"*The failure mode of 'clever' is 'asshole.'"* – John Scalzi

Several general points of discussion, before diving into the article:

First of all, if you are a small business looking for sales growth, the Small Business Innovation Research (SBIR) program is a sweet way to get some funding for your projects. No doubt about it. But working the SBIR program entails some risk. As we've noted on this blog many times, the primary risk lies in the transition from Phase 1 to Phase 2, as your small business moves from firm, fixed-price contract awards to cost-reimbursement contract awards. With that transition comes a host of new compliance requirements. If you aren't prepared for them, they will bite you squarely in the … pocketbook.

Second, if you are an innovative, entrepreneurial, technology-focused small business, it's more than likely you have some very smart people running the company. Perhaps a couple of Ph.D.'s; almost certainly a few engineers with deep expertise in some important areas. Smart people; well trained in the scientific method. Rigorously logical. Able to identify inconsistencies and exploit them. Excellent!

Just keep them the hell away from the government auditors.

The rules of government contracting, including government contract cost accounting and government contract compliance, are not logical. They are not internally consistent. You cannot smart your way through them. You cannot bulldoze the auditors with your otherwise formidable intellect. That ain't the way that works—not at all.

You master the rules of government contracting by memorizing them, by reading legal cases that interpret them, by working with them and negotiating them. You don't master that body of knowledge by being smarter than the next guy (though that helps); you master it by persevering through it. You accept the logical inconsistencies and the ridiculously complex compliance rules as part of the fabric, and you realize that it's not business: it's government.

Third, many small businesses struggle with how to record compensation for the owner—particularly if the owner is also working on the company's projects. In those circumstances, some of the owner's labor is for the management of the company as a whole – G&A expense labor – but some of the labor is also directly allocable to the project(s) on which s/he is working – direct labor. Direct labor is burdened with other costs, such as G&A expenses. It's a complicated situation often made even more difficult by a simplistic bookkeeping system, or a decision to stick to "cash basis" accounting when "accrual basis" accounting is really the better choice.

When you wrap up the three discussion points above into one government contractor, you have an environment in which the government auditors are going to be looking for things you did wrong … and they are almost certain to find them. You're going to have an accounting system that is ill-suited to your new contracts, coupled with accounting entries that are likely to be non-compliant with requirements you didn't know you had. And your engineers and smart technical folks are going to argue with the auditors, secure in the knowledge that they are the smartest ones in the room … which is going to come across as arrogance (whether justified or not) and is going to cause those auditors to dig in their heels and, perhaps, call in the big guns of the U.S. Government. It ain't gonna be pretty, but it *will* be expensive.

Finally, thanks to Darrell Oyer for pointing out this latest example of SBIR failure in his newsletter. It slipped under our radar screen, but it's got too many lessons in it to ignore. So we'll talk about some of the lessons here.

We will be talking about the April, 2015, **decision** by Judge Thrasher at the ASBCA in the appeal of Accurate Automation Corporation (AAC).

AAC, located in Chattanooga, Tennessee, is the kind of innovative small business the Department of Defense says it wants to foster, one that "specializes in advanced Unmanned Vehicles, Transient Voltage Suppression devices, and other supporting technologies." AAC is a closely held corporation; its President was Mr. Robert Pap. The company employees engineers, scientists and physicists. In the mid-2000's, AAC received two SBIR awards from the U.S. Navy—both of them via cost-plus-fixed-fee (CPFF) contracts.

Mr. Pap was a salaried management employee, but he also worked on at least one of AAC's projects. As we noted above, that situation presents challenges; and those challenges were exacerbated when the company chose not to pay Mr. Pap his full salary because of working

capital constraints. AAC claimed those unpaid costs as salary (including the direct labor portion). Apparently there was some notion that Mr. Pap received additional stock in lieu of the unpaid salary, but that part is kind of hazy.

What's not hazy is that DCAA questioned the unpaid claimed costs and Mr. Pap attempted to argue the auditors off their position. The arguments were of no avail and DCAA issued a Form 1, which questioned $53,788, an amount calculated as the sum of $20,430 in direct labor dollars, $22,398 in allocated overhead costs on those wages, and $10,960 in allocated G&A expenses. The situation was actually a bit worse than that. As the ASBCA decision noted, "The DCAA audit actually reviewed three AAC contracts questioning $95,863 in direct labor costs that were not paid. However, $75,433 of the questioned costs was related to Contract No. N00039-0l-C-2206 which was closed by the time of the audit." The Contracting Officer upheld the disallowance and AAC appealed to the ASBCA.

The primary argument raised by AAC's attorneys was that Mr. Pap had a deferred compensation agreement with his company and thus AAC was allowed to accrue for the salary expenses even though they had not been paid. As Judge Thrasher noted in his decision, the compensation Cost Principle at FAR 31.205-6 contemplates deferred compensation, but puts some conditions in place before such costs can be claimed as allowable. The two conditions for allowability are—

1.

The costs shall be measured, assigned and allocated in accordance with 48 CFR 9904.415, Accounting for the Cost of Deferred Compensation.

2.

The costs of deferred compensation awards are unallowable if the awards are made in periods subsequent to the period when the work being remunerated was performed.

Right away the small business seeking to implement an allowable deferred compensation plan has a challenge, because the Cost Principle invokes Cost Accounting Standard 415. That's a fairly complex and tricky Standard. Suffice to say that the amount of deferred compensation to be recorded in this year's books is the present value of the future compensation to be paid. Good luck with that calculation.

But AAC didn't record the present value of the future compensation; it recorded the full amount. In fact, there was some doubt that AAC even had a deferred compensation plan. The company's attorney's arguments to that effect were undercut by Mr. Pap's audit responses to DCAA, which unequivocally stated that AAC did not have a deferred compensation plan. In another audit rebuttal, Mr. Pap stated that the salary costs had not been paid, even though the company's position was that the salary costs had been paid in stock (or, in the alternative, forgiven by Mr. Pap). Judge Thrasher wrote—

… Mr. Pap's own statements contradict his declarations. DCAA noted and raised this same issue as a result of their review of AAC's 2005 cost proposal. Mr. Pap responded by letter in June 2008 specifically addressing the existence of a deferred compensation plan and unequivocally stated there was no deferred compensation plan in place in 2005, 2006 or 2007 … When DCAA provided him an opportunity to provide proof of payment of the costs questioned for the same reasons in AAC's CFY 2007 proposal, his first response in January 2014 was that he had not been paid yet … Appellant would now have us believe, contrary to his prior statements, that a plan did exist in 2007 and he was paid in 2008. I do not find this credible.

Mr. Pap's words, reprinted by the Court in Finding 3 of the decision, were unfortunate in both content and tone. The content was bad enough, but the tone seemed more than a little condescending. (See our second discussion point, above.)

Do we need to tell you that AAC lost its appeal?