

Pacific Northwest Consultants, LLC

Special Interest Articles

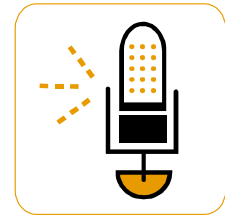
Selected Cost Accounting Standards – See Page 2

Compliance Risk Issues for 2008 – See Page 4

Unabsorbed Overhead - See Page 7

Contents

Determining Allocability	3
Adequacy of Final Incurred Cost Proposals	4
False Claims Act Correction Act of 2007	5
Training Opportunities	6



Contractor Code of Business Ethics

Federal Acquisition Circular (FAC) 2005-22, effective December 24, 2007, contained a final rule to address the requirements for contractor code of business ethics and conduct and the display of Federal Agency Office of the Inspector General (OIG) Fraud Hotline Posters. It contains both a policy statement and some mandatory requirements.

Policy: FAR 3.1002 states that contractors should have a written code of business ethics and conduct. To promote compliance with such code of business ethics and conduct, contractors should have an employee business ethics and compliance training program and an internal control system that is suitable to the size of the company and extent of its involvement in Government contracting, facilitates timely discovery and disclosure of improper conduct in connection with Government contracts, and ensures corrective measures are promptly instituted and carried out.

Mandatory Requirements: While the policy applies as general guidance to all Government contractors, there are additional requirements applicable to certain contracts and contractors (including subcontracts and subcontractors).

For all contracts greater than \$5 million (unless commercial items procured under FAR Part 12 or per-

formed outside the US), contractors are now required to prominently display in common work areas an agency fraud hotline poster. Additionally, if the contractor maintains a company website as a method of providing information to employees, the contractor shall display an electronic version of the poster (electronic versions are available for downloading from our website, www.PacificNWC.com).

Additionally, if these \$5 million contracts have performance periods exceeding 120 days, contractors, within 30 days of contract award, must have a written code of business ethics and conduct and provide a copy of the code to each employee engaged in performance of the contract. Further, the contractor shall promote compliance with its code of business ethics and conduct. *Comment: The term "promote" is very subjective. Contractor efforts in this area should be commensurate with its size and the risk environment.*

Additional Mandatory Requirements for Non-Small Businesses: The new regulations require contractors to develop ongoing business ethics and business conduct awareness programs and related internal control systems within 90 days after contract award.

The internal control system must be sufficient to facilitate timely discovery of improper conduct in connec-

tion with Government contracts and ensure corrective measures are promptly instituted and carried out.

The internal control system should provide for periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the contractor's code of business ethics and conduct and the special requirements of Government contracting, 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, internal and external audits, as appropriate, and disciplinary action for improper conduct. *Comment: Contractors need to consider the cost impact on existing fixed-price work resulting from compliance.*

Additional Regulations Coming: On November 14, 2007 a proposed rule was published that expands upon the foregoing requirements. The proposed regulation would require contractors to notify contracting officers without delay whenever they become aware of violations of Federal criminal law by a principal, employee, agent or subcontractor and to fully cooperate with any Government agencies responsible for audit, investigation or corrective actions. The proposed regulation also addresses the contractor's record of integrity and business ethics to the relevant information to be included in past performance information.





CAS 410 requires contractors to allocate G&A expenses to final cost objectives (e.g. contracts) over one of three allocation bases.

Cost Accounting Standards

This newsletter continues our coverage on Cost Accounting Standards. In past newsletters, we've discussed 12 standards. In this issue, we discuss two additional standards; CAS 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives and CAS 416, Accounting for Insurance Costs. Past newsletters are available on-line at www.pacificnwc.com.

CAS applies to negotiated contracts over a certain threshold (currently \$550 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.

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 (see, for example, the discussion on CAS 416 below).

CAS is designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors.

Regardless of exemption or

CAS 410 – Allocation of G&A to Final Cost Objectives

The purpose of CAS 410 is to provide criteria for allocating business unit G&A expenses to final cost objectives. The standard defines G&A expenses to include only expenses that are incurred for the general management and administration of the business unit as a whole and that do not have a directly measurable relationship to particular cost objectives. Insignificant expenses that do not qualify by definition as G&A expenses may be included in the pool for conven-

ience.

The G&A expense pool must be allocated to final cost objectives (i.e. contracts) by means of one of three cost input bases, a total cost input (TCI), value-added cost input (usually total production cost excluding material and subcontracts), or single-element cost input (e.g. direct labor), whichever is most appropriate. Special allocations are permitted when the benefits from G&A to a particular final cost objective significantly differ from the benefits accruing to other final cost objectives.

Government and contractor representatives have frequently disagreed about what circumstances justify the use of a special allocation. They have also disagreed over the appropriate cost input base, particularly the conditions under which the inclusion of material and subcontracts from the allocation base distort the allocation of G&A to final cost objectives.

Today, all three allocation methodologies are in wide use by Government contractors.

CAS 416 – Accounting for Insurance Costs

CAS 416 covers accounting for purchased insurance, self-insurance and payments to a trustee of an insurance fund. When coverage is obtained through purchase of insurance or payment into an insurance fund, the premium or payment normally should represent the insurance cost. Amounts representing coverage for more than one year should be assigned pro-

rata among the cost accounting periods covered by the policy term.

When coverage is not obtained through purchased insurance or payment into an insurance fund, the contractor should follow a program of self-insurance. Self-insurance is defined as the assumption or retention of the risk of loss by a contractor, either voluntarily or involuntarily.

CAS 416 requires self-insured

contractors to make a self-insurance charge for each period, for each type of self-insured risk based on an estimate of the projected average loss for that period. Insurance administrative expenses, if material, should be allocated on the same basis as related costs. FAR 31.205-19 makes the self insurance provisions of CAS 416 applicable to all contracts,

Random Musings

The Office of Management and Budget (OMB) increased the fiscal year 2008 performance goal for Performance Based Acquisitions to 50 percent, up from 45 percent in fiscal year 2007. OMB believes that if effectively implemented, the PBA strategy affords the Government many benefits, such as competitive pricing, innovative solutions, quality services and better results.

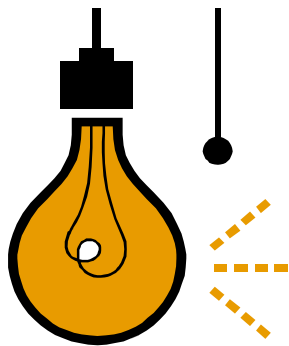
The Truth in Negotiation Act (TINA) regulatory changes proposed in April has not yet been finalized. The proposal will in part revise the definition of "Cost or Pricing Data" and change "information other than cost or pricing data" to "data other than cost or pricing data" A public meeting was held in Wash DC on November 15th to seek additional views before finalizing the proposal.

When Katrina struck in August 2005, FEMA had only 36 contracting officers on staff. It now has 200. Wonder what they're doing these days?

The recently unveiled OMB website, www.USAspending.gov contains data on contracts, grants, and loans. The Washington Times was "sorry to report" that \$700 hammers and bridges to nowhere were not easily discoverable. OMB claims that the data covers 90 percent of all spending. Wonder what's in the other 10 percent?

An Army technician ordering a Seal Replacement Parts Kit from a defense contractor noted that the price of the kit seemed unusually high based on the price of each individual component, and contacted investigators. Investigators examined the price of the components and the cost the company incurred to assemble each kit, and discovered that the contractor was marking up each kit by approximately \$500. Investigators further discovered that the Government had purchased a large number of the kits at the inflated price. As a result of the observant technician's number-crunching, the defense contractor agreed to a voluntary refund of \$44,000.

Have a happy new year.

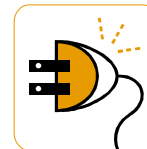
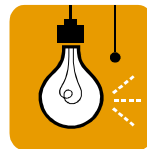


Determining Allocability

A cost is allocable to a government contract if it is incurred specifically for the contract; benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (FAR 31.201-4).

The first two criteria - incurred specifically for the contract and benefits both the contract and other work and can be equitably distributed - are straightforward and not custom to controversy. The third criterion - necessary to the overall operation of the business - is often used by the Government to take exception to incurred and forecasted costs.

If the cost is necessary for



overall business operation, then it is assumed that they are of a general (overall) benefit to all cost objectives (commonly known as general and administrative expenses) For example, the salary of the chief executive officer's secretary is necessary to the operation of the firm. By charging the costs to G&A, there appears to be a proper cost allocation because even though the secretary's activities may not benefit any particular product, they do support the overall operation of the firm.

On the other hand, if the cost does not benefit any specific cost objective and does not support the overall operation of the company, it should not be allocated to Government contracts. For example, a company that employs the president's son at a salary

of \$100 thousand per year but has no evidence that he has performed any work that is of benefit to the company, should not allocate the son's salary to any Government contracts.. The salary is not necessary for the overall operation of the company.

Dues, subscriptions, licenses, fees, travel, and selling are examples of G&A accounts that auditors will scrutinize carefully to ensure that those costs meet the allocability criteria - especially at contractors with a mix of commercial and Government business.

Auditors will also apply procedures to ensure that costs charged direct to contracts do not also benefit other work of the contractor.

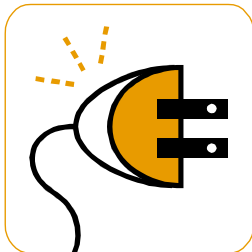
Compliance Risk Issues for 2008



There are a number of issues that, based on our past experience with DCAA and our consulting group coupled with trends in the Government contracting environment, be of importance to auditors and procurement officials during the upcoming year.

Professional and Consulting Costs. Government audit oversight will continue emphasis on determining that costs for these services are adequately documented. The focus will be on determining if contractors are maintaining adequate supporting data to demonstrate the purpose and reasonableness of the costs. In particular, auditors will be interested in broad scopes of work and fixed or monthly fees.

Organization Costs. Buying and selling companies, divisions, and segments give rise to reorganization costs and such costs are expressly unallowable. Expect auditors to scrutinize cost records of contractors engaging in buying or selling organizational components. This



would include the activity of contractor personnel as well as directly associated costs.

Executive Compensation. Auditors are aggressively evaluating executive compensation utilizing a variety of national salary surveys to gauge the reasonableness of those costs. Contractors should evaluate the compensation levels using viable wage survey information, and to maintain that data as evidence of reasonableness.

Consistency in Allocating Direct and Indirect Costs. Although this is a very basic cost accounting principle, we have seen companies ignore the requirement for consistency in allocating direct and indirect costs, incurred for the same purpose in like circumstances. Also, sometimes the customer (the Government contracting agency) will dictate a particular cost charging practice that results in noncompliance.

Statistical Sampling Techniques for Capturing Unallowable Costs. In a previous

newsletter (Vol. 1, No. 2) we discussed the FAR 31.201-6 revisions that specifically allows contractors to use statistical sampling as a method of identifying and segregating unallowable costs. There are two things that you need to keep in mind. First, you need to understand statistical sampling; developing homogeneous pools, drawing samples, projecting results, and assessing confidence. DCAA auditors are highly trained in statistical sampling techniques so your application must be defensible. Second, it is highly advisable to get an advance agreement with the contracting officer on the adequacy and sufficiency of your sampling process.

Incurred Cost Submissions. Requirement for timely submission of incurred cost submissions (within 6 months of your fiscal year end) continues to be high on DCAA's priority list. Contractors who are late are more likely than ever to have their direct billing authority suspended.

Adequacy of Final Indirect Cost Rate Proposals

In October, DCAA issued guidance to remind its auditors to evaluate contractors' incurred cost proposals upon receipt and immediately notify the contracting officer and contractor of significant inadequacies. Inadequate proposals have contributed to an increase in hours ex-

pected to perform the audit. Some of the items frequently omitted include: i) reconciliation of books of account to claimed costs, ii) reconciliation of total payroll to total labor distribution, iii) schedule of direct costs by contract and indirect expenses applied at claimed rates, iv) listing

of auditable subcontracts and related information, v) listing of cost billed/claimed on T&M/Labor Hour contracts, and vi) schedule of cumulative direct and indirect costs claimed and billed.

The audit guidance instructs auditors to either

request additional information or return the submission as inadequate when a claim is lacking the required information. The choice will probably depend on the prognosis for obtaining the missing information in a timely manner.

False Claims Act Correction Act of 2007

On September 12, 2007, Senator Grassley introduced a bill to amend the False Claims Act. This bill is intended to overturn three Federal court decisions that to some, have undermined both the spirit and intent of the 1986 False Claims Act, notably the "qui tam" provisions or the ability of whistleblowers to share in the amounts recovered by the U.S. Government from companies guilty of fraud, waste, and abuse.

The first case, U.S. Totten v. Bombardier Corporation, held that false claims presented to Government grantees, in this case employees at Amtrak, were not actually presented to the Federal Government. As a result, the Government was precluded from recover-

ing money lost to fraud and abuse perpetuated against Amtrak. This bill removes the requirement that false claims be directly presented to a government official, instead tying the liability directly to Government money and property.

The second case, Rockwell v. U.S. was decided in early 2007 by the Supreme Court who interpreted an area known as the "public disclosure bar" which prohibits a false claims case from moving forward if the case is based upon publicly disclosed information, such as a government report, unless the whistleblower filing the case was the original source of the information. In this case, a case was brought by a whis-

tleblower on a certain set of facts, expanded on by the Justice Department which ultimately settled on other grounds. This bill would require the Attorney General to file a timely motion to dismiss claims that violate the public disclosure bar.

In the third case, US DRC v. Custer Battles, the judge overturned a jury verdict that Custer had defrauded the Government of \$10 million because the money lost was not U.S. taxpayer money but was instead Iraqi money under the control of the U.S. Government. This act clarifies that non-taxpayer funds under the trust and administration of the U.S. Government subject to fraud are actionable under the False Claims Act.



This bill is intended to overturn three Federal court decisions that have undermined both the spirit and intent of the False Claims Act

History of the False Claims Act

During the Civil War, President Abraham Lincoln saw the need for a law that would deter and punish unscrupulous profiteers who were providing substandard supplies to the Union Army, those who "feast and fatten on the misfortunes of the nation while patriotic blood is crimsoning the plains of the South."

Lincoln urged the passage of legislation that would allow the Government to seek damages and penalties against perpetrators of fraud, and that would permit whistleblowers with information about false or fraudulent claims to file qui tam lawsuits on the Gov-

ernment's behalf in exchange for a share (up to 50 percent) of the recovered funds. In 1863, Congress enacted the Federal False Claims Act which became known as "Lincoln's Law".

The Act remained virtually unchanged until 1943. At that time, many False Claims Act suits were filed by individuals who literally copied their civil fraud allegations from federal criminal indictments. The people filing the suits had no independent knowledge of the wrongdoing. Congress amended the Act by enacting a "government knowledge bar" which prevented whistle-

blowers from filing suit if the suit was based on information that was already known to the government. Also, the whistleblowers share of the recovery was reduced from 50 to 10 percent.

The last major update of the FCA took place in 1986 when congress revitalized the qui tam provisions in response to widespread reports of defense contractor fraud. Since 1986, the Federal Government and qui tam relators have worked together to recover over \$20 billion in moneys that would otherwise have been lost to fraud, waste or abuse in Government programs.

Lincoln's Law – to deter and punish unscrupulous profiteers who were providing substandard supplies to the Union Army.



The Sleeter Group's annual listing of awesome QuickBooks Add-ons.

Smart Stops on the Web

Awesome QuickBooks Add-ons for 2008 sleeter.com

The Sleeter Group is a community of experts who provide consulting services to small business owners in the accounting software and business process design areas.

For the past several years, the Sleeter Group has spot-

lighted best-of breed add-ons for QuickBooks.

For companies using QuickBooks, there are hundreds of add-on products available for adding breadth and depth to the basic program – so many, in fact, that making a wise choice is difficult. This website will help pare down the list to those that have superior design, implementation

and features, and conform to good accounting principles and operating standards.

Among the 13 winners are Adagio FX, a report writer we featured in a previous newsletter, and MISys Small Business Manufacturing and Inventory Control System, a great MRP system for small and medium-sized manufacturing firms.

Interesting Software – Asset Keeper

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

Fixed asset management systems have strong calculation capabilities that greatly ease the asset management process, from acquisition through disposal. They allow assets to be grouped into a business subsidiary, by geographic

location and cost center. To comply with federal and state regulations, and to assist in accurate business valuation, asset management systems also help maintain clear and accurate documentation and audit trails, showing how assets have been depreciated and what methods were used. These systems also help to determine the depreciation treatment that provides the best

overall financial benefit to the business, a complex process considering that every taxing entity and other parties allow and require different treatment of assets.

Pro-Ware's Asset Keeper is cheaper than most (\$600) but has strong capabilities. Check it out at www.proware-cpa.com. It might be time to move from your spreadsheets.

Training Opportunities

PNWC provides specialized training in a variety of government contracting areas. On March 26th and 27th, 2008, we are offering training in labor charging and estimating systems (day 1) and FAR cost principles (day 2). The cost is \$450 per day or \$800 for both days if registered by February 29th. After that, registration is \$500/\$900.

The training will be held at the Best Western at Riveredge in Tukwila, WA, south of Seattle and near Seatac Airport.

Please visit our website, PacificNWC.com for complete details including the course syllabus. You may also call us at 206-508-1849 and request a brochure and registration form.

Space is limited and we expect these sessions will fill up quickly so you are encouraged to register early.

PNWC also offers training tailored to specific needs of individual companies. For information on how we can meet your specific needs, email your request to training@pacificnwc.com



Unabsorbed Overhead

A contractor may assert unabsorbed overhead damages in delay or suspension price adjustment proposals or claims. Unabsorbed overhead represents fixed overhead costs whose allocation to the contract has been impacted by the reduction in the stream of direct costs caused by the delay or suspension. During a delay or suspension, a contractor's other contracts will absorb more fixed overhead costs than they would have had the delay or disruption not occurred.

The use of the Eichleay formula for calculating unabsorbed overhead has become the standard method of calculating damages although courts have struggled to provide a framework of objective factors to govern the formula's application in recent years. The Court of

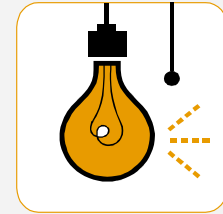
Appeals for the Federal Circuit has ruled that the use of the Eichleay formula is the exclusive means for calculating unabsorbed overhead on construction contracts.

The current formulation of the elements of an Eichleay recovery places burdens of proof on both the contractor and the government. It goes something like this. In order to establish a prima facie case of entitlement to unabsorbed overhead, the contractor must show that (i) the Government caused a delay that requires the contractor to be on standby for an uncertain period, (ii) the Government caused delay must cause an actual extension to the original period of performance, and (iii) that the contractor is unable to take on replacement work during the standby period.

The burden of proof then shifts to the Government to

show that the contractor suffered no damage because either (i) it was not impracticable for the contractor to take on other work during the delay or (ii) the contractor's inability to obtain additional work was not caused by the Government's suspension.

If the Government did not expressly issue an order putting the contractor on standby, the contractor might still be able to prove that the Government effectively put it on standby by indirect means. To do this, the contractor must show that (i) the government delay was not only substantial but was of indefinite duration (the Government did not tell the contractor that work will begin again on a certain date), (ii) it was required to be ready to resume full work immediately, and (iii) effective suspension of much, if not all, of the work on the contract (P.J. Dick, Inc. v. Department of Veterans Affairs, 324 F.3d 1364 (Fed. Cir. 2003))



...fixed overhead costs whose allocation to the contract has been impacted by the reduction in the stream of direct costs caused by the delay or suspension.

Unabsorbed Overhead - Entitlement

The Government is naturally wary whenever a contractor includes unabsorbed overhead in its delay or disruption claim. There are a number of facts and circumstances that it will examine to help determine the propriety of the claim, including;

- Evidence that the asserted Government delay/suspension did not cause any extension in the actual time of performance beyond the original or previously revised contract performance date
- Evidence that the contractor was or was not able to begin work on the next new contract in the extension period because of continuing work on the delayed/suspended contract.
- Evidence that the contractor did or did not secure a replacement contract or other substituted work between the start of the delay/suspension period and the end of the period of extension beyond the original or previously revised performance period.
- Evidence of contractor-caused delays that were concurrent with the alleged Government delay.
- Evidence that the contractor was aware of differing conditions or other causes of the asserted Government-caused delay before the original bid submission.
- Evidence that the contractor was unable to obtain replacement work because its bonding capacity was limited due to circumstances unrelated to the Government-caused delay.

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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!
See us at:
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