GCA DIGEST

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UNIQUE ISSUES RELATED TO BUYING OR BEING ACQUIRED BY A GOVERNMENT CONTRACTOR

(Editor's Note. Companies doing business with federal, state and local government are now" hot" targets to be acquired. Equally, companies in the government arena are looking to buy other companies to diversify or expand their capabilities. Transactions involving government contractors involve several unique administrative issues while failure to understand certain key costing and intellectual property issues can significantly affect the value of the target company. For the discussion below of name changes, conflict of interest and small business we have used many of the ideas in a recent article written by Agnes Dover of the law firm of Hogan & Hartson, LLP written in the July 2004 issue of Briefing Papers while for the discussion of the novation process, cost issues and intellectual property we have mostly relied on our consulting experience helping firms evaluate acquisition candidates.)

Novation Process

Though long-lived statutes (e.g. Anti-Assignment Act) prohibit transferring contracts to another company, the government recognizes the need to provide the means to transfer a contract when ownership changes and assets are transferred. FAR 42.12 sets forth the basic and procedural requirements for recognizing a successor in interest to a government contract when that contractor's assets are transferred. Generally, the government will want a Novation Agreement for most transactions that are not pure stock purchases. Even when there is such a stock purchase arrangement the FAR states there may be issues related to the change in ownership where a formal agreement is appropriate. FAR 42.1202 provides detailed instructions on how to notify the Administrative CO, what information to provide (e.g. documents describing the transaction, list of affected contracts, evidence of capabilities to perform) and required documentation such as authenticated copy of the instrument effecting the asset transfer, certified copy of board's minutes and authorization to the asset transfer, articles of incorporation of new entity, legal opinion the transfer is effected under applicable laws, balance sheets, evidence security clearance requirements are met, etc.

A Novation Agreement is the vehicle for the government to consent to assignment of a contract. It is three-way agreement (i.e. tripartite) between the seller, buyer and the government. In the typical Novation Agreement, the government recognizes the buyer as the successor-in-interest to the seller. The seller waives "all rights under the contract" against the government and guarantees the buyer's performance (or in lieu of a guarantee, offers a suitable performance bond). The buyer, in turn, assumes the seller's obligations under the contract. FAR 42.1204(e) sets forth a model Novation Agreement. The FAR states this model agreement may be adapted to fit specific cases. It is not uncommon for the government to set forth additional clauses that may not be in the FAR.

One peculiarity of going though the novation process has to do with timing. FAR 42.1204 contemplates that a request for a Novation Agreement will normally be submitted after the transaction has been consummated. For example, the FAR requires "authenticated" copies of the transaction documents, balance sheets certified as of the date immediately following the transaction, and legal counsel's opinion on the legal validity of the transfer. As a practical matter the buyer and seller should enter into a separate agreement (e.g. subcontract) in which the seller delegates to the buyer authority to perform government contracts in the seller's name for a period of time after the closing until all Novation Agreements are executed.

Change-Of-Name Procedure

When no novation is required, such as where there is a stock purchase or merger, if the name of the contractor entity is expected to change you must prepare and submit several documents in support of an application for recognition of name change. FAR 42.1205 addresses the "Change-of-Name Agreement" package such as signed copies of the agreement, authenticated copy of the document effecting the name change, legal opinion and list of affected contracts that identify the CO for each.

If a change-of-name procedure is called for it is prudent to contact the government early since it is not

uncommon for the ACO to prompt a request to undertake the novation process even though no novation is legally required. Early consultations will provide an opportunity to explain why the novation agreement is not necessary. The process for the change in name typically takes a few weeks to a few months. Once approved, each contract should be modified to reflect the name change.

Assignment of Proposals

The courts and GAO have held that assignments of bids and proposals are not precluded by law. The key requirement is that the original offeror remains intact with access to the same resources and with the intention to honor its prior commitments. (*Editor's Note. A former employer bid on and was about to be awarded a $75 million contract where offers of our large corporate parent's resources were considered a significant positive factor in our evaluation. Before award, we found out our large corporate parent had sold us to a smaller firm, and in spite of assertions that our former corporate parent would continue to support our contract, the government awarded the contract to someone else reasoning the benefit of our association with our former parent was no longer valid. Morale: be careful about the impact of changes in ownership on future and outstanding bids.)*

In spite of the fact that transfer of bids and proposals are allowed, special steps may be needed. The FAR requires that before awarding a contract, the CO must determine whether the offeror submitting the proposal is "responsible", with adequate financial resources, past performance evaluations and record of integrity. The authors recommend notifying the procuring CO of the transfer of the pending bid to avoid any confusion. However, before notifying the procuring CO the transferee should determine whether the transfer would negatively impact the evaluation of the bid.

Organizational Conflicts of Interest

Mergers and acquisitions where both the buyer and seller are government contractors can raise issues. When the buyer and seller operate in related business areas, such as advisory or assistance services, the acquisition of one entity by another can create organizational conflicts of interest (OCI) making the need to plan and guard against unexpected loss of business opportunities resulting from OCIs.

FAR Part 9.5 defines the basic rules, stating an OCI "may result when factors create an actual or potential conflict of interest on an instant contract or when the nature of the work to be performed on the instant contract creates an actual or potential conflict of interest on future acquisitions." COs are charged with identifying and evaluating potential OCIs as early as possible and once identified, the CO must "avoid, neutralize or mitigate" potential conflicts before contract award. To protect against OCI concerns, the regulations specifically limit the award of some contracts to contractors providing specific services. For example, a contractor providing systems engineering and technical direction cannot be awarded a contract to supply the system or any of its component parts. Or, if a contractor prepares and furnishes contract specifications, the contractor must generally not be allowed to furnish these items as either a prime contractor or subcontractor. FAR 9.508 provides examples of nine different situations where OCIs might arise.

♦ OCI Avoidance and Mitigation

A careful review of potential OCI concerns is important to identify and find actions to mitigate them. For example, a transaction can result in a situation where the resulting entities can be disqualified from certain competitions. Or, the merger can create OCIs that force the acquirer to relinquish some of its or the targets existing contracts. The parties need to be forward-thinking and suggest strategies to the CO to avoid or mitigate any potential OCI concerns.

The initial step in an OCI due diligence review is for the companies involved to identify those sectors of their business where OCI are likely to develop. For example, if the target specializes in advisory and assistance services the acquirer should review whether it is currently supplying products connected with those services. Or, if the target is providing systems engineering and technical assistance services for certain products the acquirer should evaluate the effect of these services on future business.

Once actual or potential OCI issues are identified, the owner of the contract – which could be the target or acquirer – should determine whether existing mitigation plans, if any, are sufficient to handle an OCI. The parties need to decide whether the owner of the contract is prepared to take the necessary steps to avoid the OCI. For example, a mitigation plan can provide for "firewalls" separating the conflicted sectors of the merged entity. A more drastic step might call for the acquirer to divest that portion of the target's business that creates the OCI.

Acquiring Small Business Entities

Special issues arise when a large business acquires a small business that is receiving contracts under various Small

Business Administration programs. Generally a small business may be eligible to receive preferential treatment in connection with government contracts or grants. The term "small business concern" means a concern, including its affiliates, that is independently owned and operated, not dominant in the field of operation and is qualified as small under SBA size standards. The SBA determines the size status, including affiliates, as of the date the firm submits a written self-certification that the firm is small as part of its initial proposal. There is no requirement that an agency terminate a contract where a small business concern becomes "large" after the self-certification. Recently, the GAO recognized in a recent decision that the government may exercise an option to extend the term of a small business set-aside contract notwithstanding the fact the contract is no longer held by a small business. The GAO said there was no requirement that a business must maintain its small status throughout contract performance after it self-certified itself as small.

♦ 8(a) Contractors

The general rules described above are different if the contract is performed by an 8(a) firm. Technically, 8(a) contracts are subcontracts to the SBA which acts as the prime contractor to the actual buying agency. In general, 8(a) contracts must be performed by the company that obtained the original 8(a) contract. The SBA's rule require the acquired company be considered together with the controlling parent company for purposes of determining size status and ownership by minority persons, even if the business were to continue in existence as a subsidiary.

Additional rules apply when an 8(a) contractor (or its assets) is acquired or sold to a non-8(a) company. Whether in the base or option year, the contractor must be terminated for the convenience of the government unless the SBA waives the termination requirement. The same waiver requirement applies under an asset sale which requires a novation.

To continue performance after the transfer of ownership a timely waiver must be obtained from the SBA where the contractor must request such a waiver before "actual relinquishment of ownership or control" e.g. the closing. In so doing so, the 8(a) contractor must specify the grounds on which it requests the waiver and demonstrate such grounds are met. Practically, if contract performance is well underway, an agency will find it easier and less disruptive to continue the contract rather than terminate and issue a new procurement. A closing of a deal may be contingent upon obtaining a waiver and deal negotiations should consider providing for a price adjustment at closing if a waiver is rejected. If the waiver is still pending at the close, it may be appropriate to have a contingent deferred payout as part of the price.

The Briefing Papers article also addresses special issues when a foreign entity acquires an interest in a US company performing government contract work requiring access to classified information. Though we will limit discussion of this issue due to its limited relevance to most of our readers, let it suffice to say that to maintain valid security clearances, the foreign company must take steps to mitigate concern over foreign ownership, control and influence (FOCI). The steps will depend on amount of foreign control: if there is insufficient ownership of stock and the foreign firm is not entitled to board representation, then the US company's board may pass a simple resolution. If there is greater foreign control, other options exist such as establishing a Voting Trust or Proxy Agreement whereby the foreign owner relinquishes day-to-day control of the clearly US entity.

Due Diligence Issues

During the "due diligence" process (finding out as much information as possible in a limited time), several issues related to ascertaining the value of the acquired company needs to surface:

♦ Valuation of Backlog

The variations of government contracts make assertions about contract backlog problematic. Recent increased use of Indefintite Delivery-Indefinte Quantity (IDIQ), Multiple Award Schedule (MAS) and Blanket Purchase Agreement (BPA) contracts does not obligate the government to purchase significant items or services. Though these contracts may be awarded with great fanfare and large dollar amounts announced, they often only provide the contractor with the right to compete for future orders and those orders may never be funded. What really counts when assessing a seller's backlog is the receipt of funded orders. Hence the buyer needs to carefully examine orders actually received under IDIQ, MAS and BPA vehicles when conducting due diligence of seller's backlog with particular focus on the amount of funding, terms and scope of the orders.

♦ Audits/Investigations

The government's extensive audit rights, particularly under negotiated contracts, provides it numerous

remedies that can result in retroactive price adjustments to the contract price under the Truth and Negotiations Act (TINA). Although TINA was amended in 1994 and 1996 to limit its application to only certain type of contracts with exclusion of its requirements on "commercial item" contracts, a careful due diligence needs to identify the seller's universe of TINA covered contracts, its history with TINA and any expected price adjustments. When we request data from the seller in our due diligence efforts, we ask the seller to identify the universe of TINA covered contracts to both gauge potential liability and evaluate their understanding of their own contracts when pursuing other information. In addition, fraud liability under the False Claims Act must also be examined.

♦ Claims & Terminations

The government has the unique rights to change the scope and other terms of performance of a contract as well as terminate all or part of it in exchange for "making the contractor whole." The buyer needs to assess all existing claims, potential claims and termination settlements and estimate the likelihood of recovery. In our due diligence, we have found many circumstances of exaggerated assertions of potential recovery. We have also encountered the opposite circumstances where though the seller did not identify any potential claim and termination benefits, our close examination of the likelihood of certain recoveries provided a significant source of unexpected value to our buyer client that was later realized.

♦ Cost Allowability/Indirect Rate Submissions

A unique aspect of government contracting is the set of rules that specify the types of costs that can be reimbursed as either allowable or allocable to a given contract. For cost reimbursement contracts and other types where downward adjustments to billings can be imposed, the rules will dictate how much a contractor gets paid. In addition, the prices set for certain firm fixed price contracts will also depend on what these rules will allow the contractor to receive. In both cases, the contractor will agree to interim billing rates or forward pricing rates and these rates will be subject to retroactive adjustments based on audits of the contractor's actual incurred costs experience for a given year.

The amounts of these readjustments are not often clear at the time of a buyer's due diligence efforts resulting in potential time bombs in the future. Incurred cost proposals for relevant years may not have been prepared. If prepared, they may not have been audited. If audited, the rates for a given year may not have been settled, where the contractor, government auditors and contracting representatives may be in the middle of resolving numerous questioned costs issues. If settled, the seller may have (inadvertently or not) not disclosed the results and the impact on relevant contracts and subcontracts.

The due diligence efforts need to identify the future liability of these potential time bombs. An estimate of liability needs to be taken. For example, at the very least, the buyer may want to ascertain the seller's historical experiences (e.g. ratio of billed to settled costs), adequacy of financial reserves, etc.

♦ Intellectual Property

A contractor doing business with the government needs to exercise considerable care to assure it does not grant an "unlimited rights" license to the government for its technology or other assets. Such a license could entitle the government to give the design - either in the form of technical data or computer software code - to other companies and to authorize those companies to copy and sell the product illustrated in the data or code to any customer, anywhere. On the other hand, a contractor that developed its intellectual property at private expense or, to some degree, not at government or public expense can protect it (*see GCA DIGEST Vol. 2 No. 1 on Primer of Intellectual Property*). The company's policies related to protecting its intellectual property and the status of its intellectual property, especially if the seller's proprietary technology accounts for a significant share of its value, needs to be examined during a due diligence.

Knowing Your Cost Principles and Cost Accounting Standards…

COST ACCOUNTING STANDARD 401

(Editor's Note. As part of our on-going series on cost principles, we have addressed not only allowability issues but have also confronted cost allocability problems. Generally, the FAR cost principles in section 31.205 cover whether a cost is to be allowed or not while the cost accounting standards address how a cost can be assigned or allocated to a particular government contract or task order. Consequently, we have decided to expand our coverage of cost principles to include cost accounting standards, particularly those relevant to all government contractors, whether or not they are CAS covered. The source of information we have used is the actual cost accounting standards including preambles, several texts

such as Mathew Bender's Accounting for Government Contracts Cost Accounting Standards and Karen Manos' Government Contract Costs and Pricing and the Defense Contract Audit Agency Manual (DCAM)

The Controller General's 1970 feasibility study that prompted legislation establishing the Cost Accounting Standards Board expressed concern that contractors sometimes presented cost data significantly different when pricing work than how it was recorded and reported. For example, it was common for a contractor to bid on a contract using an average labor rate for its entire plant but to charge the contract with the actual labor rate of the worker used. COs and auditors alleged that this practice provided for contractors to manipulate the situation to their advantage where contractors would use the plantwide average rate for proposal purposes and then would use a mix of lower-paid people on firm fixed price contracts while using a mix of higher-paid people on cost type contracts. These types of difficulties underscored the need for consistency between estimating practices and those used for cost accounting practices.

Basic Requirement

In promulgating a cost accounting standard the government wanted a basis for comparing costs estimated in a proposal with costs accumulated during contract performance and with costs reported on government invoices, claims or other billings. It concluded that the best basis for such a comparison was to make sure there was consistency between costs in a proposal and costs accumulated and reported.

CAS 401 requires consistency between estimating and accumulating cost in two ways. The contractor's practices for estimating costs in pricing proposals must be consistent with its practices for accumulating actual costs. Conversely, the contractor's practices used in accumulating costs for a contract must be consistent with the ways it estimates costs for proposal purposes. Thus a contractor can be in non-compliance with CAS 401 in two ways: contractor fails to estimate its costs in accordance with its disclosed estimating practices and second, a contractor estimates in accordance with its disclosed estimating practices but accumulates its costs in a different manner.

♦ Cost Estimating

The requirement for estimating costs focuses on the accounting structure of the proposal – that is, the accounting practices used in preparing the proposal. It does not pertain to the amounts estimated or the estimating techniques used. For example, a contractor may estimate costs that would include labor, material and overhead based upon historical data, industry averages or other recognized estimating techniques because the standard does not prescribe any estimating technique. In other words the contracting parties can decide the appropriate techniques used to estimate quantities, hours or dollars. CAS governs the method of presenting this data in a proposal.

The baseline for establishing consistency is based on the date of the final agreement on price. This is important because many contractors assume the consistency requirement applies when a proposal is originally submitted. It is quite common for proposals to be revised many times from the original to final negotiation and the baseline applies to the date of final agreement on price.

♦ Cost Accounting

The cost accounting standards do not provide for a change in cost accounting practices during contract performance. So every accounting change, whether required by the standards, contracting parties or pursued unilaterally by the contractor, is a non-compliance with CAS 401 since the cost accounting practices used in accumulating and reporting costs differ from those used in preparing the proposal. (*This is a good reason to choose initial accounting practices carefully before a CAS covered proposal is prepared.*) As a practical matter, changes can occur but they must be made in accordance with the administrative requirements of CAS (e.g. notification, cost impact analysis).

In spite of proposing costs on a contract or task order basis, some contractors' accounting system do not accumulate costs by contract or task order but use a non-job cost system such as accumulating costs by operation, cost center, department, project or program. The contractor can still comply with the standard as long as it has procedures in place to identify costs by the contract or task order that was proposed. Of course the government or its auditors may have requirements to accumulate costs by contract, especially on cost-type contracts, but these requirements are not based on CAS 401.

Required Level of Detail

Perhaps the most problematic issue of CAS 401 involves the level of detail provided in estimating and accumulating costs. Generally, accumulating and reporting contract costs in greater detail than in pricing a proposal is permitted, but the opposite is not.

Consistencies that must exist. At a minimum, the following consistencies between estimating and accumulation of costs must exist: (1) classification of costs as direct or indirect (2) the charging or proposed charging of each element or function to the respective indirect cost pools and (3) the method of allocating indirect costs to the contract. These consistencies must be followed even if the proposed contract costs suggest a different treatment. For example, if the contractor accounts for scrap and attrition as an indirect cost but the contract permits recovery as a direct cost, proposing a cost as direct while accumulating it as indirect is an inconsistency with (1) above.

The request for information in a solicitation must be closely examined. If there is the appearance of a CAS 401 inconsistency, the contractor needs to distinguish between the data that is consistent with its cost accumulation system and other data requested as support or documentation. A solicitation cannot require a contractor to change its accounting system but the government is usually responsive when the contractor explains and reconciles the differences between data requests and data consistent with its accounting system.

Three conditions for cost grouping in proposals. First, cost grouping must be homogeneous. This is the first of many cost accounting standards where the concept of "homogeneous" costs are put forth even though neither the CAS Board nor accounting literature provides a clear understanding of the term. Two conditions of homogeneous must be met: (1) the costs included in a pool need to have the "same beneficial or causal relationship" to the proposed contract (e.g. if the allocation base of an indirect cost pool is direct labor then the costs in that pool should be appropriately allocated to cost objectives by direct labor) and (2) if the costs included in the pool were separately allocated to the cost objective – contract – there would not be a material difference than if these costs were pooled.

Next, the elements of cost groupings in pricing the proposal must be reconcilable to cost elements in the cost accumulation system. Reconcilability requires there be an audit trail i.e. ability to trace the cost elements from the cost accumulation system to the cost groupings in the proposal. For example, use of a "wrap-around rate" or a fully loaded rate on a proposal is generally accepted by government auditors even though there may be a technical inconsistency because each rate included in the loaded rate can be reconciled back to the accounting records.

Lastly, the actual costs incurred on the cost objective can be traced to the cost elements in the cost accumulation system which, in turn, can be traced to the cost groupings in the proposal. For example, a contractor who accumulates direct costs separately from indirect costs but for proposal purposes includes fringe benefits as part of its proposed direct labor costs formally violates the consistency requirements of CAS 401. But for practical purposes, the government often overlooks this issue. The justification for allowing this apparent inconsistency is that auditors argue there is sufficient evidence to compare actual results with proposed numbers and therefore they are satisfied.

Greater detail in the estimate. Estimating costs in greater detail than accumulating and reporting them represents a non-compliance so either the contractor can provide less detail for estimating or greater detail for cost accumulation. However, the government may not like less detail for estimating purposes so procurement officials may instruct auditors not to cite contractors for non-compliance (though deficiencies in estimating systems may be cited instead). Even the DCAA Manual alerts auditors that contracting officials may request more information than is needed for cost accumulation purposes. Contractors can protect themselves from non-compliance assertions by clearly distinguishing costs being proposed and data being used to support proposed costs.

Use of memorandum records

When the CAS was being promulgated contractors expressed concern they would have to revise their formal accounting system. The CAS Board denied it stating that "cost accounting records are usually supplemental and subsidiary to financial records" noting only that "cost accounting records be reconcilable to general financial records." In this, the CAS Board officially adopted the policy that memorandum records are sufficient for complying with CAS. Contractors, generally smaller ones, can use memo records for their cost accumulation system. The CAS Board added two other conditions to the requirement that memo records be reconcilable to accounting records – the data must be maintained in a manner that permits audit and verification.

What constitutes memo records changes over time? For many years auditors recognized worksheets and workpapers as memo records. In the information age, it expanded this to computer spreadsheets, databases, analytical software, etc. The government is now

considering whether off-line activity based costing software or emails containing financial data represents adequate memo records. For now, any record any place that supports the facts and figures in the accounting system will be considered as a memo record.

Other Issues

♦ Costs by Product Line, Not Contract

It is not uncommon for firms to accumulate and estimate costs on some other basis than contract costs. In *Texas Instruments*, the contractor had a fixed price supply contract where it estimated costs using an average unit cost computed on a product line basis. This was consistent with the way it accumulated and reported costs which was based on product lines rather than individual contracts. The government contended the use of the government form for contract pricing purposes implied estimates on a single contract basis, which implied the need to accumulate costs on a contract basis. The ASBCA ruled the estimate reflected the contractor's estimate of cost to perform an individual contract and the data presented on the proposal form was the end product of this estimating process. The Board ruled CAS 401 did not require estimating, accumulating and reporting costs by individual contract, citing CAS 401.50 that requires only cost be estimated in sufficient detail as to allow comparison with actual costs but it does not require estimating and accumulating by individual contract (*Texas Instruments Inc. ASBCA No 18621, 79-1 BCA 12,800*).

♦ Proposing Rates Not Included in Accounting System

General Engineering bid on a time-and-material contract which provided for a "cost of material" clause allowing reimbursement of material costs plus "material handling costs." On the proposal form that provided a blank space for a percentage figure for material handling costs, the contractor inserted a 15-percent figure in the blank. The government assumed this percentage was its indirect cost rate for a material handling pool whereas the contractor's accounting practices was to include these costs in its overhead pool rather than maintaining a separate material handling pool.

The Court decided that there was not consistency between estimating and accumulating, saying there would be no problem if there was more detail in the accounting system rather than in the proposal but in this case, more detail existed in the proposal i.e. a rate given for material handling costs. By showing a 15% rate for material handling costs, the contractor indicated it had a separate handling pool with a direct material allocation base but because the accounting system including these material handling costs in its overhead pool, the proposal contains an inconsistency in estimating. Another difficulty cited was the government could not easily audit the actual costs against the estimated costs nor reconcile the proposal to the cost accumulation system (*General Engineering & Maching Works v Sean C. O'keefe, 12 FPD 34*).

♦ Terminations

Cost estimates used in proposals for new contracts anticipate the contract runs from award to completion and CAS 401 consistency requirements apply to this period of performance. When a contract is terminated for convenience it creates a situation not anticipated when proposing the contract. Commentators have stated that contractors cannot maintain consistency once the government terminates the contract. Under FAR part 49, cost arrangements of a termination claim can vary substantially from the cost arrangements of the original proposal and hence by definition, termination procedures comply with CAS 401.

♦ Percentage Factors for Scrap and Other Losses

The interpretation of CAS 401 requires that when percentage factors are used to support scrap costs and other losses and the actual costs are accumulated in an undifferentiated account, the contractor must maintain adequate records of actual scrap costs and losses to support such a percentage. Interpretation No. 1 in 1976 stated that contractors applying a percentage factor to a base such as total material must support the factor by historical experience though the interpretation did not prescribe the type or level of detail, leaving it up to the government contracting authorities to decide depending on the circumstances. DCAA instructs its auditors to cite a noncompliance when the contractor does not maintain a separate record of the costs represented by the proposed factor. However, when the contractor adjusts the quantities of individual line items in a bill of material, either by applying a factor or adding a specific quantity of additional units, the contractor is deemed to comply with the standard because the estimate is a representation of the total cost of individual parts and under most situations, the cost and quantity of the individual parts can be determined from the accounting records.

Illustrations

The standard has some good illustrations on what constitutes consistent or inconsistent practices and the DCAA Manual has some on what can be done to overcome a noncompliance with CAS 401. Here are a few.

♦ Consistent Practices

Estimating	Accumlating
1. Estimates average direct labor rate	Records direct labor based on actual costs for each individual
2. Estimates an average cost for minor standard items	Records actual costs for all minor items
3. Applies an estimated overhead rate to estimated direct labor costs	Accounts by individual cost accounts which are accumulated in a cost pool

♦ Inconsistent Practices

4. Estimates a total labor amount for all engineering labor which includes different labor and does not provide reconciling supporting data	Accounts for engineering labor by function e.g. drafting, designers, production engineers
5. Estimates labor by function e.g. drafting, production engineering, etc.	Accumulates total engineering labor in one undifferentiated account
6. Estimates one single dollar amount for direct labor, material and overhead	Records separately actual labor and material as direct costs and overhead as indirect cost

(Illustration No. 4 is a violation because (1) the grouped costs are not homogeneous and (2) significant costs cannot be compared. Illustration No. 6 is precluded because the estimate grouping is inconsistent with the classification of actual costs as direct and indirect – the standard requires estimating and cost accounting practices be consistent as to classifying costs as direct or indirect.)

Below are some examples of inconsistent practices and how to make them compliant with the standard.

1. The contractor's proposal shows engineering labor by class (e.g. Engineer 1, Engineer 2, etc.) while it accumulates engineering labor by type (e.g. electrical, design). Rather than change the accounting system, provide a reconciliation where the proposed costs by class are reconciled to the engineers by type. Requirements for special breakdowns identified in the solicitation or by the contracting officer is a matter of discussion between the parties and not dealt with by CAS 401.

2. Prepares separate estimates for cost of raw material, subcontracts, purchased parts and interdivisional transfers while these costs are not separately identified in the cost records. The solution is either for the contractor to be required to accumulate costs consistent with its estimates or prepare supplemental records as long as they are reconcilable to formal accounting records (e.g. the undifferentiated account).

3. In a proposal, used a material additive factor to cover the cost of small common usage items based upon historical experience while for accounting purposes, these items are computed as a percentage of direct labor hours. DCAA says either the estimating or accounting system needs to be changed.

4. Estimates by line item (e.g. data, first article) but accumulates labor, material and overhead for the contract as a whole which creates an inconsistency because its records are in less detail than its estimates. Solution is estimate and accumulate combined costs by the contract, which is consistent with the requirements of FAR 15.408, Table 15-2 because the level of detail required by the Table has been authoritatively established to be an acceptable baseline for compliance with the standard. If the costs of each line item is material and distinct the contractors should probably be required to accumulate costs by line item.

Classic Oldie…

MATCHING THE COST PROPOSAL WITH THE GOVERNMENT ESTIMATE

(Editor's Note. In addition to exploring "hot issues" in reasonable depth, the GCA DIGEST also tries to provide practical help in costing and pricing actions. In the following guest article, we attempted to give some insight into how the government

will respond to a contractor's cost proposal and what information you may want to consider providing in order for the government to justify awarding you the contract at an attractive price. The article was written by Katherine Szymkowicz who is President of The Acquisition Network (TAN) and before that she was a Contracting Officer for the Federal Government (GSA, Navy, Army) for over eighteen years. Kathy can be contacted at 415-861-0556.)

As a contracting officer overseeing up to thirty COs and Specialists, I saw every type of submittal and heard every argument for a price that you can imagine. I have seen (through horrified eyes) negotiations stalled for months over the number of brooms to be used to clean a ten-story building. I've seen negotiations for a $10,000 job take over a year to complete! I have seen contractors walk away from the negotiation table because they simply couldn't afford the time it was taking to submit their proposal in *another* format. How easy it could have been if only the contractors understood what the CO wanted.

It all comes down to the cost proposal. All business development effort and expense you put in is aimed at getting that cost proposal to the contracting officer. The better you understand what the CO wants and how the cost proposal is reviewed, the better are your chances of presenting a proposal that will result in the award of a price you want.

The Government Estimate (GE) is an estimate of the cost to perform the contemplated work that is usually developed by the government technical specialist supporting the job. The GE will be itemized into a format with a cost for each line, totaled for the bottom line GE. When you bid a job or are a part of competitive negotiations (i.e., "the Best Value"), bottom line is what counts. But during one-on-one negotiations the CO will be looking for agreement among those lines of numbers provided by the technical expert.

Most often the Contracting Officer reviewing a cost proposal is not a technical expert in the field for which the procurement is being made. This means the CO will depend very heavily on the Government Estimate and will assume it is correct. Your cost proposal will be compared, line-by-line, to the GE. Anything that does not match, whether higher or lower than the GE, will be cause for concern.

This approach emphasizes the need for your cost proposal to be in the same format as the GE. The more information you have up front about the Government's estimating format the better. Most of the time the GE will itemize each work classification (i.e., Principal, Project Manager, Electrician, etc.) as well as materials, supplies, overhead and profit indicating percentage for each. If negligible, these and other items may be grouped as a single item but preparers are told not to be afraid to over-itemize.

If you have identified different work categories, the CO might question or disallow prices that are in fact close or identical to the Government Estimate because the cost is not recognizable to him in the format you provided. For example, your proposal might present Project Management as a single category for costs, showing a line item cost of $45,000 which includes costs for a site office. The Government Estimate shows Project Manager at $23,000, Principal at $12,000. The CO looks at this, compares $45,000 to $35,000 and lets you know you are too high and it becomes clear after several rounds of (costly) negotiations that he will not accept more than $35,000. Now he has not told you what his GE looks like, so without asking the proper questions and giving him the proper information, you will not know that in fact your price includes elements that are not included in his.

In this case the CO has not considered the fact your Project Management includes the direct costs for the site office. The CO has allowed for this in the development of his overhead estimate. What he has not done is move it from the overhead allocation to the Project Management line to match your proposal. Your best approach at this point is to explain to the CO exactly what is included in your Project Management costs. Basically what you are attempting to do is show him that he has included the cost somewhere else, but you are not given the luxury of viewing his total proposal to know exactly where the costs are hidden. You must give him enough information to make the determination himself.

There are other circumstances where your costs are simply higher than the GE. When this occurs, it is your job to tell the CO why your costs are higher in such a way that he can justify the increase. Again, this can be a game of twenty questions since you don't know exactly what the Government has based their estimate on. But with the right information, you can lead the CO to the place where he sees that your price is higher because you have included something that he did not include AND THAT HE NEEDS!

For example, your estimate shows 98 hours for Painters; the GE is much lower (though of course the CO won't tell you how much lower, only that it is A

LOT). Tell the CO exactly what the Painters will be doing and how you determined the hours. When you say "I allowed for 8700 square feet, two coats, you may find a difference in square footage or the CO may realize that the GE is based on one coat (the specs were vague). Or when you explain that OSHA requires two workers for the height involved, you may learn that the Government forgot that little detail in their estimate! But the more information you give the CO, the more he has to justify your price. Just remember that the CO will never write: "GE says 45 hours but the contractor insists she needs 98!" He will write: "The GE allowed for a crew of one person, but OSHA regs for the height involved require a two person crew. The increased crew does not provide for accelerated accomplishment of the painting since the structure makes it impossible for more than one painter to work at a time for 80% of the effort." But he will write this only after you have helped him understand the justification!

Justifying costs can be done by itemizing the work included and by using industry rules of thumb. "The CADD Specialist is producing this many drawings in this many hours, the Project Manager is 10% of the total labor hours. " This type of reasoning gives the CO what he needs to justify your price.

The bottom line is realizing that the CO must justify any deviation from the Government Estimate. This line is higher, this line is lower and this is why. This is the purpose of the final Memorandum of Negotiations which results in your award. The GE and your proposal will be lined up, item by item and where there are deviations after negotiations, the CO will state the justification for the change to the GE. Where you do not provide adequate justification, the GE will remain unchanged and your price adjusted.

Understanding what the CO wants and why is the first step in successful negotiations. By providing the CO with a proposal in the proper format, then giving the justification needed for any areas of concern will likely result in a price you can love and will make the CO's job easier. You can bet he will remember that next time he's looking for a contractor in your field.

NOTICE REQUIREMENT FOR CONSTRUCTIVE CHANGES

(Editor's Note. Effective use of Changes clauses to adjust prices for out of scope work often represents the difference between mediocre and excellent profitability on government contracts. Though it eventually pursues a price adjustment, many contractors often choose not to provide timely notification to their government clients of intention to pursue an adjustment. Reasons can vary - it does not want to make an issue of it, it fears controversy, wants to wait to see if the contract profit is low, etc.. A recent article in the June 2004 issue of The Nash & Cibinic Report discussed some recent cases illustrating the notice requirements for pursuing price adjustments when a constructive change to a contract occurs.)

The need to notify the government of a constructive change – that is for work beyond that required by the contract but without a formal change order – is based on the premise that an ordering official must know or have reason to know that an order will constitute extra work. Though constructive changes have long been considered a valid type of change justifying additional cost recovery, interestingly, the changes clauses for fixed price contracts (FAR 52-243-1), cost type contracts (52-243-2), time-and-material or labor hour contracts (52-243-3) or commercial item contracts (52-212-4) do not mention either constructive changes nor notification requirements. There are two exceptions: (1) FAR 52-243-4 covering construction contracts requires notification to the contracting officer and prohibits recovery of costs if notice is not given within 20 days of receiving the change order and (2) FAR 52.243-7, Notification of Changes, which is an optional clause intended for use in negotiated research and development or supply contracts for major weapons systems expected to be over $1 million, addresses constructive changes and provides detailed notice requirements. The later does not prescribe any sanctions for failing to comply with notification requirements.

Government Knowledge. Most recent cases have provided contractors recovery if they did not notify the government of constructive changes when the government is aware of the contractor performing extra work. Most of the cases have focused on determining what constitutes "government" knowledge the contractor is performing extra work and the extent to which the government is harmed by failure to be notified. All the changes clauses vest authority to order changes in the contracting officer. If the contractor performs work at the direction of a government representative other than the CO or gives notice to that person, the work is considered to be "volunteered" and not subject to recovery. For example, in *Standard Coating Service*, an inspector had no authority to order changes, in *Mc ll Generator & Electric* there was no proof the project manager had CO authority and in *Ervin & Associates*, the Court cited the contractor's "experience

as a government contractor" as reason to know the CO should have been notified directly. In other cases, the working relationship of the CO and certain representatives were such as to assume the CO had knowledge of actions and notification to them was sufficient. For example, in *Cessna Aircraft Co.* even though the technical representative lacked express authority he had implied authority and there appeared "to be no reason" CO did not know and in *Kumin Associates* the Board ruled the CO had "little day to day involvement" with administering the contract and had delegated significant contract administration to authorized representatives.

Prejudice (i.e. Harm) to the Government. The government can be harmed in a number of ways by failure to receive notice of a constructive change. For example, it may decide to alter action to avoid a claim or delay may make it impossible to investigate the matter. As a general rule, the government has the burden of establishing prejudice. Several cases ruled there was neither alleged nor demonstrated harm caused by lack of notice. Other cases have held that any delay caused a degree of prejudice but rather than barring a claim, the lack of timely notice should increase the contractor's "burden of persuasion." Though later cases challenged the clarity of the term, one case held this higher burden of persuasion resulted in denying the claim. The knowledge of government personnel administering the contract may be such that the government was not prejudiced by lack of written notice. In *Dan Rice Construction*, no prejudice from lack of written notification occurred when the inspector knew of the contractor's complaint of extra work and reported such facts in his daily reports to his supervisor.

The authors conclude the cases indicate a contractor that has not given timely written notice of a constructive change to the CO may still have a good chance of recovery. A detailed examination of the interactions of the parties may convince the board or court the government had sufficient notice and either ordered the change or acquiesced in the extra work. But still, the best action is to provide proper and timely notice of changes to the CO because to do otherwise can be risky and may lead to expensive litigation. Most importantly, it is good contracting – common sense and good customer relations required a contractor to inform their customer if it expects to be paid extra for work it considers beyond contract requirements.

COST PRINCIPLES CHANGES CHART SINCE 2002

When allowability questions arise, the general rule is that the versions of the cost principles found in FAR 31.205 on the date of the contract governs. Because the cost principles undergo changes it is a good idea to know which version of the cost principles applied to a particular contract. Though there were more structural and edit changes, the following represents the substantive changes since 2002. The following chart is a scaled-down version of the chart included in the February 2005 issue of the Nash & Cibinic Report.

FAC	EFFECTIVE	FAR Sect.	DESCRIPTION
2001-08	July 29, 2002	31.205-35	Removed the limitations in paragraph (a)(2) on number of days of temporary lodging during transition period; added paragraph (a)(10) making allowable payments to employees for increased taxes and FICA incident to relocation ("tax gross-ups") and paragraph (a)(11) making allowable payments for spouse employment assistance; increased the ceiling in paragraph (b)(4) for miscellaneous expenses from $1,000 to $5,000; and deleted previous paragraphs (c)(4) and (C)(5) since these costs were made allowable under paragraphs (a)(10) and (a)(11).
2001-14	June 23, 2003	31.205-10	Changed the term "cost" to "cost of money" and distinguishing between contract costs and the cost of assets under construction by adding the statement that the cost of money "is measured, assigned, and allocated to contracts in accordance with 48 CFR 9904.414 or measured and added to the cost of capital assets under construction in accordance with 48 CFR 9904.417, as applicable."
		31.205-45	Deleted the coverage of "Transportation costs."
		31.205-48	Deleted the word "Deferred" in the heading, thus limiting the definition of "research and development" to this specific Cost Principle.
2001-16	Aug. 25 2003	31.205-38	Made changes described as "restructuring" but stated "The rule does not change the allowability of selling costs."
2001-16	Oct. 31 2003	31.205-12 and 31.205-13	Restructured the paragraphs and removed "unnecessary and duplicative language" stating "The rule does not change the allowability of costs."

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		31.205-45	Restructured the paragraphs and removed "unnecessary and duplicative language" stating "The rule does not change the allowability of costs."
2001-18	Jan. 12 2004	31.205-6	Modified paragraph (j) to use terminology consistent with CAS 412 and 413, to revise the allowability limitation on employee stock ownership plan (ESOP) contributions, and to remove the requirement for the Contracting Officer to approve the ESOP contribution rate.
		31.205-11	Made editorial changes and stated "The rule does not change allowability of depreciation costs. However, changes have been made that may effect the determination of depreciable costs for tangible personal property; for example, only residual values in excess of 10 percent need be used and residual values need not be recognized when certain depreciation methods are used."
		31.205-19	Eliminated the U.S Treasury discount rate provision for computing actual losses.
2001-22	May 5 2004	31.201-2(a)	Changed the introductory statement from "The factors to be considered in determining whether a cost is allowable include the following:" to "A cost is allowable only when the cost complies will of all the following requirements:"
		31.202(a)	Removed the first sentence that had stated, "A direct cost is any cost that can be identified specifically with a particular final cost objective." The substance of this statement with additional provisions is now located in FAR 2.101(b), "Definitions."
		31.203	Totally restructured. New paragraph (a) specifies when allocation according to CAS is required. Removed the fist sentence of previous paragraph (a) (now paragraph (b)) that had staged, "An indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective." The substance of this sentence is now located in FAR 2-101(b).

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