provides guidance on using inventory costing methods, and improves the measurement and assignment of costs to cost objectives. It requires contractors to accumulate the cost of material and allocate it to cost objectives according to written statements of accounting policies and practices.

The end use of a category of material must be identified at the time of purchase or production if the cost is to be allocated directly to a cost objective. A category of material may be allocated directly even though the company maintains an inventory of this material, as long as the cost objective was specifically identified and the cost allocated at the time of purchase or production. Similarly,

materials used solely in performing indirect functions or which are not significant elements of production costs, may be allocated to an indirect cost pool.

When allocating material from inventory, any of the common methods (FIFO, LIFO, etc.) are acceptable as long as they are consistently used.

Random Musings

DoD wants to slow down its payment cycle. It is proposing to increase the time allowed to make payments under cost-reimbursable contracts from 14 to 30 days. The proposed rule does not apply to small businesses. DoD states that the proposed change will allow DoD to better cash manage payments and is consistent with other Government agencies. The comment period ends October 1st.

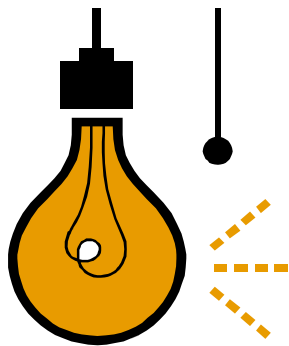
The Cost Accounting Standards Board increased the threshold for the application of CAS from \$500 thousand to \$650 thousand, the same as the threshold for compliance with the Truth in Negotiations Act (TINA). In other CAS news, the Board exempted T&M and labor-hour contracts for the acquisition of commercial items from CAS coverage.

The federal acquisition workforce increased by 4.6 percent between 1999 and 2006 while the value of the contracts awarded increased by 100 percent from \$199 million to \$400 million.

The SBA is proposing to change the way it calculates the number of employees in determining small business size status. It is proposing to calculate based on the average over the last three completed calendar years. Currently, it uses a rolling average over the preceding 12 months. The current method, according to SBA is burdensome to small businesses.

Eight Boards of Contract Appeals have now been consolidated into one, the Civilian Board of Contract Appeals. Cases from GSA, Agriculture, HUD, Interior, Labor, Transportation, and VA were transferred to the new Board. DoD and NASA still have their own Boards of Contract Appeals.

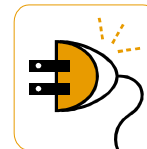
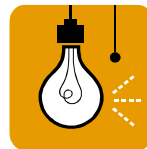
The Federal Funding Accountability and Transparency Act of 2006 requires the existence and operation of a searchable website that provides public access to information about Federal expenditures. Under a pilot program that affects contracts over \$500 million, contractors will be required to enter data on each subcontract including subcontractor name, date of award, amount, and more.



Profit on Government Contracts, Yes it is Allowed

One of the primary purposes for establishing and operating a business is to earn a profit. When conducting contract negotiations, it is important to follow the requirements of FAR 15.404-4, Profit. This FAR section works in the contractor's interest but sometimes, the government overlooks the following key paragraphs;

FAR 15.404-4(2). It is in the Government's interest to offer efficient contractors opportunities for financial rewards sufficient to stimulate contract performance,



attract the best capabilities of qualified large and small business concerns to Government contracts, and maintain a viable industrial base.

FAR 15.404-4(3). Both the Government and the contractors should be concerned with profit as a motivator of efficient and effective contract performance. Negotiations, aimed merely at reducing prices by reducing profit, without proper recognition of the function of profit, are not in the Government's interest. Negotiations of extremely low profits use of historical averages, or automatic application of predetermined percentages to total estimated costs do not

provide proper motivation for optimum contract performance.

Recently we've witnessed situations where either contractors proposed extremely low profit percentages or the Government was attempting to impose an arbitrarily low profit figure.

It is important to develop a comprehensive pricing strategy that includes a reasonable profit objective. The primary drivers will be the financial risk the company is assuming including contract performance, work statement requirements, deliverables, degree of difficulty, and contract type.

Contingencies (FAR 31.205-7)



A contingency is a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at the present time. Costs for contingencies are generally unallowable for historical costing purposes because such costing deals with costs incurred and recorded on a contractor's books. However, in some cases, as for example, terminations, a contingency factor may be recognized when it is appli-

cable to a past period to give recognition to minor unsettled factors in the interest of expediting settlement.

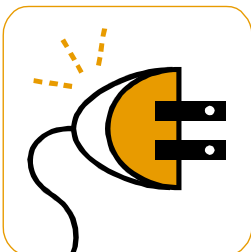
Contingencies included in estimates of future costs are allowable if the contingency is based on current conditions and the impact is foreseeable with reasonable limits; e.g., anticipated costs of rejects and defective work.

On the other hand, contin-

gencies included in estimates of future costs are unallowable if the contingency is based on known or unknown conditions and the impact cannot be measured accurately enough to provide equitable results to the contractor and to the Government ; e.g. the outcome of lawsuits.

In practice, estimates for contingencies are very difficult to support.

Severance Pay (FAR 31.205-6(g))



Severance pay is a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated. Severance pay is allowable if it is required by law, employer-employee agreement, an established policy that constitutes an implied agreement; or the circumstances of the specific employment.

A number of years ago, in response to some questionable practices, the Gov-

ernment tightened the regulations and disallowed severance where there was continuity of service by the employee.

Payments made in the event of employment with a replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility,

subsidiary, affiliate, or parent company of the contractor are not severance pay and are unallowable.

Normal turnover severance payments are allocated to all work performed in the contractor's facility at the time of the separation. Abnormal or mass severance pay must be allocated in the period it is incurred. The Government will participate in its fair share of any specific payment.

Management Decisions – TINA Disclosure Required?

What is a contractor's duty under the Truth in Negotiations Act (TINA) to disclose management plans, business strategies, budget forecasts, estimates and other judgmental projections? TINA requires the disclosure of all facts a prudent buyer or seller would

reasonably expect to affect price negotiations significantly. The Government has taken positions that business plans and projections represent management decisions that could have a significant bearing on costs. In Lockheed Corp., ASBCA 36420, the ASBCA provided guid-

ance concerning disclosure of business plans. First, business plans and projections do not become cost or pricing data until the contractor decides to act upon them. Second, the plan must bear a substantial relationship to costs and a company official with requisite authority must have

decided to act on the plan. And finally, purely judgmental estimates are not cost or pricing data and projections containing a mix of facts and judgments need not be disclosed as long as the factual data have been previously disclosed.

Know Your Business Environment

A recent ASBCA (Armed Services Board of Contract Appeals) decision underscores the importance of doing your homework before submitting a bid (ASBCA Nos. 54066, 54067, April 9, 2007). Ellis Environmental Group (EEG) out of Florida was awarded two fixed-price construction contracts for renovation of buildings at a Naval Air Station in Mississippi. These contracts were subject to a Contractor's Use Tax levied by the State of Mississippi in the amount of 3.5 percent of the total contract price. EEG had no previous work in Mississippi and was not aware of that tax when it responded to the RFP and consequently, failed to include the amounts in its offered prices. The tax was not included in the price of the

awarded contracts either.

After contract award, EEG sought an exemption from the State. Mississippi refused. Then, EEG filed a claim with the Navy for about \$215 thousand, the amount of the tax. That too was denied so EEG appealed to the ASBCA. EEG argued that it was entitled to recover based upon a "unilateral mistake".

The Board reasoned that because FAR 52.229-4 unambiguously required EEG to include all taxes in the contract price, the sole argument left was for EEG to argue that it was not bound by the clause due to its own unilateral mistake.

A contractor seeking post-

award reformation of its contract on grounds of unilateral mistake has the burden of proving by clear and convincing evidence certain elements including evidence that the mistake was a clear-cut clerical or mathematical error or a misreading of the specifications and not a judgmental error.

The Board concluded that EEG's failure to ascertain the nature and extent of taxes required by the State of Mississippi was not a clear-cut clerical error or mathematical error. Nor was it a misreading of the specifications. Rather, it was a judgmental error; consequently, the mistake made was not a qualifying mistake that would entitle EEG to reformation.



A contractor seeking reformation of its contract on grounds of unilateral mistake has the burden of proving that the mistake was not a judgmental error.

Unilateral Mistakes – What Contractors Must Prove

A contractor seeking post-award reformation of its contract on grounds of unilateral mistake has the burden of proving by clear and convincing evidence the following five elements.

- A mistake in fact occurred prior to contract award
- The mistake was a clear-cut clerical or mathematical error or a misreading of the specifications and not a judgmental error
- Prior to award the Government knew, or should have known that a mistake had

been made and therefore, should have requested bid verification.

- The Government did not request bid verification or its request for bid verification was inadequate, and
- Proof of the intended bid is established.

Contractors are not precluded from recovery for unilateral mistake even though the contractor may have been negligent in preparing its bid or proposal (Ruggiero v. US, 420 F.2d 709, 713 (Ct.Cl. 1970)).

In one case, a supplier

gave an erroneous price quote on specialized aluminum foil (\$1.61 per 100,000 square inches rather than \$1.61 per 1,000 square inches. The Board held that the error was a clear-cut clerical error and the fact it was made by a supplier was irrelevant. The Board also found that the contractor's mistaken reliance on that quotation was not an error of judgment (see ASBCA No. 30883, 88-2 BCA Par 20,534).

It is possible to obtain contractual relief because of a unilateral mistake but the burden of proving the five elements rests with the contractor.

Its possible to obtain contractual relief because of a unilateral mistake but the burden of proving the "five elements" is difficult.



Accounting Software World – the leading comparison site and directory for accounting and ERP software.

Smart Stops on the Web

Accounting Software World
accountingsoftwareworld.com/

Choosing an accounting software solution can be a challenge. There are many things to consider when evaluating an accounting system solution including reviewing available products, comparing industry-specific vs. general accounting programs, integration with other existing

software, determining price/investment budget, availability of local support, and training.

A company needs to know the vendor's reputation, how stable the software, how long its been on the market, whether it will satisfy long-range needs, what modules are available, and whether it will help better manage the business.

Accounting Software World, the leading comparison site and directory for accounting and ERP software can help you in your decision process. This site contains information on all the major accounting products. You are able to read reviews, compare features, and determine pricing.

Interesting Software – Google Docs

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

Google Docs is an on-line software suite consisting of word processing, spreadsheets, and presentations. It is compatible with Microsoft Office so you can upload .doc, .xls, or .ppt files, edit, format, spell-check, and view them, share

them, invite others to edit documents at the same time, and then download to your desktop as Word, Excel, or PowerPoint files. You can even publish these files on the web, allowing access to a wide audience.

These applications do not include all the features of their Microsoft counterparts but they do include all the features that most people

use. The good news is that Google Docs is free. Users need to establish Google accounts (also free). Documents can be stored on-line and accessed by whoever you grant that privilege. Each user can store up to 5,000 documents. The files are backed up often and Google generally ensures security against unauthorized users.

<http://docs.google.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 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



The (dreaded) DCAA Form 1

DCAA auditors use the DCAA Form 1 to suspend or disapprove costs on cost-reimbursable contracts. Auditors use the form to suspend unsupported direct or indirect costs until the required data are received and a determination can be made as to the allowability of the costs. Auditors use the form to disapprove direct or indirect costs for which audit action is complete, the costs are considered unallowable, and the contractor does not concur. For disapproved costs, the procedures for issuing a Form 1 varies based on whether the costs are audit determined or ACO negotiated

Suspended or disapproved costs are withheld from future billings. If the costs are direct, they will be withheld from a future billing on the particular con-

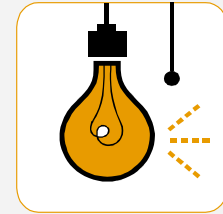
tract to which they were initially billed. If the costs are indirect, they will be withheld from all contracts to which indirect costs were allocated, most likely through an adjustment to billing rates.

Auditors will allow contractors "sufficient time" to provide supporting data for any claimed and/or billed costs. "Sufficient time" is not defined and carries a level of subjectivity. In responding to auditor requests for supporting data, there are a couple of things to be aware of. First, if a contractor has a systemic problem in readily supporting claimed costs, the auditors may well view this as an accounting system deficiency and reflect the deficiency in its internal control rating. Poor internal controls will lead to increased audit oversight and could potentially affect the award of future contracts.

Secondly, when auditors experience unreasonable delays in obtaining supporting data and significant claimed costs remain unsupported by the contractor, they are guided to consider whether to report an "Access to Records" deficiency. This escalates the issue outside the immediate DCAA office, puts the contractor on a "list" and could (but not likely) lead to a subpoena.

For contractors approved for direct billing, processing the DCAA Form 1 may require the contractor's direct billing authority to be temporarily rescinded. This would slow down payment process and disrupt cash flow to some extent.

Contractors who feel they are not being given adequate opportunity to respond to an audit request, can and probably should present their case to the contracting officer.



Auditor use the DCAA Form 1 to suspend or disapprove costs.

The Government Contract Dispute Process

The Contract Disputes Act (CDA) of 1978 established a process for all disputes arising under or relating to a government contract. A contractor that has a dispute with the Government must be careful to follow the CDA's mandated procedures, or it risks waiving or otherwise losing its right to proceed against the agency. Notably, the act requires continued contract performance pending resolution. Briefly, the process includes the following:

Presentation of a claim. A contractor initiates the disputes process by present-

ing a claim in the form of a written demand or a written assertion to the ACO. It must be in writing, request a "sum certain" and demand a final decision. If the claim is over \$100 thousand, it must also be certified.

Contracting Officer's Decision. If the contractor and Government are unable to negotiate a resolution to the dispute, the contracting officer must issue a final decision that articulates the agency's position with respect to the claim.

Appeal to a Board of Con-

tract Appeals. A contractor initiates an appeal to the Board of Contract Appeals (BCA) by filing a "Notice of Appeal" within 90 days of receipt of the ACO's final decision. The BCA's decision may be appealed to the U.S. Court of Appeals for the Federal Circuit.

Appeal to the U.S. Court of Federal Claims. A contractor initiates a proceeding at the COFC by filing a complaint within one year after receipt of the ACO's final decision. A judge's decision may be appealed to the U.S. Court of Appeals for the Federal Circuit.

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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.

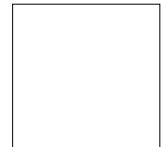
Our Staff

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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