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CHALLENGE TO QUESTIONED COSTS CLAIMED TO BE "COMMERCIAL"

(Editor's Note. Though the government is required to pay a "fair" price for its products and services, there is considerable effort put into lowering prices paid. One of the most fruitful methods of lowering the price paid is to assert that a given cost allocation method adopted by a contractor should be altered to achieve a more "equitable" (translated – lower) price. We frequently encounter such positions in our consulting practice and when we think the government's position is wrong, we challenge them. In our ongoing interest to provide our readers with "real life" case studies, we thought we would present the results of a recent consulting engagement we had to challenge a Defense Contract Audit Agency draft report questioning significant costs on the grounds the expenses were "commercial" and hence not allocable to government contracts. Though every point put forth would likely not apply to your unique circumstances, some most definitely will. The consulting team included our firm and Len Birnbaum of the law firm of Birnbaum and Yumeda LLC. Len is one of the most imminent consultants and attorneys in the field and we are glad to say he is a member of our "Ask the Experts" panel.)

Background

The company (the contractor is real but we will not divulge the name) creates and sells software and provides IT services to a variety of government and commercial clients as both a prime contractor and subcontractor. The market for its software products and IT services varies. Products originally intended for the government market sometime become potential and actual sources of commercial business while, conversely, products developed for commercial use often become attractive to its government sector clients. For example, many of its products and IT services originally targeted for the commercial market such as engineering services, financial services, information management and related software are included in GSA schedules marketed to the government sector.

In 1999, the company purchased a company that sold software to a variety of commercial companies in the agricultural field. The company was attractive because its technology could enhance Contractor's existing line of products and it saw a large potential business in both the commercial and government markets. Though some of the technologies were adapted to Contractor's existing product line, the product line of the new company was discontinued in 2001 due to significant software problems that could not be fixed.

The company has consistently maintained three indirect cost rates: (1) fringe benefits allocated on a total labor dollar base (2) overhead allocated on a direct labor dollar base and (3) General and Administrative (G&A) allocated on a value added base (total costs minus direct material and subcontractor costs).

Activities Associated With the Costs Questioned by DCAA

Included in the labor overhead pool are costs associated with the new business line. Contractor decided to separately track indirect costs associated with the new business to ascertain the initial costs it invested to get the product line up and running and ready to sell. These costs are captured in three accounts - Development, Sales and Technical Support where Development represents writing code, Sales represent outside sales effort and Technical Support primarily represents activities associated with fixing problems with the new product line as well as in-house sales and marketing efforts to identify potential customers' needs.

History of DCAA's Acceptance of Contractor's Indirect Cost Structure

In an audit report issued in early 2001, DCAA found Contractor's accounting system to be adequate for accumulating, reporting and billing costs under prospective government contracts. Specifically, the audit report stated that it found Contractor's accounting structure to provide "a logical and consistent method for allocation of indirect costs to intermediate and final cost objectives".

Earlier incurred cost proposals for 1997 and 1998 had been audited. During this time the company actually proposed creating separate commercial and government rates where DCAA rejected that suggestion, recommending instead that the overhead pool be continued on a company-wide basis. Contractor agreed not to attempt to segregate overhead between government agencies and commercial customers and subsequently submitted its 1999 Fiscal Year Overhead Submission on a basis which did not distinguish overhead rates based on the class of customer. This was accepted by DCAA.

DCAA's Position

In its audit of Contractor's 2000 incurred cost submittal, DCAA eliminated $650,000 of indirect costs from its overhead pool representing the three cost accounts discussed above, asserting these costs were related to "commercial activity." DCAA also eliminated $75,000 from the overhead labor base asserting these were direct costs associated with the "commercial" contracts of the acquired company. The result of these questioned costs were to reduce Contractor's overhead rate by over 25 percentage points.

The basis of DCAA's position was that allocation of about 50% of the firms overhead costs were associated with "commercial activities" of the new product line while the labor base associated with this activity represented only 10% of the total overhead base of direct labor. They asserted the commercial contracts provided little "proportionate benefit" to the government and resulted in an "inequitable" allocation of costs to government contracts. DCAA asserted these costs "represent(s) indirect expenses identified to Contractor's commercial product lines that are not allocable to government contracts and should be allocated to the commercial contracts through a commercial direct labor base." Rather, consistent with FAR 31.201-4(b) and 31.203(b) Contractor should create separate indirect rates for its commercial work.

Basis for Disagreeing with DCAA's Position

1. *Contractor's product lines and technologies are not a "commercial product line."* The agricultural product line is really a family of software products and technologies intended to meet a broad range of needs in both the government and commercial marketplaces. We provided several example of (1) where the technologies of the new product lines were incorporated into several items of its existing work including several government prime contracts and subcontracts in 2000 and (2) government contracts were not only envisioned but were being actively pursued with, for example, the Department of Agriculture.

2. *The costs questioned are homogeneous with other costs in the overhead pool and do not call for separate overhead rates based on classes of customers.* The nature of Contractor's efforts and processes to develop, sell and produce the products are no different than any of its other products. These same type of costs in support of other product lines and technologies are included in the same overhead pool and allocated on the same direct labor base, thus undermining any rationale to create and maintain separate rates for the agriculture products by any other criteria including class of customers.

Further, the agriculture product line does not meet the conditions usually associated with establishing separate overhead rates for commercial and government business. Generally, such practices may be encountered at large firms that maintain separate facilities, have distinctly different production processes and produce unique products or services for each marketplace. None of these conditions apply here.

3. *The expense incurred on the agricultural products is related to expanding the sales and cost base of the company as a whole.* Even if the agricultural product line was exclusively commercial there is a long history of court and board decisions that provide a wide range of costs are allowable and allocable to government contracts when they are necessary for operation of the business and contribute to increasing the company's revenue. The broad application of the principle necessary to the "overall operation of the business" is well grounded in case law (Lockheed Aircraft Corp. vs. United States, 375F.2d 786,794 (Ct. Cl. 1967) and TRW Systems Group of TRW, Inc. ASBCA, 11499, 68-2 BCA 7117).

In another case (Lockheed – Georgia Co., Div. Of Lockheed Corp. ASBCA 27660, 90-3 BCA 22957), the contractor allocated costs through its G&A expense pool costs that were associated with marketing aircraft to commercial and foreign military service customers. The Board held the prospect of increasing non-government business for its aircraft business would benefit the contractor's government contracts by increasing production efficiency. In addition, the Board found that the costs also benefited government contracts because, if successful, the resulting contracts

would absorb overhead and G&A. The Board also recognized that these efforts resulted in technological advances that were applied directly to aircraft sold to the government.

Similar results were reached in questions of allocating indirect costs incurred in connection with expanding commercial business. The Boards ruled that when the potential business provided "general benefit" to the company the costs were properly allocated to government work. In Daedalus Enterprises, Inc. ASBCA 43602, 93-1 BCA 25499 and General Dynamics (ASBCA 18503, 75-2 BCA 11521, Affd., 76-1 BCA 25499) the Boards ruled the sales and marketing costs incurred in promoting commercial business provided "general benefit" to the company. When commercial business did not develop, the Board ruled in Data-Design Laboratories (ASBCA 27535, 85-3 BCA 18400, Reconsideration Denied, 1986 ASBCA Lexis 619 (August 7, 1986) the costs were allocable because the government would have benefited from a reduction in overhead cost had a commercial market developed.

4. *The costs questioned are "G&A and IR&D" type expenses*. After we presented the cases discussed above DCAA asserted they were irrelevant because the disputed costs were included in the overhead pool while the cases discussed only "G&A and IR&D type expenses." We disagree with DCAA's position for two reasons. First, as we have repeatedly asserted and DCAA has not challenged, the costs in question are primarily research and development (e.g. fixing software glitches, researching industry trends) and marketing-type costs (e.g. identifying end user needs), which certainly qualify as "G&A or IR&D type expenses." The fact Contractor chooses to assign these costs to their overhead rather than the G&A pool does not contradict the fact they are the type of costs addressed by the cases which mostly address IR&D and marketing and sales type costs. We do admit the costs in question could have, and perhaps even should have, been included in the G&A pool rather than the overhead pool.

Second, whether the indirect costs are included in the overhead or G&A pool for allocation purposes only makes a difference if a contractor uses the "total input cost" method to allocate G&A. Under these circumstances, the costs are allocated over a broader base. Contractor, however, uses the "value added" method to allocate G&A costs, which excludes subcontract costs and material costs from its base. Therefore, direct labor is the only driver. In other words, the indirect costs in question will be allocated in the same manner whether such costs are included in overhead or G&A.

5. *The equitable estoppel principle precludes retroactive adjustments*. The DCAA draft audit report recommends that the method of allocating overhead costs be changed retroactively to a different method other than what had been proposed, negotiated and incorporated in Contractor's current contracts. With respect to government contracts, the Courts and Boards will not permit a retroactive disallowance of costs when the contractor can show that it reasonably relied on the government's prior conduct. This principle is known as "equitable estoppel" or "estoppel". It applies where the contractor can show a history of acquiescence or approval of a particular cost accounting practice by the government. Based on the information provided below, it is undisputed that Contractor in establishing its indirect cost structure relied on the prior approval by DCAA. In addition, it is undisputed that the government had actual notice of all relevant facts that the government realized or should have realized that Contractor would be severely prejudiced and suffer a loss as a consequence of the retroactive application
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The rule against retroactive cost allowances has been applied in a variety of contexts. Most often it has been applied in cases involving disputes over cost accounting practices of various sorts such as the composition of overhead pools (Wolfe Research and Development Corp., ASBCA 10913, 69-2 BCA 8017 Peninsula Chem RESEARCH Division of Calgon Corp. ASBCA 14384, 71-2 BCA 9066 Sanders Associates, Inc. ASBCA 15518, 73-2 BCA 10055 and Design Laboratories ASBCA 27245, 86-2 BCA 18830) and the method of allocating overhead costs (Litton Systems, Inc. vs. United States, 449 F.2nd 392 (Ct. Cl. 1971), AC Elecs Div., General Motors Corp. ASBCA 14388, et. al., 72-2 BCA 9558, Reconsideration Denied 72-2 BCA 9736).

The pricing of Contractor's negotiated government contracts and commercial services and products listed on the GSA Schedule were based on its long-standing, established and accepted cost accounting practices. Any retroactive adjustment establishing separate indirect costs pools would have a dramatic effect on the pricing of commercial work, which is the basis for establishing prices on the GSA Schedule. Contractor cannot reprice its existing contracts retroactively.

6. *There is a history of acquiescence by DCAA of Contractor's established accounting practice.* DCAA indicated (1) its review of workpapers indicated it was not aware of the practice and (2) its review of Contractor's accounting system in 2001 for purposes of evaluating proposed rates was not relevant for an audit of a prior 2000 incurred cost review. We provided facts indicating not only was DCAA aware of the practices in its earlier reviews but that establishing separate commercial and government rates was discussed and DCAA had advised Contractor against it. As for its 2001 review, we cited DCAA guidance showing review of an indirect rate structure is a basic audit step and should have been reviewed for an accounting system survey. The fact the accounting system was accepted in 2001 does not mean it is irrelevant for a 2000 incurred cost audit – DCAA is now, in 2003, attempting to change a system it previously (in 2001) accepted.

7. *We disagree with DCAA's references to FAR 31.201-4 and FAR 31.203(b) as grounds for disallowing the costs.* FAR 31.201-4 provides that one of three conditions be met in determining whether a cost is allocable to a government contract – as a direct cost or an indirect cost either as a cost that benefits more than one contract or is necessary for the overall operation of the business. The costs being questioned by DCAA certainly are necessary for the overall operation of the business. As for DCAA's observation that the direct costs of the agriculture product labor represents only 10 percent of Contractor's direct labor base, this is perfectly consistent with the nature of most R&D expenditures – the indirect labor is expended first in order to develop the product and then once the product is viable, revenue and direct costs are realized. DCAA has inappropriately taken the normal expenditure sequence of developing products to be indications of a misallocation of costs to government contracts.

Whereas FAR 31.203(b) provides general guidelines in grouping indirect costs (i.e. logical groupings such as manufacturing overhead and G&A, selecting an appropriate distribution base) there is no suggestion that overhead pools should be grouped by customer type. It is simply too great a stretch to reference this FAR section as providing support for distinguishing commercial versus government costs and then advocating that separate rates be established.

8. *Adopting DCAA's position would violate certain other government accounting requirements.* For example, FAR 31.203, which DCAA cites part (b) of that section in support of its position, fails to consider section (c) which prohibits fragmenting the base – "once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements." DCAA has fragmented the base and attempted to retroactively establish indirect cost pools based on the type of customer rather than considering the operational nature of the work.

Though Contractor is not CAS covered, the cost accounting standards are instructive. It should be noted that there would be a violation of CAS 401 (consistency of how costs are proposed , accumulated and reported) because DCAA's proposed retroactive establishment of separate rates would conflict with the manner in which it proposed prices on its prior contracts including its prices used on the GSA schedule.

Further, CAS 418 provides that indirect costs shall be accumulated in indirect cost pools, which are "homogeneous." The Standard provides in part: "An indirect cost is homogeneous if each significant activity whose costs are included therein has the same or a <u>similar</u> beneficial or causal relationship to the cost objectives as the other activities whose costs are included in the cost pool." (underscored for emphasis). Contractor's overhead pool is homogeneous. The elements included in its overhead pool, for the most part, have the same or similar beneficial or causal relationships. As stated above, Contractor is a labor-intensive business and the support costs are similar for both government agencies and commercial customers. Contractor's employees are not assigned by class of customers and they work on both government and commercial contracts.

9. *DCAA misinterprets the concept of "benefit".* DCAA's allusion to Contractor's practices not providing "benefit" to the government resulting in an "inequitable" allocation of costs indicates they are unaware of a recent, seminal case – <u>Boeing North American, Inc. v. Roche</u>, 282 F.3d.1320, 1329 Fed Cir. 2002). That case ruled "the word 'benefit' as used in FAR 31.201-4, refers to an accounting concept and does not impose a separate requirement that a cost benefit the government's interest for the cost to be allowable." The case held the concept of "benefit" used in FAR 31.201-4 refers only to an accounting concept which describes the "nexus" required between the cost and the contract to which it is allocated. The Court held "the requirement of a 'benefit' to a government contract is not designed to

permit…an amorphous inquiry into whether a particular cost sufficiently benefits the government so that the cost should be allowable."

We are waiting to hear DCAA's response.

IMPACT OF SMALL BUSINESS FINANCING DECISIONS ON COST AND PRICING REQUIREMENTS

(Editor's Note. One of the advantages of being a small business is the considerable financial flexibility they have. Unlike publicly held companies subject to a world of constraints imposed by the investor community – keeping stock price high, maximizing profit, maintaining an ideal capital structure of debt and equity, staying within pre-established financial measurements (e.g. ROE, ROA, ROI), keeping wealth within the company, substituting short term growth for long term health, etc. - small companies can and do follow different objectives resulting in a wide variety of behavior. Owners' decisions significantly impact the cost and pricing of government contracts. Though we reference no particular source, the small business behavior described and the impact on government requirements are based upon our observations of hundreds of companies during our consulting engagements.)

Small Business Behavior

The unique behavior decisions facing owners of non-publicly traded companies often differ significantly from what the "ideal" business behavior described in various business textbooks. This behavior is usually no less sensible and includes:

What profit levels to maintain. Some companies may choose to maximize reported profit to satisfy banks, investors or potential buyers while other companies may choose to hire lots of family members or spend lavishly on recreation activities that can be write-offs of the business. Or, companies may choose to make heavy investments in research and development even though such high up front costs can hurt reported profit.

Ideal capital structure. Textbook financial theory prescribes ideal levels of equity versus debt to maintain which are generally followed by publicly traded firms. Maintaining this ideal capital structure is less important than other considerations to smaller privately owned firms. For example, since most debt for small businesses require personal guarantees many smaller companies care less about capital structure and more about their personal risks, making them more reluctant to borrow. Also, equity investments are frequently disguised as debt to allow greater access to funds. Or, though financial theory prescribes matching long term borrowing to long term assets and short term borrowing to short term assets, such prescriptions go out the window when the need to finance growth spurts or keep the vendors paid motivates owners to obtain any kind of financing they can get.

Also with respect to what level to keep retained earnings, traditional finance theory prescribes keeping this equity component high while business owners have other priorities. Decisions to keep retained earnings high are usually made so wealth stays in the company and payment of taxes are kept to a minimum while decisions to keep it low are a result of either paying more expenses from the company or transferring wealth out of the company.

Use of Assets. The assets of some companies may be bloated with not only business assets but also "personal assets" while other companies may include little or no assets where owners prefer to own the assets and rent them to the business.

Essentially, many of the business decisions affecting small privately owned companies come down to the personal preferences of the owners. The first decisions owners must make are where should the wealth of the company go – how should it be split between the owners and the company. That basic decision will heavily influence whether funds remain in the company or distributed out, whether assets remain business assets or become assets owned by the owners and family and leased to the business, how much and when are taxes paid, etc.

Implication for Government Contracting

These basic decisions have major implications on the cost and pricing rules government contractors must follow:

- **When personal assets are part of the business**

Many owners keep as many assets as possible in the business that include not only the essential assets needed to conduct business but additional ones from autos to hunting lodges and chalets. Many of these assets can be a source of additional cost recovery on government contracts as depreciation, cost of money,

etc. Of course, contractors should be prepared to demonstrate the assets have a business purpose and the advantage of added cost recovery must be weighed against the resulting higher contract prices that can make contractors noncompetitive. If the owners do decide it is in their interests to keep wealth within the company yet fear their cost structure makes their government pricing too high, they may voluntarily delete the costs associated with many of their assets when computing their indirect rates.

♦ Leasing business assets to the company

Many business owners choose to transfer wealth out of the company, buying then leasing to the company assets needed to run the business. The amount the company (government contractor) pays the owner of the asset is often problematic, especially when owners want to maximize the cashflow they receive from the business. Auditors consider such arrangements as related party or less-than-arms-length transactions and they receive considerable scrutiny. Where the contractor often rents the use of assets at market value, the government usually requires the lower of "cost of ownership" or market value. However, rental costs may be allowable when the same asset is rented to non-affiliated entities so as to constitute a commercial rate.

The allowable costs of ownership the contractor pays the related party is supposed to be the same costs as if the company owned the asset. Such costs include depreciation, taxes, insurance, repairs and maintenance and cost of money. FAR 31.205-36 states and several board cases have ruled that cost of money may be included as an element of ownership even if it was waived as a factor in the price or estimates of individual contracts.

Depreciation costs are primarily covered by FAR 31.205-11 and CAS 404 and 409. There is considerable latitude how these costs are computed. For example, the period of capitalization of the asset can vary depending on its "economic life". Also the method of depreciation (e.g. straight line, accelerated methods) can provide considerable latitude. The level of audit scrutiny will often vary by class of asset. Real estate arrangements are always examined (auditors will ask to see copies of leases) while other classes of assets may be scrutinized less, especially if the amounts are not significant. Be aware that arguments that the rental amount is the "going market rate" is seldom accepted unless you can show (1) there is a "commercial market" for your assets – you lease the same assets to non-related parties or (2) the market rate is less than the ownership costs.

If the assets are older, and fully depreciated, then cost of ownership costs must be replaced by unique rental arrangements. Like usage rates of fully depreciated assets in the company, use charges of assets owned by related parties and leased to the company need to be negotiated and documented in advance agreements. FAR 205-11 states that in computing a reasonable use charge, consideration should be given to (1) the replacement cost and estimated useful life at the time of negotiation (2) the effect of increased maintenance costs and decreased efficiency because of the age of the asset and (3) the amount of previous charges made to government contracts and subcontracts. Many government departments maintain schedules of costs they charge contractors who use government furnished property on commercial contracts and those schedules might be useful in providing bases for usage charges. As previous board cases have ruled (e.g. S.S. While Dental Manufacturing Co., ASBCA No 4102) use charges need not be recorded in the books and records of the contractor for it to be charged to the government.

♦ Family members and friends on the payroll

Compensation of business owners of closely held firms are closely scrutinized by the government. As we discussed in "Executive Compensation" (Vol.4, No.4 of the GCA DIGEST), DCAA has rewritten its guidance to ensure senior executives and owners of small companies receive close inspection. First, "high risk" individuals have been broadened to include employees who can exercise influence over their compensation to include owners, partners, individual executives and officers as well as their family members. Auditors are told to determine if the individual level of compensation is "reasonable" where the burden of the reasonableness test often falls on the contractor to demonstrate their level of compensation is reasonable. Auditors are instructed not to limit their review to only those employees holding high-level positions. Auditors attempt to determine if the level of compensation is matched to the job class and to ensure high risk individuals have the same duties as other members of the same class. For example, if the President's son is an engineer the auditor must confirm (sometimes with technical assistance) the son is not over-graded at a higher level of engineer or is overpaid for the work they perform.

♦ Award of perks

Certain perks (e.g. memberships, etc) will likely be scrutinized closely while others (e.g. auto leases) may not. We have seen auditors attempt to disallow many perks, claiming they are unallowable "entertainment" expenses or they should be included as compensation and then disallowed as "excess compensation" if the total exceeds certain benchmarked amounts or is a "distribution of profits." You should be able to defend the expenditures as business related and demonstrate they are not disallowed by a cost principle. You should also be able to defend your compensation level as "reasonable" if the perks are included as compensation. Comparison of your practices with those in your industry would also help.

♦ Spend on recreation

Certain recreation costs are clearly unallowable costs while others would likely be considered appropriate business expenses not considered unallowable according to FAR cost principles. For example, sporting events, golf club membership, etc are explicitly unallowable as entertainment costs. Others may be allowable such as meals where business is conducted (unlike IRS guidelines, 100% is allowable). Others fall into gray areas and contractors take varied approaches to including or deleting such costs. Those more conservative will identify all gray area costs as unallowable while others will consider a hint of business purposes as justification for maintaining the costs are allowable. Remember, auditors will most likely select certain expense accounts, examine all or a sample of transactions and make determinations of allowability from there. If a transaction is subject to penalties (e.g. "explicitly" unallowable costs) contractors may want to take a more conservative approach with those while other costs not subject to penalties could justify a less conservative approach.

♦ Financial capability audits

Auditors are now instructed to conduct more frequent financial capability reviews of contractors. One of their first steps is to obtain financial statements, compute common ratios (e.g. profit margins, return on equity, return on assets, working capital levels, asset levels, etc.) and compare the results against established standards to determine if there is any financial risk. If your ratios are outside of the norm, you want to avoid any assertions that you do not have the financial wherewithal to perform your contract. The guidance followed by auditors has, in the main, been drafted to reflect sound financial decisions found in the public sector rather than less optimal but nonetheless sensible financial decisions taken by smaller business owners. If the resulting financial ratios cause concern, the auditor may need to take into account certain decisions made by the business owner. For example, if the owner chooses to minimize assets in the company and instead buys them outside the firm and leases them back then the auditor needs to reflect this in the report. Or, for instance, if return on equity is low, you may want to indicate the reasons retained earnings are higher than normal. Or, again, if equity levels are excessively low, you may need to demonstrate how certain "loans" are really disguised equity.

NEW PROPOSED REVISIONS TO CIRCULAR A-76

(Editor's Note. The Bush Administration's emphasis on outsourcing the acquisition of goods and services from the public to the private sector is expected to open up enormous opportunities to government contractors. The manner in which the government decides whether to contract out or continue to have government employees provide the items is covered by the Office of Management and Budget (OMB) Circular A-76 and since 1983, the Circular A-76 Handbook. A recent proposal to significantly change A-76 has become, thus far, this year's "hot topic", generating positive comments from both the public and private sectors and considerable commentary (e.g. January 21, 2003 issue of Federal Contract, the Winter 2003 issue of The Lyman Group, January 8, 2003 issue of The Government Contractor).

Background

Under the current Circular A-76 and the Handbook, if "commercial" goods or services are being produced or performed by government employees the government will generally not "outsource" them to the private sector unless the private sector prevails in a "cost comparison" between the public and private sector. Once a suitable in-house commercial-type activity is identified the first step is for a cost comparison among private offerors. The successful contractor proposal from that competition is then compared to the cost of continued in-house performance. The cost comparison process then involves six steps:

1. The development of a Performance Work Statement (PWS) and Quality Assurance Surveillance Plan (QASP)

2. The performance of a management study to determine the Government's Most Efficient Organization (MEO)
3. The development of an in-house Government cost estimate
4. Issuance of a request for proposal or invitation for bid (IFB)
5. Comparison of the in-house bid against the proposed private sector bid
6. The inevitable appeal process designed to assure that all costs entered into the Cost Comparison Form are fair and accurate and calculated in accordance with the guidance of the supplement handbook.

Under Circular A-76 the competition to select the private offeror to be compared to the in-house offeror is limited either to the low bidder in response to an IFB or to low cost/technically acceptable offeror in a negotiated procurement. A 1996 revision provides for the possibility of a "best value" comparison (cost/technical tradeoff) and an adjustment to the offeror's bid to make them comparable but this provision is often confusing and has rarely been followed.

In response to numerous concerns expressed inside and outside of government Congress required the Comptroller General to convene a panel of experts to study the policies and procedures related to transferring commercial activities from government to federal contractors. The following changes primarily adopt the Panel's recommendations.

OMB's Proposed Changes

The changes would rescind the existing Circular and Supplemental Handbook and replace them with a completely rewritten two-page Circular and six attachments:

Attachment A:	Inventory Process
Attachment B:	Public-Private Competition
Attachment C:	Direct Conversion Process
Attachment D:	Inter-Service Support Agreements (ISSA)
Attachment E:	Calculating Public-Private Competition Costs
Attachment F:	Glossary of Acronyms and Definitions

The changes are intended to modify several perceived weakness including (1) the Circular provides excess opportunities for agency work to be performed without competition (2) the competition process is too complicated (3) there is insufficient flexibility to make best value decisions (4) many believe the process is susceptible to "gaming" and (5) accountability for results is lacking.

Key Changes to Circular A-76

♦ Establishing the presumption that activities are commercial

Under the changes a government activity is presumed to be commercial and hence subject to A-76 competition unless an agency can demonstrate it meets the new definition of "inherently governmental activity." This should certainly expand the government activities that are subject to public-private competition.

♦ Standard Competitions

Public-private competitions are now called "standard competitions" and will occur under one of four procurement methods:

a. *Sealed bid method.* This method matches FAR Part 14 for private sector offerors where a price is given and rarely challenged unless there is a question about a responsibility determination. For public sector offers, contracting officers must evaluate offers for responsiveness and cost realism, including a determination that there are no material unbalanced bids. The emphasis on evaluating "cost" rather than "price" realism, which more closely follows FAR 15.414 rather than FAR Part 14, reflects the government's acknowledgement that current public sector accounting systems are incapable of collecting financial data with enough precision to allow for price analysis.

b. *Negotiation acquisition method using the Lowest Price Technically Acceptable (LPTA) method of source selection.* Under the LPTA and the CTTO procurements discussed below, all tenders are opened simultaneously. Exchanges may then occur between the source selection authority (SSA) and offeror representatives in accordance with FAR 15.306 that may include (1) clarification without discussions when the contracting officer intends to make a contract award without discussions (2) communications leading to competitive range determinations and (3) discussions after the competitive range has been determined.

c. *Negotiation acquisition using the Cost/Technical Tradeoff (CTTO) method of source selection embodying the Integrated Evaluation Process.* Under the CTTO method all offers are received and evaluated simultaneously in accordance with rules in FAR 15.101.1 when an agency desires to consider award to other than the lowest-priced offeror or other than the highest technically rated offeror. In an effort to overcome the Defense Department's constraint to make awards under public-private competition on the basis of lowest price, the OMB has come up with a hybrid approach called the Integrated Evaluation Process. Under the process, an agency offer may be eliminated from the competitive range on factors other than lowest price. Once the competitive range is established for all remaining parties, the SSA may make a decision based on low cost or other than low cost in which case it must summarize its decision, provide a narrative explaining the cost-technical tradeoff and a quantifiable rationale for the decision based on other than lowest cost.

d. *Negotiation acquisition using the Cost/Technical Tradeoff (CTTO) method embodying the Phased Evaluation Process.* Under the Phased Evaluation Process, the agency would solicit submissions of only technical proposals during Phase 1 and encourage the private sector offerors and the in-house MEO to propose performance standards that differ from the requirements stated in the solicitation. The SSA will determine whether any of the proposed standards are necessary within its budget limitations and if they are accepted the CO will issue a formal amendment to the solicitation stating the specific changes. Upon receiving the proposed revisions, the SSA will conduct negotiations in accordance with FAR 15.306. Then in Phase 2, all parties submit cost proposals based on the revised changes where the low cost proposal will be selected. (*Editor's Note. Some commentators have indicated this will not be viewed well by the private sector because it is precisely the enhanced performance standards and manner of achieving them that provides them competitive advantages under traditional best value competitions and release of such "proprietary information" to all will eliminate their advantage.)*

♦ Compressing Competitions to 12 Months

The proposed changes will require agencies to complete A-76 competitions within 12 months with the threat that work will be competitively outsourced if not completed. The OMB has mandated that agencies following one of the four above procurement methods must complete the process from beginning of public announcement to performance decision date within 12 months (there is a one time six month extension allowed if granted by the deputy director of procurement of OMB). This is a sharp change from previous rules that allowed competitions to last for as much as four years. The consequence of exceeding these time limits can result in the source selection occurring only among private sector bidders, which is a big change from current rules that cancel the competition and retain the work in-house when timeframes are exceeded.

♦ Incorporating FAR principles in procurement process

The changes intend to use FAR procurement procedures to the maximum extent possible including:

Greater uniformity in applying basic requirements. For example, in-house offers (referred to as "agency tenders") will be required to respond to a solicitation within the same timeframes required of private offerors or other public agency tenders or risk elimination from the competition. Another example is elimination of separate reviews of in-house proposals by an Independent Review Official (IRO) while others are reviewed by the source selection evaluation board (SSEB) where now the SSEB will evaluate all offers simultaneously.

Communications and negotiations. Now communications and negotiations will be guided by FAR principles covering exchanges between the government and private sector.

Post award accountability for in-house performance similar to that expected of private sector contractors. For example, agencies relying on in-house providers or public reimbursable providers will be required to document changes to the solicitation, track actual costs and be terminated for failure to perform. Agencies will also be required to re-compete work being provided in accordance with the same time limitations imposed by the FAR on contracts with the private sectors.

Better planning in accordance with FAR Part 7. In effort to eliminate failed A-76 competitions in the past or ones where poor results stemmed from failure to identify proper grouping of activities, agencies must now follow similar steps contemplated under FAR Part 7 to (1) gather workload data and establish data collection systems (2) designate competition officials (3) determine roles and responsibilities of participants and (4) develop a preliminary completion schedule.

♦ Other Important Changes

Recognition of key differences between private and public offerors. Though there is considerable effort to level the competitive playing field the changes do recognize that not all provisions of a solicitation apply equally to both the public and private sector. For example, agency offers will not require (1) labor strike plans (2) small business strategies (3) subcontracting goal plans (4) participation of small disadvantaged business (5) licensing or other certifications or (6) past performance criteria unless a government MEO has already been implemented.

More competition of ISAAs. The changes will expressly require agencies compete commercial ISAAs and expressly authorize agencies to compete against the private sector as well as other agencies. The OMB states the proposed changes will expand public versus private competition by eliminating numerous exceptions that have permitted federal agencies to provide services to one another, usually on a sole-source basis, in the form of inter-service support agreements (ISSA). All commentators have lauded the new requirement to re-compete these commercial activities as a major source of increasing opportunities for private contractors.

Avoiding COI. The proposal seeks to implement rigorous measures to avoid organizational conflicts of interest by separating teams that work on A-76 competitions and defining what constitutes conflict. Responding to sensitivity that there is or may be conflicts of interest in having the same individuals prepare and evaluate offers or the same individuals evaluating offerors being adversely affected when private firms win an award, the proposed rules call for separation of the PWS team, the MEO team and the SSEB team. However, PWS team members may participate in the SSEB if they are not directly affected by the competition. The mere fact that individuals may provide data, management information, costing data or other technical support does not constitute personal or substantial involvement.

One controversial area that was not affected by the proposed changes is there are no new proposals to improve the way government calculates its proposed costs.

Know Your Cost Principles…
RESTRUCTURING COSTS

(Editor's Note. Many of our clients and subscribers have been, are or will be going through restructuring arrangements – mergers, acquisitions, divestments, reorganizations with other entities, etc. – and the rules covering allowability of the resulting costs are quite confusing. The confusion often centers around "external organizations" versus "internal organizations" and when is a cost versus benefit analysis needed to make restructuring costs allowable. Even when that hurdle is surmounted there are a variety of specific FAR cost principles related primarily to facilities and compensation costs as well as cost allocation issues that present additional barriers to recovering these costs. We will present some background information on the regulations and consider what auditors will likely be looking at in making a determination of whether the resulting costs are allowable. The source of this article is a variety of texts including our favorite "Accounting for Government Contracts" by Lane Anderson and the July 2002 version of the DCAA Contract Audit Manual (the relevant sections have been updated from earlier versions).

Background

Definition. External restructuring costs are the non-routine, nonrecurring costs after a business combination that affect the operations of the business entities that were not previously under common control. Normally these costs are considered to be incurred within three years of the business combination. DFARS 231,205-70(b)(4) defines external restructuring costs as the costs, both direct and indirect, of restructuring activities. Restructuring activities are defined as non-routine, nonrecurring or extraordinary activity to combine facilities, operations or workforce to eliminate redundant capabilities, improve future operations and reduce overall costs. (*Editor's Note. These "external restructuring" costs are a result of a business combination and are distinct from "internal restructuring" costs that also may include similar activities but relate to actions affecting only one business unit rather than one or more business units newly under common control.*)

Regulations. The government was ambivalent over a rash of corporate reorganizations in the early to mid nineties. They recognized that lower defense spending required consolidation of defense related industries and this was a good thing if it maintained a strong defense industrial base but they worried that the riches being generated from the reorganization would add costs to government contracts. Such concerns led to the National Defense Authorization Act of 1997 which provided that restructuring costs stemming from business combinations after September 1996 would be allowable only if (1) audited savings for DOD contracts exceeded the costs by a factor of two to one and (2) the business combination had to result in the "preservation of a critical capability." Regulations

implementing this legislation are at DFARS 231.205-70.

The DFARS provided dollar thresholds for when the regulations would apply and established several steps before external restructuring costs could be reimbursed. The limitations the regulation puts on cost recovery apply to only those companies where the restructuring costs are $2.5 million or more of costs allocated to DOD contracts. Costs less than $2.5 are considered immaterial and the limitations of recovery do not apply. The $2.5 million amount refers to all restructuring activities associated with a business combination and is not to be applied project by project or business segment by segment. A decision that the threshold is not met cannot be reversed in the future if conditions change (e.g. business mix differs from projected mix).

In accordance with DFARS 231.205-70 the other conditions for allowability include (1) contracts must be properly novated to the appropriate business entity (2) the contractor must submit a proposal for the planned restructuring projects that includes a breakout of costs by year and cost element showing projected costs and savings and an audit conducted to ensure unallowable costs are excluded *(though too detailed to recount here, see the Defense Contract Audit Agency Manual, Chapter 7-1903 for details on what must be included in the proposal and Chapter 7-1906 how DCAA will audit it)* and (3) the ACO must negotiate an advanced agreement that provides a cost ceiling for allowable restructuring costs. Until these steps are completed, the contractor must segregate the restructuring costs and make sure they are suspended from billings, final cost settlements and overhead rate settlements.

Cost Issues Affecting Allowability and Allocability of Restructuring Costs

Restructuring costs with less than a $2.5 million impact on government contracts or that can demonstrate a two for one cost savings are allowable but several cost principles and rules of cost allocation set up substantial barriers to full cost recovery.

Organizations costs. FAR 31.205-27 restricts the allowability of these costs by stating merger and acquisition costs and the costs for resisting mergers and acquisitions as well as costs for divesting organizations are unallowable. These costs related to setting up the reorginization include fees like attorneys, accountants, investment bankers and consultants as well as other expenses such as banking and incorporation fees.

We should note the wording of this cost principle uses the phrase "reorganization" which is often confused by both contractors and auditors because "internal reorganization" of contractor activities is commonly used for reorganizing existing businesses not involving a merger, acquisition or divestment. The cost principle was never intended to restrict the cost allowability of such activities.

Environmental remediation. Environmental cleanup effort frequently arises in connection with restructuring activities but, in general, DCAA asserts the remediation costs (e.g. soil or water contamination cleanup, asbestos removal, etc.) do not meet the DFARS definition of restructuring costs. Hence, these costs should be excluded from any cost versus savings analysis provided to the government and should be negotiated under a separate agreement.

There are several facility related costs subject to various cost limitations that affect otherwise allowable restructuring costs. For instance (1) *idle facilities* and *idle capacity* under FAR 31.205-17 limit reimbursement to one year unless the ACO agrees to a longer period (2) FAR 31.205-52 restricts *asset write-up* costs such as depreciation, cost of money, etc to costs that would have been incurred had the reorganization not occurred (3) FAR 31.205-16 limits estimates on *gain/loss on asset sales* only to contingencies where there is a ready market and sales are reasonably foreseeable (4) FAR 31.205-31 precludes *plant rearrangement* costs for returning a plant to commercial use unless there is an advance agreement and (5) FAR 31.205-21 restricts *extraordinary maintenance and repairs* to a factor calculated for gain and loss on a sale rather than a normal period cost.

There are also several employee related costs that limit full recovery of otherwise allowable restructuring costs. For example (1) employee termination costs such as *early retirement incentives* and *severance pay* have certain restrictions in accordance with FAR 31.205-6 (2*) retention pay*, especially "golden handcuff" arrangements are unallowable in accordance with FAR 31.205-6(l) (3) *relocation* costs have several limitations under FAR 31.205-35 and 46 (4) *recruitment* costs under FAR 31.205-34 has certain restrictions (5) *employee training* costs must pass muster with FAR 31.205-44 and (6) *bonuses* must meet several conditions in FAR 31.205-6 before they are allowable, In addition, any increase in costs resulting from changes in *pension plans* and *post-retirement health benefits* are not considered restructuring costs according to DFARS 231.205-70 and hence are subject to separate review

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by specialized auditors who will evaluate changes in accordance with FAR 31.205-6 and CAS 412 and 413.

♦ Allocation considerations

The DCAM Chapter 7-1909 provides guidance to auditors in various cost allocation issues:

1. *Deferral versus expense method*. CAS 406.61 was amended in 1997 to require specific restructuring costs of one restructuring event (say acquisition of Company A) to be treated as a deferred charge and amortized over a period in which the benefits are expected to be accrued but not longer than five years. The restructuring costs of a second restructuring event (say acquisition of Company B) may be expensed. Subsequent guidance issued by the Director of Defense Procurement on May 20, 1997 provided it would be acceptable for ACOs to agree to allow contractors to expense restructuring costs in one period when the government benefits (the impact on government contracts would be favorable if, for example, the mix of government contracts were such that there were more contracts at a later date than in the period the costs were expensed).

2. *Direct costs*. Direct restructuring costs which benefit a single cost objective should be charged to only that objective. For example, if a contractor's restructuring activities result in the need to recalibrate special test equipment used on only one contract then the recalibration costs should be charged to that one contract.

3. *Indirect costs*. For indirect restructuring costs, they should be allocated in accordance with CAS 403, allocating home office costs, if they are incurred at the home office. If incurred at a business segment level where the benefit is for more than one segment, the costs should be assigned to the home office and allocated, again, according to CAS 403. If the costs are incurred at only one segment and benefit only that segment, they should be allocated only to that one segment in accordance with CAS 418.

4. *Accounting change*. If the contractor does not have an established or disclosed cost accounting practice covering restructuring costs the deferral of such costs is considered an initial adoption of a cost accounting practice and not an accounting change. If a contractor does incur restructuring costs and has a disclosed practice that does not provide for deferring such costs, then it is considered a cost accounting practice by DCAA when the cost is deferred.

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