REDSTONE Government Consulting

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# Uncompensated Overtime – January 29, 2015 FAR Change Limits Method to "Adjusted Hourly Rate" (aka: Diluted Rate)

*By Michael Steen, CPA, Senior Director at Redstone Government Consulting, Inc.*

In the FAR revision January 29, 2015 to 52.237-10, Identification of Uncompensated Overtime (UCOT) which is applicable to service contracting (FAR Part 37), the FAR Council changed the definition of UCOT to *adjusted hourly rate (including uncompensated overtime)*. This change also mandates: i) the use of the adjusted hourly rate applied to all hours proposed, whether regular or overtime (for hours applicable to employees exempt from the overtime requirements of the Fair Labor Standards Act) and ii) paid time off shall be included in the normal work week for computing UCOT hours.

The FAR retained the previous example of a UCOT rate (now adjusted hourly rate): 45 hours/week proposed with a straight time hourly rate of $20 equates to an adjusted hourly rate of $17.78 (40/45 x $20 = $17.78). The FAR also retained requirements or statements: i) to identify proposed UCOT hour by labor category at both the prime and the subcontract level, ii) that the accounting practices for estimating must be consistent with cost accumulation and reporting (implicitly CAS 401), iii) to include a copy of the contractor policy addressing UCOT, and iv) a cautionary statement that proposals with unrealistically low labor rates or that do not demonstrate cost realism will be considered in a risk assessment and evaluation. Regarding that cautionary statement, it should be noted that FAR 37.115-2(a) expressly states that the "use of uncompensated overtime is not encouraged". Other statements reinforce this including a source selection factor regarding "unbalanced distribution of uncompensated overtime among skill levels and its use in key positions". The negative implications are self-apparent although the FAR council has never explained the significance of "unbalanced UCOT" or why it would be an issue in key positions, frequently occupied by exempt employees who routinely work significantly more than 40 hours per week.

## THIS ISSUE:

Beyond generally discouraging UCOT in the FAR, a number of individual solicitations outright prohibit UCOT by requiring bidders to use a standard work year (i.e. 2,080 hours per year which should be interpreted as total productive and paid-time-off hours for an employee). By implication (or expressly stated), the source selection official does not want to allow price or cost variation by virtue of a bidder's use of UCOT hours to reduce the hourly labor rate or the fully burdened/with profit labor rate for labor categories on T&M contracts. In some cases, the solicitation allows more than the standard work year, but indicates that the proposal will be evaluated (compared to other bidders) based upon the standard work year. Apparently, the government is averse to getting more hours at a lower rate because it "might degrade" the quality of those hours.

For those contractors who's estimating and accounting already use automatic rate adjustment features (salary divided by total worked and paid-time-off hours for the pay period), the January 29, 2015 FAR change is a non-event. For those contractors who use alternative methods for estimating and accounting for UCOT hours, this could be a traumatic event given that it eliminates those alternative methods, at least for any contractor submitting a bid on a services contract subject to 52.237-10. For example alternative methods which here-to-fore have been considered compliant by DCAA (CAM 6-410) include diluting or pro-rating the hours (e.g. 50 actual hours yields a pro-ration factor of .80 hours in which case only 40 hours are pro-ratably distributed for the work-week) or estimating total hours by employee for the year divided into the employee salary to yield a projected hourly rate by employee. Other government interpretations, including AASHTO (American Association of State Highway and Transportation Officials), profess to an alternative method which is to record all hours worked at the employee straight-time hourly rate wherein the variance (over-absorbed payroll dollars) is credited to the same overhead pool which includes the employee direct labor (OH allocation base). In fact, AASHTO maintains that its method is the only FAR compliant method because the employee's direct labor rate remains constant and cost objectives equitably share in the OH credit.

Although the January 2015 FAR change seems to eliminate alternatives for estimating and accounting for UCOT hours, it does not answer some fundamental questions including:

- Is there any regulation which requires "total time accounting" versus the option of only recording 40 hours per work-week (for exempt employees)? DCAA asserts that cost allocation principles require total time accounting (all hours are recorded by every employee); however, DCAA is ignoring the regulatory history wherein final regulations explicitly removed requirements for total time accounting (which had been included in the proposed rule). If a contractor does not currently use total time accounting, the January 2015 FAR change certainly does not impose total time accounting.
- FAR 52.237-10 is "service contracting" specific; thus not in all government contracts and its requirement for consistency only applies to a bid proposal and the resulting contract. Just like CAS 401, comparability (bid proposal to accumulating and reporting costs) applies to the specific contract. Although it may be operationally impractical and potentially at odds with other regulations (i.e. other Cost Accounting Standards/CAS), a contractor could have different methods for estimating and recording UCOT (adjusted hourly rates for contracts subject to FAR 52.237-10 and another method for all other contracts).
- If a contractor currently uses total time accounting, but not the adjusted hourly rate method for estimating and recording UCOT rates, does a contractor immediately change to the adjusted hourly rate method? If the contractor is CAS covered, the answer is to wait until a solicitation/proposal triggers the potential change, then propose and disclose it as a FAR 52.230-7 change (i.e. award of the contract will trigger a required change to remain compliant). If a contractor never encounters a solicitation which will invoke FAR 52.237-10, that contractor would have no reason to ever change practices for estimating or recording UCOT.

A parting shot at the January 29, 2015 FAR change, it was effected without a proposed rule which means that the FAR Councils made the change without any consideration of public comments which would have highlighted some of the "hidden issues". Not that the FAR Councils are all that likely to consider public comments, but in this case they totally ignored the practical implications, not the least of which is potentially forcing CAS covered contractors into required changes (to remain compliant) which might result in allowable increased costs

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on government contracts. Similarly, the FAR Councils are oblivious to the fact that other quasi-governmental agencies (i.e. AASHTO) have maintained that there is a different method which is the only compliant and equitable method. Reminds one of the statement from Cool Hand Luke, "what we've got here is a failure to communicate".

## ASBCA Cases and Accrued but Unpaid Compensation

*By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.*

In 2013 DCAA issued MRD 13-PPD-013 (Memorandum for Regional Directors) regarding audit testing for contractor compliance with FAR 52.216-7, Allowable Cost and Payment clause. In application to DCAA's long overdue audits of contractor indirect cost rate proposals, DCAA's audit policy is to question claimed costs that the contractor never paid citing the requirement that allowable costs only include those paid in the ordinary course of business, normally within 30 days of the contractor request for payment. Although DCAA's MRD incorrectly mixes and matches different FAR sub-paragraphs to yield DCAA's restated FAR citation, the undeniable fact is that accrued but unpaid expenses from a much earlier contractor fiscal year will be questioned if/when DCAA finally performs the incurred cost audit. Not only will they be questioned by DCAA, but it appears to be likely that Administrative Contracting Officers (ACOs) will support DCAA on this particular issue.

More ominously, if a contractor invokes the Contract Disputes Act to challenge an ACO final decision (that an unpaid cost is unallowable), it appears that the government will have a high probability of success with the ASBCA (Armed Services Board of Contract Appeals) or the CoFC (Court of Federal Claims). In the case of ASBCA No 59727, the issue involved unpaid compensation of $53,788 for Contractor Fiscal Year 2007 for which the contractor stated that the compensation was deferred because the contractor did not have the funds to actually pay the deferred amounts. Although the costs might have been allowable under a deferred compensation plan, the ASBCA concluded that there was no deferred compensation plan; hence, the compensation and allocable overhead/G&A were unallowable (no evidence that the costs had been incurred by the contractor albeit the costs had long-since been reimbursed by the government).

In a coincidentally similar case, CoFC No, 12-142C, at issue was a contracting officer final decision disallowing $91,992.77 (later corrected to $76,481.55) for unpaid costs in contractor fiscal year 2004. In this case, a 2007 DCAA audit had applied FAR 31.205-6(a)(6)(iii) for closely held companies, compensation in excess of the costs that are deductible as compensation under the IRS code is unallowable (the FAR clause was incorrect, later corrected to FAR 31.205-6(b)(2)(i) which applied to the specific contract). Similar to the ASBCA case, the unpaid compensation was attributed to a shortage of available funds which meant that each of the two owners was only paid $52,000, significantly less than the $148,684 accrued for each. Similarly coincidental, the two cases asserted that the unpaid amounts represented deferred compensation albeit neither contractor could produce a deferred compensation plan. One important clarification, the CoFC decision was only in the context of rejecting the contractor's motion to dismiss a government counterclaim (corrected amounts) which would have caused the contract disputes' process to restart. The decision on the merits of the case has not been published although the contractor appears to be facing an uphill battle given the facts and at least some similarities to the more recent ASBCA case.

The bottom line, DCAA field auditors will follow the audit guidance stipulated in the DCAA MRD and given that DCAA is auditing very old incurred costs (e.g. 2007-2009), accrued but unpaid costs which have been on the books for six to eight years will be questioned by DCAA and most likely disallowed by an ACO final decision.

## DOD-IG Reports: An Unexpected Source of Amusement

*By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.*

For many, the thought of reading DOD-IG (Department of Defense—Inspector General) for amusement is analogous to a trip to Russia to learn about business ethics...it doesn't compute. Although DOD-IG reports are not generally a source

of levity (albeit unintended), we've identified a few examples of humor (more accurately, facts and/or statements that would be funny but for the fact they actually are happening within "our" government).

- DODIG-2015-061 pertained to a Hotline Complaint wherein the IG substantiated the complaint and concluded that DCAA had no basis to apply a 20% decrement factor to the subcontract costs included as direct costs on the prime contractor's cost-type contracts. DCAA failed to comply with GAGAS (Government Auditing Standards) by failing to obtain sufficient evidentiary matter, opting instead to apply an arbitrary 20% decrement. At issue was DCAA's highly subjective view of "adequate documentation" which was caused in part by the auditor's failure to consider all of the documentation provided by the contractor (including substantial amounts provided in response to the DCAA draft report). Where's the humor in this fiasco? In responding to the DOD-IG concern that tons of additional contractor furnished documentation had not been considered as required by GAGAS, DCAA (the official agency response) was that they could not determine if the auditor had considered the additional documentation because i) the auditor subsequently left DCAA and ii) the workpapers did not address the additional documentation (one way or the other). This involved an audit which questioned $6.6 million dollars based upon a highly creative (and invalid) 20% decrement factor at a time when DCAA draft and final audit reports were reviewed by multiple layers of local and regional management; hence, for DCAA to assert and for the DOD-IG not to challenge that "DCAA did not know" if the additional contractor furnished documentation had been considered or not considered (in the final report) is ludicrous. It's absurd to even consider that tons of additional documentation in response to a DCAA draft audit report may not have been considered because only the missing auditor would know. Of course the additional documentation was considered and summarily ignored by an untold number of DCAA supervisors and managers who individually and collectively ignored the additional documentation. GAGAS may require DCAA to consider all relevant evidentiary matter, but DCAA seems to frequently discount contractor rebuttals which would derail the audit exceptions.
- DODIG-2014-115 pertains to a $2.1 billion (cost-type) proposal for which the contracting agency awarded the contract without waiting for DCAA's (untimely) advisory audit reports. In fact, MDA, the contracting agency, negotiated the cost type contract value (limitation of cost plus fixed/award fees) at $1.1 billion which reflects the available funds on the research and development missile program. Although the DOD-IG concluded that MDA could have negotiated significantly lower contract values and fees (had they waited for DCAA), the DOD-IG apparently doesn't understand that a cost-type contract has a value (limitation of costs) which is not the final price. The price to the government will be the allowable costs incurred during contract performance and in the case of this particular program, all historical trends suggest that the funded value ($1.1 billion) will need to be significantly increased once additional funding is available. Some degree of levity in the DOD-IG's misrepresenting or misunderstanding the actual impact, but the real levity lies within the chronology of events which suggest that DCAA may not be the best at protecting the interests of the taxpayer given the fact that DCAA continued to audit the proposal even after DCAA discovered that the contract had already been negotiated. Although as an agency, DCAA prides itself on proactively communicating with the customer and the contractor throughout the audit engagement, in this case, DCAA failed to proactively communicate with anyone, but rest assured that in dealing with the DOD-IG review, DCAA blamed its customer (MDA) for all communication failures (and there were plenty to go around). The following dates/events would be humorous but for the fact they actually happened, notably DCAA's failure to come close to a target audit completion date and the fact that DCAA continued to audit a contractor proposal after the contract had been negotiated and oblivious to the fact that the potential contract value had early-on been reduced by approximately 50%:
    - 11/4/2009 MDA (contracting agency) requests the audit of a $2.1B proposal
    - 12/16/2009 DCAA initiates the audit after receiving the proposal from the contractor (no explanation as to why there was a six week time lapse between the request date and the audit initiation date and of course, this is just before the holidays)

- 12/29/2009 DCAA and MDA agree to a 2/15/2010 audit report date (takes 12 calendar days merely to come up with a target audit completion date)
- 1/21/2010 MDA pre-negotiation memorandum with target of $1.18B (program funding approximately 50% of the contractor proposal; yet DCAA continues to audit the $2.1B proposal which will never be negotiated as such)
- 2/11/2010 DCAA coordinates with MDA a new audit due date of 3/15/2010; MDA has been negotiating with the contractor since 2/1/2010 (at this point DCAA's target completion date could have been 3/15/2020, MDA is already actively negotiating the cost-type contract which is merely establishing a statement of work to match existing funding)
- 2/24/2010 DCAA informs MDA that assist audits will not be complete until April; three days later MDA negotiates target cost/fees with the contractor
- 3/4/2010 DCAA (assist auditor at a subcontractor) discovers that the contract has been negotiated; surprise, surprise, without DCAA's advisory report
- 3/4/2010 MDA confirms to DCAA that the contract has been negotiated, but it would include a re-opener clause to consider audit results (seriously---there is no back to the future, there was no re-opener clause and it's virtually unheard of to include a re-opener clause in a cost type contract which is nothing more than a point in time exercise in funding)
- 3/12/2010 DCAA issued its audit report on the prime contractor forward pricing rates
- 4/29/2010 DCAA issued a memorandum to MDA with DCAA's "preliminary" audit results albeit of no use to anyone given that the audit pertained to the original $2.1B proposal which had long been overtaken by funding shortfalls.

As a taxpayer, makes you wonder about the procurement/acquisition process, but rest assured Congress is currently working on acquisition reform, but even if Congress gets it right, it remains to be seen if/how any acquisition reform can remedy a comedy of errors which is primarily attributable to a lack of competence, communications and any concept of teamwork toward a common objective.

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**August 18-20, 2015** – The Masters Institute in Government Contract Costs
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In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

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**Redstone Government Consulting, Inc.**

**NEW ADDRESS**
**Huntsville, AL**
4240 Balmoral Drive SW, Suite 400
Huntsville, AL 35802
T: 256.704.9800

Email: info@redstonegci.com
On the web: www.redstonegci.com