

Pacific Northwest Consultants, LLC

Special Interest Articles

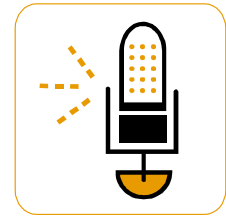
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Travel Costs

Maybe it's just our imagination but it seems that travel costs attract more attention than any other cost element in price proposals and incurred cost reviews. Maybe it's concern over the significantly increasing cost of travel. Maybe it's the awareness that alternative ways of meeting and communicating are becoming commonplace (e.g. teleconferencing, web-based meetings, on-line training). Or, maybe it's because contractors have a difficult time complying with all the intricacies of the cost principle, making it easy for the Government to successfully challenge those costs. In this article, we examine the essential requirements of the travel cost principle (FAR 31.205-46(a) and then take a look at some of the questions that might come up during a contract negotiation or an audit of incurred travel costs.

Allowability criteria: Costs for transportation (not including air fare), lodging, meals, and incidental expenses are allowable subject to certain limitations. In all cases, the methods used to estimate or calculate travel costs must result in reasonable charges but the costs for lodging, meals and incidental expenses are considered to be reasonable and allowable provided they do not exceed on a daily basis the maximum per diem rates set forth in Government published travel regulations, the Federal Travel Regulations

for continental U.S, the Joint Travel Regulations for Alaska and Hawaii, and the State Department Standardized Regulations for foreign travel.

Special Situations: In special or unusual situations, actual costs (up to 300% of the maximum allowance) are allowable. These circumstances include situations where employees must stay at a prearranged hotel or areas where subsistence costs have escalated for short periods. In these special situations, written justification approved by an officer is required. A receipt is also required for each expenditure greater than \$75.

Partial Travel Days: The maximum per diem rates generally would not constitute a reasonable daily charge when there are no lodging costs or there is partial travel days (e.g. day of departure and return).

Documentation: Travel costs are allowable only if the following information is documented: date and place of the expenses, purpose of the trip and name of person on trip and that person's title or relationship to the contractor. In all cases, auditors will request this information. In our experience, many small contractors have poor documentation practices.

Airfare: Airfare costs in excess of the lowest customary standard, coach offered during normal business

hours are unallowable (except if that airfare requires circuitous routing or travel during unreasonable hours).

Policies and Procedures: Contractors should establish comprehensive written travel policies and procedures. At a minimum, these procedures should provide for documented justification and approval of the official necessity of each trip, its duration, and the number of travelers involved. The procedures should provide for advance planning to assure that whenever feasible and economically practical, required visits to locations in the same geographical area are combined, and maximum use is made of the lowest air fare accommodations.

Consistency in charging: It is absolutely critical to ensure that travel costs are charged to the same charge number or cost objective that the traveler's time is charged to. It's amazing to us how often travel costs are charged to a different charge number than the traveler's time. Usually there's no good reason and the discovery leads to skepticism about a contractor's integrity and the adequacy of their accounting and internal control systems.

Other Questions to be prepared for: Is the proposed travel really necessary? Can few longer trips replace the proposed travel schedule? Can multiple tasks be accomplished on the same trip? Is the proposed number of travelers reasonable?



CAS 412 requires actuarial assumptions related to returns on invested funds, future compensation, inflation, mortality, and more.

Cost Accounting Standards

With this newsletter, we complete our brief synopses on the nineteen CAS standards. If you've missed the earlier coverage, previous newsletters are available on-line at www.pacificnwc.com. The final two standards, CAS 412 (Composition and Measurement of Pension Costs) and CAS 413 (Adjustment and Allocation of Pension Costs) apply to defined benefit pension

plans, and defined contribution plans as (401(k), profit sharing, SEP, SIMPLE, SEP-IRA, Keogh, etc). Most of the Standard's coverage however, deals with defined benefit plans.

If your contracts are subject to modified CAS coverage or are exempt from CAS (e.g. small business exemption), you may still have to comply with these two standards. The com-

pensation cost principle, FAR 31.205-6(j) states that "The contractor shall measure, assign, and allocate the costs of all defined-benefit pension plans and the costs of all defined-contribution pension plans in compliance with ...(CAS 412 and 413)..."

CAS 412 – Composition and Measurement of Pension Costs

CAS 412 establishes the composition of pension costs, the basis of measurement, and the criteria for assigning pension costs to cost accounting periods (CAS 413 addresses the accounting treatment of actuarial gains and losses and the allocation of pension costs to segments of an organization.

In a defined benefit plan, the contributions to be made by the contractor are calculated actuarially to provide pre-established

benefits. Pension costs for a period consists of four elements, normal costs, amortization of any unfunded actuarial liability, interest equivalent on the unfunded actuarial liability and actuarial gains and losses being amortized, and adjustment for actuarial gains and losses.

Under the defined contribution plan, the pension cost of a cost accounting period is the net contribution required to be made, after adjustment for dividends and other credits.

Normal costs are the present value of future benefits earned

by employees during the year using the projected benefit cost method.

Actuarial assumptions are related to the interest or return on funds invested and other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits.

Pension contributions must be funded in order to be allowable. Increased costs due to late funding are unallowable.

CAS 413 – Adjustment and Allocation of Pension Costs

CAS 413 establishes criteria for assigning actuarial gains and losses to cost accounting periods, valuing pension fund assets and allocating pension costs to segments.

Actuarial gains and losses represent differences between actuarial assumptions and actual experience. CAS 413 requires that actuarial gains and losses be calculated annually and assigned to cur-

rent and subsequent cost accounting periods. Typically, these gains and losses are amortized over 15 years including the current period.

Possibly the most contentious aspect to CAS 413 is how to assign pension costs equitably to segments. Contractors can use a composite method if there are no significant disparities in actuarial factors between segments and allocate costs to segments on a

base which represents the factors used in computing pension costs.

Contractors may also compute pension costs on a segment basis. Under this basis, costs shall be based on the assets and liabilities of the individual segment.

The standard also includes criteria for adjustments when there are segment closings, plan terminations, and plan curtailments.

Random Musings

Regulation Holiday - On May 9th, OMB issued a memo advising all executive agencies and departments to curtail new regulations as the current administration winds down. From now on, "...heads of executive departments and agencies should ...avoid issuing regulations that are unnecessary". And here we naively thought that all regulations were necessary to achieve important public benefits. No more new regulation proposals after June 1st (unless absolutely necessary). Wonder who gets to define "absolutely necessary"?

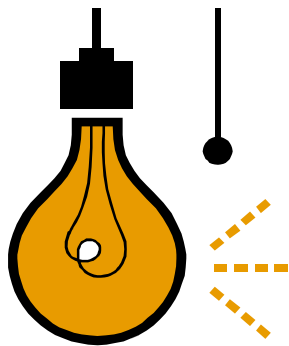
The IRS increases the Standard Mileage Rate - The IRS announced an increase in the standard mileage rate for the final six months of 2008. Effective July 1st, the rate increases from 50.5 cents to 58.5 cents per mile.

Lobbying Costs - DCAA is instructing its auditors to perform procedures to ensure contractors have properly identified and accounted for contractor effort and related costs associated with supporting legislative earmarks. DCAA

believes that costs to pursue earmarks plus directly associated costs are unallowable legislative lobbying activity per FAR 31.205-22 - a position that has merit. However, some auditors get a little carried away on compiling the "directly associated" costs. "Directly Associated Costs" must meet the definition in FAR 31.001. If they don't, the costs are allowable.

Acquisition Workforce - The Office of Management and Budget published its acquisition workforce statistics for 2007. There are 28 thousand people in positions related to contracting, 19 thousand in DoD. The average age is 46, 60 percent are women and 75 percent are college graduates. More than half are eligible to retire within 10 years.

Fed Bonuses - The median amount of money received by federal employees who got bonuses was \$560. And, only 106 thousand of 1.2 million federal workers got merit increases. This adds up to a system that doesn't have much incentives. More like an "attaboy".



Commercial Contracts

About a year ago, FAR Part 12 was revised to provide for **COMMERCIAL** Time and Material (T&M) and Labor Hour (LH) contracts. This was part of a broad effort to create and expand pathways for participation by nontraditional contractors. It was also designed to streamline some of the Government's procurement processes.

The idea of selling "commercial items" to the Government has always appealed to companies. There is no requirement to submit cost or pricing data or other kinds of supporting data in connection with the proposal and contract award. Additionally, there is usually no post-award audit requirement for the costs billed to the Government.

But commercial T&M and LH contracts are a bit dif-

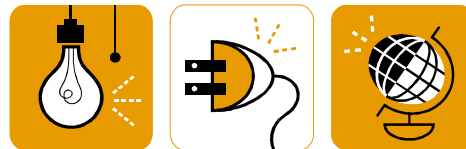
ferent, as companies have belatedly discovered. For commercial T&M/LH contracts, there is a post-award audit requirement and there is an access to records clause (FAR 52.212-4, Alt I(i)(4)).

By way of background, commercial T&M/LH contracts provide for hourly labor rates paid at the rate specified in the contract and only for labor performed on the contract that meets the labor qualifications specified in the contract. How does the Government determine whether the labor was performed on the contract and met the requisite qualifications? The Government conducts an audit.

The access clause allows the Government access to (i) records that verify that

employees, met the qualifications for the labor categories specified, original timecards (paper-based or electronic), timekeeping procedures, records that show the distribution of labor between jobs, and the employees themselves (for purposes of a floor-check). For material costs, the Government has the right to invoices or subcontracts substantiating material costs and documentation supporting payment of those invoices.

DCAA has issued guidance to its auditors on how to review these contracts. When reviewing interim vouchers, DCAA is not verifying that employees meet the qualifications for the labor categories specified in the contract. When reviewing incurred cost, that step is included.



Contractor Compliance Program



In our Oct – Dec 2007 newsletter (Vol. 2, Issue 4) we reported on the new requirement for contractor code of business ethics and conduct. About the same time as the final rule was published, a related proposed rule was published at the request of the Department of Justice. This proposed rule would require contractors to have a code of ethics and business conduct, and to establish and maintain specific internal

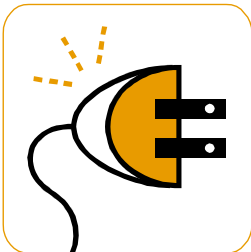
controls to detect and prevent improper conduct in connection with the award or performance of Government contracts or subcontracts.

Comments to the original proposal expressed concern about the exemptions for contracts performed outside the US (the Halliburton effect) and the exemption for the acquisition of commercial items. The revised proposed rule removes those

exemptions.

The initial proposed rule also required contractors to notify contracting officers without delay whenever contractors become aware of violations of federal criminal law. The revised proposed rule adds a provision that knowingly failing to report such violations in a timely manner will be an additional cause for debarment or suspension.

Excessive “Pass-Through” Charges – Part II



In our April – June 2007 issue (Vol. 2, Issue 2) we noted that DoD had issued an interim rule to ensure that pass-through charges on contracts or subcontracts are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor.

Essentially excessive pass-through fees are charges for indirect costs or added profits that don't benefit

the government. The initial interim rule has been widely criticized and this revision will be as well. The 70 percent reporting requirement now applies both before and after award. It's only a reporting requirement, not a threshold for coverage requirement. Where the contractor demonstrates added value and the contracting officer determines they are a benefit to the Government, the

rules do not apply.

“Added Value” is now defined as subcontract management functions that include processing orders of parts or services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, and performing quality assurance functions.

CAS 415 Revised to Address ESOPs

The CAS Board amended CAS 415, Accounting for the Cost of Deferred Compensation, to direct that costs of all Employee Stock Ownership Plans, regardless of type, be accounted for in accordance with CAS 415, and provides criteria for measuring ESOP costs and assigning those costs

to cost accounting periods.

Prior to this revision, the issue of which costs were reimbursable was both controversial and ambiguous. One of those issues was whether dividends paid to an ESOP and amounts contributed to an ESOP for the repayment of

interest were reimbursable costs. Now it's clear that the actual amount contributed to an ESOP will be a reimbursable cost whether the ESOP is leveraged or not.

The revision also clarifies that reimbursable cost for the applicable cost ac-

counting period will only apply to stock, cash, or combinations thereof that are awarded and allocated to employee accounts within that accounting period. If not allocated to employee accounts, the amounts are unallowable but may be carried over.

Supplemental Appropriations Act, 2008

On June 30th, the President signed into law, PL 110-252, the Supplemental Appropriations Act of 2008. There are a couple of items included in this bill that will impact many Government contractors.

Financial Disclosure Requirements for Certain Recipients of Federal Awards: This law requires government contractors who, in their preceding fiscal year received 80 percent or more of its annual gross revenues in Federal awards and \$25 million in annual gross revenues from Federal awards to disclose the names and total compensation of the five most highly compensated officer of the entity. This information will be publically available on-line through a Govern-

ment website. This law was a direct result of an executive of a contractor with large Iraqi contracts refusal to disclose his salary during Congressional testimony and at the time, congress was powerless to force him to do so.

In reality, existing Government regulations (FAR 31.205-6) already limit executive compensation to \$612 thousand and even that amount is subject to other "reasonableness" criteria.

Close the Contractor Fraud Loophole Act. This section of the new Law requires timely notification by Federal contractors of violations of Federal criminal law or over-

payments in connection with the award or performance of covered contracts or subcontracts, including those performed outside the US and those for commercial items. This law also came about because of the perception that contractors with large Iraqi contracts (e.g. Halliburton) were not subject to recent regulations requiring contractors to tighten up their ethical practices.



Many lawmakers believe this law is unnecessary. It's going to affect hundreds, if not thousands of Government contractors

Proposed Changes to Airline Fare Allowability

A proposed change to Travel cost principle, FAR 31.205-46(b) will affect the allowability of certain airline fares.

The current regulation limits allowable contractor airfare costs to the lowest customary standard, coach, or equivalent airfare offered during normal business hours. The FAR Councils became aware that this limitation is being interpreted inconsistently, sometimes as lowest coach fare available to the contractor and other times as the lowest coach fare available to the general public. These inconsistent interpretations lead to con-

fusion regarding what costs are allowable.

The FAR Councils believe that the reasonable standard to apply in determining the allowability of airfares is the lowest coach fare available to the contractor. It would not be prudent to allow the costs of the lowest coach fares available to the general public when contractors have obtained lower fares as a result of direct negotiation.

The real story here is the perception that many contractors are abusing the system by maintaining the lowest standard coach fare is the same as the same-

day walk-up fare. The same-day walk up fare is sometimes more than business or first class tickets purchased in advance. Using this interpretation, some contractors have been using and claiming reimbursement for the cost of business and/or first class travel.

The period for public comment has expired. There were relatively few public comments but predictably, those from companies and industry associations were against the proposed rule while those with Government connections favored it.

Another loophole to be closed.



A great place to begin your search for new accounting software

Smart Stops on the Web

Accounting Software World
www.accountingsoftwareworld.com

Accounting Software World from K2 Enterprises is a great place to begin your accounting software search and selection project. The site contains independent reviews of many of the leading software products, links to the manufactures websites, and much more. It breaks

down the different products between entry-level, small to medium size, mid-range, enterprise, and ERP solutions. It also breaks down the solutions by targeted industry. The construction category currently has 24 different products listed.

The site has many useful tools such as the white paper on best practices to software selection and

other reference material..

K2 is a national provider of continuing professional education for accounting and financial personnel. One of their most popular seminars is the Accounting Software Symposium ("the most you can learn about accounting software in one day"). The next seminar here in the Pacific Northwest is scheduled for Bellevue in August.

Governance, Risk, and Compliance

GRC (Governance, Risk Management, and Compliance) is an increasingly recognized term that reflects a new way in which organizations can adopt an integrated approach to these three areas. Governance is the responsibility of senior executive management set the tone at the top. Risk management leverages internal controls to manage and mitigate risk throughout an enterprise.

Compliance is the process that records and monitors the policies, procedures and controls needed to enable compliance with Government regulations as well as internal policies.

There has been a definite focus shift by the government (quality control, audit, etc) from a transaction based approach to a systemic approach to assuring that contractors have effective GRC programs.

The number of vendors offering GRC software is astounding and trying to determine the best product for a given business problem can be challenging. Prices tend to be high and so is the cost of implementation and maintenance.

If you know of any GRC software suitable for small Government contractors, drop us a note at info@pacificnwc.com.

Need Training?



PNWC provides specialized training in a variety of government contracting areas. Our standard training modules generally take three to four hours while our extended training modules are designed for one and two days. PNWC training qualifies for CPE in most states.

PNWC training modules are continuously updated to

reflect the most current regulations and trends in the Government including current high risk areas identified by DCAA.

Current training modules include:

- Truth in Negotiations (TINA)
- FAR Cost Principles (Allowable and Unal-

lowable costs)

- Internal Controls over Labor and Timekeeping
- Internal Controls over Estimating Systems
- Ethics for Government Contractors
- Terminations and Claims.

Allowability of Legal Costs for Civil Cases

A recent decision by the Armed Services Board of Contract Appeals (ASBCA) clarified the standard for determining allowability of legal costs and settlement costs in defending against a sexual harassment suit brought by a former employee (ASBCA No. 53884, 54461, 07-2 BCA Par 33674). The employee's lawsuit was subsequently settled out of court. The contractor, Tecom, paid the employee some money but did not admit to any wrongdoing.

Tecom charged the legal fees for defending the suit to the G&A (general and administrative) cost pool and charged settlement costs directly to the contract for which this employee was hired and worked. In claiming reimbursement for the costs, the contractor asserted that while the accusation was false, it had simply made a

prudent business decision to settle the case out of court. The Government refused to reimburse the contractor for either legal or settlement costs so the contractor appealed.

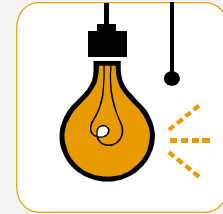
In the appeal, the Government relied on a decision by the Court of Appeals for the Federal Circuit in *Boeing North America v. Roche*. In the *Boeing* case, the court established a "likelihood of success" test to determine the allowability of legal fees and settlement costs. That is, the allowability of the costs depended on Boeing's likelihood of success if their case had it gone to trial.

Applying that standard to this case, the Government argued that the Tecom's costs were unallowable unless it could show that it likely would have prevailed if the sexual harassment lawsuit had gone to trial. Additionally, the Gov-

ernment argued that the costs should not be allowable because they were similar to penalties for wrongdoing under FAR 31.205-15.

Tecom argued that the "likelihood of success" test applies only to lawsuits involving fraud or false claim allegations under FAR 31.205-47. Costs related to Legal and other Proceedings. In this case, there was no allegation of fraud so the argument had no bearing. The ASBCA agreed and ruled that the recovery of legal costs in defending the allegation of sexual harassment was not barred by FAR 31.205-47.

The ASBCA also disregarded the Government's other argument that the costs were essentially unallowable fines and penalties. The settlement of a civil case for a private harm was not related to a fine or penalty assessed by a Government agency.



Legal fees and settlement costs related to a civil case for private harm are allowable.

Internal Control Deficiencies

In a previous newsletter (see Vol. 2, Issue 2 – April - June 2007) and we discussed the differences between significant deficiencies and material weaknesses. If significant deficiencies or material weaknesses are disclosed during an audit, the Government will render one of two opinions; either the system will be inadequate or it will be inadequate in part.

Whether the system is inadequate or inadequate in part is a matter of auditor judgment. Generally, if deficiencies affect only certain control objectives or parts of the system, the

audit opinion will state that the system is inadequate in part and identify the inadequate portions of the system. However, if the nature of the deficiencies is such that the reliability of the entire system is affected, the audit opinion will state that the system is inadequate, even if the deficiencies only relate to certain control objectives or parts of the system.

For example, if the contractor's controls related to labor authorization and approvals are so deficient that they result in or could result in labor costs being

charged to the wrong final cost objective, the opinion on the labor system should be inadequate. If there is inadequate control over work authorizations, the integrity of the entire system is impacted, even though the deficiencies relate to only one control objective.

Of course, neither opinion is good for business. If faced with potential deficiencies, be sure the auditor considers mitigating circumstances and compensating controls. For example, work authorizations may be deficient but since there's only one contract, the risk of mischarging is not a factor.

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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.

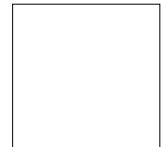
Our Staff

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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