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NEW CASE CHANGES ACCOUNTING FOR IR&D COSTS

(*Editor's Note. Proper treatment of independent research and development (IR&D) and bid and proposal (B&P) costs are often a source of confusion. Last year we reported extensively on the results of a new case, Newport News, that effectively forced contractors to charge costs that had ordinarily been considered IR&D to specific contracts where such costs were usually not recoverable. Whereas there was a long history of distinguishing between "explicit" requirements of a specific contract, where R&D (and by extension bid and proposal costs) costs would be charged directly to a contract and "implicit" requirements where costs would be charged as IR&D and allocated to all contracts, the Newport News case, in effect, discontinued the distinction, significantly broadening the times that R&D had to be charged direct to a contract. The following case changes the impact of that case and clarifies how both IR&D and B&P costs should be treated. There have been several articles commenting on this important case where the most interesting one we have relied on was written by Tom Lemmer and Philip Seckman of McKenna Long and Aldridge LLP, the lawyers representing ATK Thiokol, in the April 6 issue of Federal Contract Report.*)

The United States Court of Appeals for the Federal Circuit affirmed the Nov 30, 2005 United States Court of Federal Claims (COFC) decision in *ATK Thiokol v United States, 68*. The two decisions should end the debate that has existed for four decades regarding the proper interpretation of the phrase "required in the performance of a contract." The Federal Circuit held the phrase means that research and development (R&D) efforts are independent and associated costs qualify as IR&D costs, unless the R&D effort is specifically required by the terms of a contract. The standard applies to all IR&D, including development of commercial products and permits "parallel" IR&D and the use of "branch technology" so long as contracts are negotiated and drafted properly and the proper cost accounting practices are in place and followed consistently. The Fed. Circuit decision also provides contractors extra confidence that their adherence to their written disclosed practices will guide whether R&D costs properly are classified as indirect costs under CAS 420 (which is largely incorporated in the FAR hence affecting non-CAS covered contracts equally) and are allowable under FAR 31.205-18. The Court affirmed contractors are free, within the broad parameters of CAS, to establish their own accounting practices that make sense for them and that once established bind the contractor and government.

Background

The basic issue was the proper standard for determining whether R&D costs are indirect IR&D costs and when they are direct costs of a contract. Two regulations define the types of costs that qualify as IR&D.

1. CAS 420, which governs the allocation of IR&D and B&P costs, provides the term IR&D does "not include the costs of effort sponsored by a grant or required in the performance of a contract." Under CAS 402, R&D costs that are "independent" have a broad benefit which are indirect costs to be allocated to all contracts while when R&D costs are "required in the performance of a contract" they must be treated as direct costs because only one contract benefits.

2. FAR 31.205-18, which covers allowability of IR&D and B&P costs, contains the same limited phrase "required in the performance of a contract" to define the types of costs that do not quality as IR&D or B&P. As we see later, the fact this phrase applies to both IR&D and B&P is key to the court's decision.

Some History

The government has long recognized that IR&D benefits and is critical to the contractors' financial health and technological growth and thus its ability to supply the goods and services the government needs. However, beginning in the late 80's and into the 90's the government began to question contractors' treatment of R&D effort as IR&D. During this period there was a decline in defense spending which prompted a government push for defense contractors to expand their business into commercial markets. These moves were considered to be a means of increasing the contractors' base and thus decreasing its indirect costs. This shift was accompanied by an increase in IR&D effort which prompted a number of aggressive auditors to question IR&D costs viewing them as related to "commercial

development" where now they were considered "required in performance" of commercial contracts. Since the 1990s several cases reinforced the government position that the phrase should be interpreted broadly (e.g. *Mayman V Martin Marietta, US vs Newport News Shipbuilding, TRW Inc*). These cases emboldened auditors to increasingly question IR&D costs and created uncertainty and even risk of fraud allegations for contractors.

The outcome was these cases issued decisions that were inconsistent with the settled distinctions between direct and indirect costs as well as the interpretation of B&P costs which are defined using the same definitions. The *Newport News* case went the furthest going so far as to interpret the "required in the performance" to mean an effort "implicitly" required to perform a contract. This position was often adopted by the government and formed much of the government's basis in *ATK Thiokol*.

ATK Thiokol Dispute

In the early 90s, in response to shifting market conditions and increases in the commercial launch market, ATK's predecessor, Thiokol Corp. concluded that with certain technical upgrades, a variant of its Castor IV rocket motor could increase sells to both the commercial and government buyers. As part of its sales strategy, ATK began to market the upgraded Castor motor to various potential customers such as McDonnell Douglas, Lockheed Martin and the US Air Force. In Feb 1996, Misubishi began to express an interest in purchasing the upgraded Castor motor but refused to pay for general development effort required to upgrade the motor. ATK's proposals and subsequent contracts with Misubishi, therefore stated it would sell it ready-to-launch motors where the contract price did not include any of the upgrade effort.

The Court was influenced not only by the Mitubishi contract that prohibited charges directly to the contract but also because (1) multiple contracts benefited and (2) charges to IR&D was consistent with its disclosed practices. As for multiple contracts, the two parties reasonably concluded there was a likelihood of multiple sales to numerous customers where the records of ATK management approval of expenditure of company R&D funds made this clear. As for consistency with its disclosed practices and prior accounting practices, ATK's disclosure statement said R&D costs would be indirect unless (1) the particular contract in question specifically required ATK to incur the cost (2) the contract paid for the cost and (3) the cost had no reasonably foreseeable benefit to more than one cost objective.

After making its accounting decision, ATK proposed an advance agreement to the government to establish the costs would be properly allocable and allowable IR&D costs. The contracting officer disallowed the costs on the basis that they were "required in the performance" of the Mitsubishi contract and therefore had to be charged direct to that contract.

The COFC Decision

The Court of Federal Contracts held that resolution of the issue should depend on interpretation of the contract and relevant FAR and CAS requirements. A detailed discussion of relevant regulations (CAS 402, CAS 402 Original Interpretation NO. 1, and FAR 31.205-18) led it to the conclusion that the phrase "required in the performance" determines whether the costs are properly IR&D costs and the contract and disclosed practices should determine whether the requirement has been met. Here it found that ATK and Mitsubishi did not intend for Mitsubishi to pay for the upgrade costs under the contract because the parties believed there was a commercial market for them and it appeared likely there would be multiple purchases for the motors. The Court also found that ATK accounted for the effort consistently with its disclosed practices and hence it properly charged the costs to IR&D.

The Government and ATK's Positions on Appeal

In its appeal, the government contended the correct interpretation of "required in the performance of a contract" precluded all costs whether they were specifically or implicitly required by the contract. Relying on the *Newport News* case, the government argued it could not meet its contractual commitment to sell Mitsubishi the motors without putting in the upgrade effort, arguing the effort was "necessary" or "implicitly required". The government argued the COFC decision should be reversed stating the decision would allow contractors to routinely "game the system" by improperly shifting commercial contract costs to the government.

ATK said the COFC decision should be affirmed for two reasons. First, it argued the decision "achieved harmony" between the definition of IR&D and B&P – that is should be interpreted similarly – since the two costs were defined in the regulations using the

same limiting phrase. Second, the decision was consistent with *Boeing Co v US* where there the issue was whether different circumstances allowed certain B&P costs could properly be charged direct and indirect where the government concluded that a specific requirement in an existing contract is a differing circumstance that triggers charging normally indirect B&P costs as direct. As for its reliance on the *Newport News* decision ATK argued it was wrong because it ignored relevant regulations and Federal Circuit precedent. As to the government's gaming the system argument, ATK countered that the cost shifting feared by the government was precluded by CAS 402 as well as its stated practices that identified the times costs would be charged direct or indirect. Finally, ATK argued the government's position would create a "first-in-line" problem that would harm the government. That is, if the government's interpretation of any "implicit" cost being included in "required by a contract" that would mean the first purchaser of any product would have to pay all R&D costs associated with that product. Since the government is often the first purchaser of products, the government would pay for all the R&D effort rather than benefit from spreading R&D costs across the contractor's entire business base.

The Federal Circuit's Decision

The Federal Circuit ruled that R&D effort is IR&D unless the effort is "specifically required by the terms of an existing contract." Its reasons were as follows:

1. In considering whether the phrase "required in the performance of a contract" has clear meaning, it stated that "standing alone the language of the regulation is ambiguous." By recognizing the ambiguity, the Circuit rejected the claimed "plain language" advanced to support the *Newport News* case that claimed both specifically and implicit costs are part of the contract.

2. It next looked to see whether the regulatory history provided a clear meaning and the Circuit concluded that was "inconclusive."

After concluding both the clear language underlying the *Newport News* case and regulatory history was not helpful, it then turned to relevant regulations, specifically CAS Interpretation No. 1 and settled interpretations of B&P costs.

3. CAS Interpretation No. 1. The Circuit concluded IR&D costs must be treated the same as B&P costs. Interpretation No. 1 clearly distinguished between B&P costs being a specific requirement of an existing contract and different circumstances when normal B&P costs relate to all work of a contractor. It stated circumstances are different because preparing a proposal specifically required by the provisions of an existing contract relate only to that one contract while all other proposal costs relate to all work of a contractor. The Circuit then held though Interpretation No. 1 does not address IR&D costs, IR&D must be interpreted the same as B&P costs since otherwise IR&D and B&P costs would require a "different construction" which is impossible when there is identical regulations and language for both types of costs.

4. The Circuit rejected the gaming the system argument of the government concluding there was no risk contractors would routinely manipulate contract terms in order to charge the government for costs that do not properly qualify as IR&D.

5. The Circuit agreed with ATK's position on the adverse effects cause by the "first-in-line" position. It explained that the government's approach would either disproportionately burden the contract that happened to be first in line or ensure the first contract would loose money if the R&D costs were not recoverable. To allocate research costs that is expected to benefit multiple contracts, both commercial and government, to only the first contract "is not sensible as a policy matter." It added since the purpose of IR&D costs is to encourage innovation those costs benefit government contracts since they are associated with effort to invigorate and improve the products sold to the government.

Clarifying the IR&D Test

The authors state the Circuit's decision should provide clarity to contractors and the government regarding what R&D effort is not independent and hence direct. It also addresses other cost accounting issues.

1. The decision establishes that like B&P costs, R&D effort is independent unless the effort is specifically required by the terms of an existing contract. Absent such a specific requirement, contractors can confidently classify R&D costs as IR&D and charge them as indirect.

2. Contractors still must ensure their disclosed practices are consistent and compliant with CAS 402. Specifically, contractors should ensure that R&D costs incurred in like circumstances for the same purpose are classified consistently and the disclosed practices identify these circumstances. (*We would argue disclosed practices need not be limited to a formal CAS disclosure*

statement and since FAR Part 31 closely mirrors CAS 402 requirement, it applies to non-CAS covered contractors as well.)

3. Now it is safe to clearly state that R&D costs not "specifically required by a contract" is an IR&D cost. To further clarify the authors recommend the phrase be defined in its disclosed practices to mean (a) the effort is not specifically required by the contract's Statement of Work or specifically included in the contract's cost or cost build-up in support of a contract price and (b) there is reasonable expectation the effort will benefit more than one contract.

4. Since the facts and circumstances of a particular contract will continue to be relevant in any determination, contractors should carefully consider the facts relating to any contract where it can be argued that R&D effort is not IR&D. Relevant facts might include (a) parties' intent as shown in proposals, negotiation documentation and other documentation (b) contract's wording (c) contract's cost estimates and actual costs (d) why IR&D effort was taken and (e) explanation of why there was a reasonable expectation of benefit for multiple contracts.

5. The long standing practice of "parallel" or "generic" IR&D effort along with funded direct R&D effort remains in tack. Though the *Newport News* case had the effect of questioning such practices the result of the Circuit decision permits contractors to engage in R&D effort to support ongoing contract work and classify such costs as IR&D as long as the necessary conditions expressed above are met.

6. The case affirmed that B&P costs are subject to the same rules as IR&D costs. The decision on how to determine whether R&D costs are required under a contract or are properly IR&D should be the same for B&P costs. To treat these two differently is to risk questioned costs.

7. The decision established the primacy of a contractor's disclosure statement. *ATK* affirmed that contractors enjoy substantial discretion in selecting their disclosed accounting practices and once established have a sound basis to dispute government, especially DCAA, attacks on contractors' accounting practice. The *ATK* case addresses specifically CAS 402 which gives the contractor freedom to determine how it will classify certain costs as long as it is consistent where the disclosed practices are the primary means for establishing these practices. Absent a CAS non-compliance, the contractor's practices are considered acceptable and if the government insists on a change, the contractor should be compensated for it.

Finally the authors added a couple more conclusions. The *ATK* decision has provided much needed clarity regarding when R&D effort is IR&D costs. Contractors should examine their cost accounting practices, disclosed practices and related policies and procedures to ensure IR&D costs are maximized. They should ensure their contract pricing and negotiation policies as well as standard terms and conditions and SOWs for both government and commercial contracts establish a clear statement of intent regarding what R&D effort is specifically required by the contract.

CONSIDERATIONS FOR DETERMINING PROFIT

(Editor's Note. We are often asked by our readers to provide more insight into what profit rates to propose and how to negotiate "fair" profit rates. Though we have addressed the issue previously ("What's a Fair Profit or Fee?" in the Nov-Dec 2001 issue of the GCA REPORT) we still need to address how to best defend a given level of profit against FAR criteria. We found an article in the July 2009 issue of Contract Management written by Bud Almas and Fred Schlich of B3 Solutions LLC that we found particularly interesting because (1) the auditors were both former Air Force officers presumably involved with negotiating profit rates for the government and (2) the list of considerations they put forth (we are usually not particularly great fans of lists) is consistent with the types of points we have helped clients put together to justify their proposed profit rates.)

The concept of "profit" has a variety of meanings. To economists it is the expense needed to attract offerors to commit its resources, finance people consider it as the incentive to risk capital in uncertain environments, accountants consider it as the difference between revenue and costs and the IRS as its tax target. To the government, as provided in FAR 15.404, a profit rate is that which is "sufficient to stimulate efficient contract performance, attract the best capabilities of qualified large and small businesses" to enter the government marketplace and to "maintain a viable industrial base."

When price is based on competitive forces profit, like all other costs, are assumed to be at a fair level due to market forces. When a price analysis is made, a review of profit may be made but is not separable from other costs in reviewing an overall determination of price reasonableness. It is only when a cost analysis is made that profit becomes a factor to propose, analyze and negotiate. In negotiating

profit the FAR 15.404(4) warns against such methods as negotiating low profits, use of historical averages or automatic applications of predetermined profit percentages to cost estimates because they "do not provide proper motivation for optimum contract performance." Rather the FAR prescribes a "structured approach" where "common factors" and "other factors" are required to be analyzed in arriving at a fair profit. Whereas "other factors" are considered to be those that may be unique to a given agency, acquisition or specific procurement approach, "common factors" are specified as contractor effort, contract cost risk, federal socioeconomic programs, capital investments and cost control and other past performances.

1. *Contractor effort* is broken into four elements:

a. Material Acquisitions. This subelement seeks to measure contractor input and management of the acquisition necessary for the contract output. Higher profit is justified if the input is more complex, difficult to obtain or requires management of many suppliers and subcontractors. Conversely, less profit is appropriate if, for example, the work required was done by all-inhouse labor.

b. Conversion of Direct Labor. Higher profit consideration should be given if the labor required is more diverse, more skilled or requires more supervision and coordination. Higher profit would apply if a contract requires pulling together tight schedules of, for example, engineers, scientists or high end manufacturing skill levels. At the lower end of the profit spectrum are contracts with a high level of staff augmentation where much of the day-to-day tasking effort is made by the government. However, even in such circumstances, difficulty in recruiting or retaining employees may justify higher profit levels.

c. Conversion Related Indirect Costs and General Management. Indirect cost effort has a material impact on overall quality and cost of a contract. Indirect effort that is routine in nature provides little support for high profit but activities that are specialized needing, for example, continuing education or highly technical IT systems suggest a higher profit.

2. Contractor Cost Risk. The type of contract awarded is considered to be a strong indicator of contract cost risk. The authors provide a continuum list of contracts from high to low risk where time and material/labor hour is at the bottom, next is cost plus and cost sharing arrangements followed finally by various fixed price arrangements. (*The placement of T&M at the highest risk level is contrary to normal perception of cost type contracts being the highest risk.*) The authors stress other factors than contract type also impact the nature of cost risk. Work that is routine, has lots of cost history and is predictably steady carries much less risk than work that is not, even if both are based on fixed prices. Also contracts that are not definitized carry less risk than those that are because negotiating such contracts normally look to actual costs making them closer to cost type contracts.

3. Federal Socioeconomic Programs. The FAR explicitly uses higher profit to incentivize contractors to provide greater opportunities for socioeconomic programs. We and the authors find that generous programs are not sufficiently highlighted when it comes to negotiating higher profits.

4. Capital Investments. Making "capital investments" that will provide for efficiency and better performance are of great interest to the government are to be considerations for higher profit. Like federal socioeconomic programs, contractors need to identify their current and planned capital investments when negotiating their profit levels.

5. Cost Control and Other Past Performance. FAR profit guidelines put emphasis on using profit levels to reward past successful efforts at cost control as well a future, planned efforts. These should be put forward during profit negotiations.

6. Independent Development. Contracting officers are encouraged to reward contractors with higher profit levels who contribute to independent development, as opposed to government funded work, that directly benefits or will benefit contract performance.

In addition, agencies are required to have their own structured approach to analyze and negotiate profit. The DOD Weighted Guidelines, DD Form 1547 is the most well known. The authors state such guidelines have limitations where profit analysis should be more than simply putting in values on a form and tend to be excessively subjective. (*Editor's Note. That may help explain why we do not see these guidelines used except maybe at the prime contract level for major systems acquisitions.*)

Of course profit rates negotiated on a contract do not equate to actual financial gain on a contract. Efficiencies gained on fixed price contracts can increase the gain, for example, and incurrence of unallowable costs on cost type contracts can decrease it. This information

is not and should not be privy to government auditors. The authors end their article by stating no matter what the negotiated profit is, negotiations aimed merely at reducing prices by reducing profit without recognizing the proper role of profit is not in the government's interest – a thought that often needs to be repeated during negotiations.

Case Study...

RECOMMENDATIONS FOR USING A SUBCONTRACT/ MATERIAL HANDLING RATE

(Editor's Note. Our client has a history of burdening its subcontract costs as well as certain direct material and equipment costs in various ways, sometimes using a special burden rate (SBR) and sometimes using a full G&A rate. They asked us to help them establish criteria for using either the SBR or full G&A rate and recommend any changes we thought appropriate. The following is a highly edited version of our report. We have used the term "Contractor" rather than divulge the name of our client and changed the numbers used.)

The intention of this memo is to recommend what I consider to be the best way to provide add-on charges to such direct costs as subcontractors, materials and purchased parts to meet its twin goals of providing pricing flexibility and compliant accounting practices.

Background

*2005 Proposal***.** Prior to 2005, all subcontract, material and purchased parts were burdened with a SBR that varied from .5 to 3 percent over the years. In 2005, the company established an accounting change where the SBR would apply to some subcontract costs while the full G&A rate would apply to others. Though a memo written at the time indicated the criteria for determining what rate would apply should be based on dollar value of subcontracts (full G&A burden applied to subcontracts and purchased parts valued at less than $50K and the SBR applied when the cost exceeded $50K) it appears as if this suggestion was not consistently followed.

*On-Going Discussions***.** Over the years, several alternatives ways of when to apply the SBR were considered but no definitive decision was made. There appears to be a keen understanding that whatever criteria is used, the decision should be based on what will satisfy Contractor's clients and provide a competitive edge while making sure that Contractor does not give up excessive dollars it would be allowed to receive. All people I spoke with as well as memos I read emphasized the need to come up with a way to be able to provide flexibility in pricing, using a lower rate when needed and a higher rate when it would be acceptable. Several criteria alternatives were put forth:

1. Large or small, similar to the criteria expressed in the 2005 memo.

2. Purchases where Contractor does or does not "add value."

3. Whether the purchase involves doing business with a "strategic partner" (use the SBR) or non-strategic partner (use the full G&A). Examples of a strategic partner might include subcontractors under Small Business Innovative Research (SBIR) awards that provided essential technology breakthroughs.

4. Distinguishing between subcontracts and purchased parts with some variation of consideration for large versus small dollar purchases.

5. Some suggestions recommended a combination of criteria such as a procurement exceeding $100K with no value added.

The internal memos I read had some thoughtful insights into the weaknesses of the above criteria. For example, one memo challenged the "added value" criteria due to the difficulties in determining when value was and was not added while another memo challenged the large versus small dollar criteria, pointing out both some small but also some large, expensive items required a SBR.

What Options are Available. Early in the engagement Contractor asked us to identify the types of indirect rate options they had. We provided a memo identifying five general options for burdening subcontract/PPE costs – (1) Contractor's current SBR method adjusted for greater consistency (2) pure value added G&A base (3) added value G&A base and a special material and/or subcontract burden rate (4) total cost input (TCI) G&A base and (5) a modified TCI base where only a portion of subcontract costs based on dollar criteria would be included in the base. We indicated all five options were potentially defensible against FAR and CAS criteria (too detailed to recount here).

*What Cost Elements Go Into the SBR and G&A Pools***.** There was also a history of difficulty in determining what costs should go into the SBR cost pool used to compute the rate. The current methods of using either timesheets or estimates of time spent on supporting

subcontracts and purchases included in the base were subject to significant imprecision and I was concerned they would likely be challenged by auditors. As for the G&A pool, traditional pure G&A costs such as CEO and CFO as well as business development, IR&D/Bid and Proposal and board of director expenses are included. Other less strict G&A type costs are also included in the G&A pool such as senior operating managers, senior VP support staff such as HR, IT and Technology as well as all functions of accounting and finance, contracts and legal.

Future Contract Work. In my mind, the key for understanding the issues lie in first determining the type of work likely to be performed in the near future and what was their clients' attitudes about applying full G&A rates to selected ODCs. My interview with the heads of the company's two business units identified the following type of work:

1. Research and Development projects. This business represents the majority of Contractor's current work which includes outputs of professional labor, prototype items and short production runs. Here, the managers indicated a full G&A rate would be acceptable to its clients on most subcontract costs despite the fact most subcontract and material costs were currently burdened with the SBR. However, one particularly large subcontract (representing close to 75% of the dollar value of subcontracts) that did receive the SBR could not be burdened with a full G&A rate because it would be strongly resisted by the customer.

2. SBIRs.. Though representing a small dollar value of business, these contracts are strategically important for future business. The managers indicated they would like to see no G&A or at most a small SBR applied, especially for Phase I SBIRs, since they are reluctant to have indirect costs take up highly limited funds of these contract vehicles.

3. Hardware. Currently this work does not require a cost buildup to determine price so no add on is applied to subcontract/parts costs. In the future, the company is going after a large, probably CAS covered contract, where the price will be based on a cost buildup estimate and half the costs will be subcontracted out. One of the managers said a full G&A rate would likely be acceptable.

4. Production Items. In this work, much of the work is subcontracts with large prime companies where Contractor provides high end items where there is little price sensitivity so Contractor can apply even higher G&A rates with no resistance from its clients.

Our Conclusions

2005 Proposal. The 2005 proposal seems to be an excellent improvement over what went before. Rather than the "one size fits all" SBR approach, the distinctions of high and low dollar subcontract costs provided a way to burden similar costs differently for achieving the goal of pricing flexibility. The weakness of the 2005 proposal was that pricing strategies for different types of contracts were not clearly defined and the details were left for the future – what are the costs in the SBR pool and what criteria for applying the rates.

Basis for Applying the SBR Versus Full G&A Rate. The confusing nature of the criteria to be used and weaknesses of them all is a source for significant potential audit challenges to Contractor's rates. The commonly acceptable rules are: – like costs must be treated consistently and the way to burden subcontracts is to either use a TCI G&A base or a value added base where subcontracts, material and/or equipment parts may be burdened with a handling rate. A subcontract rate (excluding material and PPE) is commonly accepted for non-CAS covered contractors (though auditors will sometimes challenge this).

Any other choice is a tough sell. In our experience, we have not seen any criteria where value added, strategic or non-strategic partner or combination with large versus small costs has been accepted when reviewed. The only criteria we have seen accepted (we helped sell this approach) is a large versus small basis (e.g. below and above $50K) where the methodology for identifying the pool is clear (e.g. specific individuals assigned to the pool, subcontract handling cost center). However, considerable "selling" must be involved to gain acceptance including a convincing justification narrative, allusions to relevant regulations and case law and a cost impact analysis ideally showing how the government benefits (has less dollars allocated to relevant government contracts).

In addition, since the two types of subcontract costs where the lower SBR rate most commonly apply – SBIRs and certain large R&D contracts where lower dollar and high dollar subcontract costs apply, respectively - a low/high price threshold criteria applied to all subcontracts would not make much sense. Though it is true SBIR contracts and a limited number of other R&D contracts would benefit by a low SBR rate, other contracts where both low dollar and high dollar subcontract costs can be burdened with full G&A would result in excess dollars "left on the table" by applying an unnecessary low burden rate.

What Cost Elements Go Into the SBR Pool. If reviewed, the current method of assigning costs to the SBR pool would be challenged. Estimates are normally unacceptable except when used for forward pricing purposes. Costs based on timesheets have the potential of being more acceptable but is vulnerable to having an auditor conduct a floor check where if problems of inaccurate timekeeping are found it would make the entire cost pool unsupported. One approach that would likely be accepted entails including subcontract support costs into one or more cost centers and allocating a portion of those costs to the SBR pool based on some objective measurement like number of invoices. Nonetheless, DCAA is notorious for carefully evaluating the accuracy of the types of bases used to allocate these types of cost center expenses (e.g. number of vendor invoices) where if inaccuracies are found in the base all costs are disallowed including those costs allocated to overhead.

*Future Contract Work***.** Both the types of business opportunities Contractor is facing in the near future and ways G&A can be charged to those contracts are unusually varied. Given that the criteria of what G&A rate to apply should depend on client desires and pricing competition concerns as well as minimizing dollars "left on Contractor's table," the result of my discussion with management indicates the key element must be flexibility in applying rates. The SBIRs and certain other contracts where there is both a high dollar subcontract cost element and a client concern of minimizing add on costs, a zero to 3 percent add on is desirable. In other contracts, a higher rate may be acceptable but not one higher than other competitors may add, perhaps in the 8-13% range. In much of Contractor's future work the current G&A rate is acceptable where even higher rates could be approved. In my opinion, the pricing scheme selected must be able to meet these varied pricing strategies as much as possible.

Discussion of Current Rates. Contractor's 2009 G&A rate of approximately 17% and its overhead rate of 60% should be compared to other firms that Contractor does and will compete with in the future. There is no substitute for sound business intelligence to determine what these benchmark rates are because we see widely divergent "bogey" rates in different types of competitions. No general survey or consultant's impressions can substitute for such specific information.

Nonetheless there is some very limited benchmark data that can be used as a rough indicator. Grant Thorton's 15th Annual Government Contractor Industry Survey (see our 1Q10 DIGEST for a fuller discussion) that compares primarily professional service firms indicates a 13% G&A rate is normal when total cost input is the allocation base and 15% when a value added base is used. Average overhead rates for on-site labor is 60% when the overhead base is direct labor and 48% when the base is direct labor plus fringe benefits, which is the case with Contractor. For those firms using a separate subcontract handling or subcontract/material handling rate, the survey results are 4% and 3.5%, respectively compared to Contractor's 1.5%. Our experience provides a bit different results – lower G&A rates than the survey in the 8-11% range and higher overhead rates (sometimes up to 120% or more) are typical of professional service firms in our experience. The bottom line of these statistics is that Contractor's G&A rate is higher than most while its overhead rate, though higher than survey results, is still lower than most companies we encounter. Only its SBR handling rate is lower.

Recommendations

Our intention is to provide recommendations to provide Contractor sufficient pricing flexibility to be able to offer a range of add-ons amounts to its subcontract/material/PPE costs and still be in reasonable compliance with government contract accounting regulations. We would offer the following as recommended preferences.

1. *Eliminate the SBR.* Though it seeks the laudable objective of providing a cost based justification to allow Contractor to charge both full G&A and a significantly smaller add-on to its direct subcontract/ PPE costs to meet its pricing goals, its shortcomings can undermine the very goals it seeks to achieve. The criteria Contractor uses to distinguish what rate to apply are problematic and obtaining DCAA approval is unlikely if they are reviewed unless the criteria is a simple dollar threshold. However, the simple dollar threshold criterion will not accomplish the goal of applying an SBR to both low dollar SBIR subcontract costs and high dollar subcontract and equipment costs on selected R&D contracts. In addition, justifying the pool costs through unreliable timesheets or estimates is highly problematic where even a surrogate measurement, though more defensible, is also subject to DCAA disallowances. As we see below, the company's pricing flexibility objectives can be achieved in other ways.

2. *Establish one full G&A rate applicable to all subcontract/material/PPE costs where the base would be total cost input.* I believe establishing one add-on amount provides maximum pricing flexibility and would not be challenged by DCAA. Pricing flexibility stems from using a maximum add-on factor for those subcontract amounts Contractor wishes to apply a full G&A rate to without suffering objections of its client. Based on estimates of future business opportunities, this will be the case in the vast majority of contracts. Since subcontract/PPE costs represent a low amount of direct costs, adding them to the current value base would result in about a half a point decrease to the current 17%. In those situations where it wants to lower its add-on or even eliminate it, the firm has that option as discussed below.

3. *Consider lowering the full G&A rate by moving some G&A pool costs to overhead.* The 17% G&A seems rather high while the overhead rate may be somewhat low depending on what survey or experience is used (again, I urge you to use your own business intelligence). This may be desirable if Contractor wishes to charge a full G&A rate but wants to keep its burden rate low. Contractor can lower its G&A rate and increase its overhead rate to be more closely aligned with competitors by reassigning certain costs now included in its G&A pool that can legitimately be placed in the overhead pool. Examples of possible candidates include such functions as contract and subcontract administration, HR, accounting, senior operating management and certain legal expenses. Of course, this may not be a desirable move if substantially more subcontract costs are incurred in future years.

4. Two options come to mind when Contractor wants to offer a less than full G&A rate on selected contracts:

a. *Offer a management concession.* On Phase I and selected Phase II SBIRs a low or even zero add on can be offered as a management concession. A zero add on is not materially different than the current SBR offered and may be perceived as a major plus in evaluating your proposal. In addition to the SBIRs, the SBR was offered on only two contracts with high dollar subcontracts and one contract with high PPE costs in the 2009 time period. On those and other contracts a management concession (i.e. voluntary reduction in an indirect cost pool's costs) can be negotiated where less than a full G&A rate can be offered, anywhere from zero to slightly lower than the full rate.

b. *Offer a special allocation.* As an alternative to a management concession, a very limited number of contracts can offer a special allocation. The mechanics of computing a special allocation is to establish a base and pool of costs where the base represents the subcontract/PPE costs applicable to that special contract and the pool is the support expenses for those base costs. Both these pool costs, which presumably come from either or both the G&A or overhead pools, and base costs are eliminated from their respective pools and bases where the normal G&A rates are computed net of those costs. This has the advantage of offering a low (or even zero rate if no costs are transferred to the new pool) rate without diluting the G&A rate. In practice a special allocation should be used sparingly because approval before contract award by the ACO is required where often significant administrative burdens need to be followed.

COMMENTS ON NEW CONFLICT OF INTEREST PROPOSAL

(Editor's Note. The issue of Organizational Conflicts of Interest (OCI) has become one of the hottest topics around lately. Much criticism by various government groups have asserted not enough is being done to prevent contractors from winning awards when they may have unfair access to information giving them an unfair advantage over other bidders. In addition, many industry groups have been saying that several recent cases have generated rulings that make current regulations governing conflicts of interest obsolete. The current proposed rule intending to address these concerns has generated considerable commentary. We have relied on an article in the April 27 issue of Government Contractor written by Marcia Madsen, David Dowd and Rodger Waldron of Mayer Brown LLP to address this new proposed rule.)

On April 22, 2010 the Defense Department issued a proposed rule to amend the Defense Federal Acquisition Supplement to implement the Weapons System Acquisition Reform Act of 2009 (referred to as the Act). The proposed rule addresses changes for treatment of organizational conflicts of interest, representing a significant change over current regulations of OCI. It reflects a current government-wide focus on avoiding OCIs even if the goal of expanding competition suffers.

Background

Section 207 of the Act directs DOD to revise the DFARS to provide "uniform guidance" and "tighten up existing requirements" for OCIs by contractors

involved in major acquisition programs. A Panel earlier recommended the FAR Council address OCIs stating that growth of services, industry consolidation and use of multiple award contracts had increased the likelihood of OCI and the need to address it. Key aspects of the rule include:

1. Reorganization and Application. The current FAR addresses OCIs in FAR Subpart 9.5 while the proposed DFARS rule would relocate coverage of OCI concerns in a new subpart 203.12 section in the DFARS. This relocation would group OCI with improper practices and personal conflicts of interest. It is unclear whether DOD would exempt itself completely from the FAR 9.5 section. The proposed rule covers three methods for resolving COIs – "avoidance, limitation on future contracting (neutralization) and mitigation."

2. Reflection of Case Law Developments. The Rule acknowledges that the FAR provisions are outdated and do not reflect more current principles developed through many protest cases issued in the last 15 years. For example, in *Aetna Gov. Health Plans (B-254397*) the GAO recognized there are three types of OCI: (i) unfair access to non-public information (ii) "biased ground rules" and (iii) "impaired objectivity." The proposed rule mirrors these three types of OCI and goes much further by introducing new approaches and significant obligations on the part of offerors, contractors and agency personnel.

The Rule expresses a policy preference for mitigation of OCI rather than other techniques for addressing OCIs. It recognizes some OCIs are not always susceptible to mitigation in which case the CO is to either select another offeror or request a waiver. The Rule does not provide guidance on when mitigation should not be used. Authority to grant a waiver is allowed where resolution of an OCI is either not feasible or it is in the "interests of the government." Before granting a waiver, however, agencies must resolve conflicts "to the extent feasible" and the waiver should be applied only for "residual conflicts" after all techniques have been used to lessen the conflict.

3. Task and Delivery Contracts. The Rule provides that OCIs are to be addressed at both the contract and order level. If a COI can be identified at the time of award of the basic contract, COs are to include a resolution plan – mitigation or limitation on future contracting – in the basic contract. The Rule also directs COs to consider OCI at the time of issuing a task or delivery order. If there is a resolution plan in the basic contract, COs are to tailor the plan at the order level.

4. New Tools and Techniques. Though some agencies have their own OCI clauses, there is no current standard FAR OCI clause. The Rule would provide standard OCI clauses to be used by Defense agencies. If the DOD approach is adopted in the FAR rewrite then there would be standard OCI clauses for civilian and defense agencies that would address both identification and resolution of OCIs. The proposal puts forth clauses that would apply to major defense programs and others circumstances.

a. Notice of Potential COI. This clause will (i) notify the offeror the CO has identified an OCI and makes either resolution or a waiver of the OCI a requirement of award (ii) require the CO to describe the nature of the OCI and steps the government has taken to lessen the conflict (iii) require the offeror to disclose all relevant information or to represent there is no OCI (iv) require the offeror to describe any other work it performed as a contractor or subcontractor over the last five years that is associated with the offer it plans to submit and (v) describe the actions it intends to use to resolve any OCI e.g. mitigation plan, limit future contracting.

b. Resolution of OCI. This clause will be included in a contract when an OCI can be resolved through a mitigation plan. The clause will (i) incorporate the plan (ii) violations or changes to the plan (iii) require flowdown to subcontractors and (iv) when there is unfair access to non-public information the CO should consider whether a mitigation plan includes a limitation of reassignment of personnel with such access.

c. Limitation of Future Contracting. This clause will be used when the CO decides to resolve a COI by limiting future contracting. Particular work the contractor is ineligible for will be identified with a default period of three years which can be modified.

d. Disclosure of COI After Contract Award. This clause addresses COIs that may arise after contract award such as a novation of a contract or the acquisition of a business that may cause a COI.

5. The COTS Exception. The rule states it will not apply to acquisition of commercially available off the shelf items but does not apply to other commercial items. The authors point out the rule does not indicate the difference between COTS items and other commercial items.

6. Implementation of Section 207. The rule tracks the requirements of the act to tighten OCI rules. The Act provides that DOD will receive advice on systems architecture and systems engineering (SETA) matters from organizations independent of the prime contractor e.g. federally funded R&D centers. Though a SETA contract prohibits contractors or an affiliate from participating as a prime contractor the rule provides for exceptions to ensure DOD has continued access to SETA matters from highly qualified contractors. The rule would allow COs to accept a mitigation plan to enable a contractor performing a SETA contract to participate as a prime or major contractor.

Comments on the Proposed Rule

The authors provide their opinion on several aspects of the proposed rule.

1. The DFARS Subpart 203.12. The rule allows for a more "centralized and streamlined approach" that is an improvement over the current approach of allowing agencies to address their concerns in a wide variety of ways. It is interesting the new section is grouped with other improper conduct e.g. gratuities, kickbacks, etc.. Though OCI can be detrimental to the procurement process OCIs "do not turn" on improper conduct and the fact that COs may waive OCI is quite distinct from improper conduct where there is no concept of waiving requirements.

2, Definitions and Scope of Coverage. The rule is to apply to a contractor which includes the total organization including not only business units that sign the contract but subsidiaries and affiliates. The term "affiliate" is undefined so whether the entity needs to be wholly-owned or whether even small interests is sufficient for an OCI is unclear. Also, as mentioned before, there is no rationale why COTS is exempt but not other types of commercial items. The only hint is that COTS, which apply to supplies, is distinct from commercial services.

3. Identification of Resolution of OCIs – New Burdens

a. For contractors. The plan calls for contractors to make significant disclosure regarding OCIs or represent there is no OCI. It should inform the CO of any potential OCI even before preparing its offer. Also regardless of whether the offeror discloses the existence of an OCI, it must describe any other work performed on contracts and subcontracts in the last five years that is "associated" with the plans it submits. The term is undefined and can include a very broad scope of prior work. This potential broad scope and five year requirement can be quite burdensome especially for firms that my have dispersed operations or who acquired other companies in recent years where records may be poor. Even if not so dispersed it can still be quite difficult when there was no requirement in the past to track relevant information. Failure to abide by disclosure requirements can subject an offeror to civil False Claims Act and other regulatory liability as a recent case ruled.

b. For agencies. COs must consider a broad range of information. Prior to issuance of an RFP, the CO must review the nature of the work to see if a potential OCI exists. If no OCI is identified, the record must be documented while if one exists, the relevant clauses must be included. Next more information needs to be reviewed to see whether an actual OCI will exist upon award such as information put forth by offerors and both governmental (e.g. files, knowledge of people at the contracting office) and non-governmental sources (e.g. website, credit rating services). The shear volume of information to consider can be quite burdensome, especially for smaller procurements, where failure to consider some of the data may be grounds for a protest the CO failed to assess potential OCI information.

4. Impact on Protests. The current FAR directs COs to identify and evaluate potential OCI but provides little specificity. The GAO has traditionally largely deferred to agencies in their handling of OCIs as long as there was evidence some analysis was undertaken. The proposed rule contains more detail on what steps should be taken by the CO so there will be greater risks that there will be more findings an agency failed to follow the prescribed steps. For example, the proposed rule requires a CO to consult a number of sources to determine whether an OCI exists so failure to do so will likely provide a basis for a successful protest.

5. Mitigation and Avoidance. The proposed rule generally states that of the three primary methods – avoidance, limit future contracting or mitigation – mitigation is the preferred method. The proposed rule states that if the CO is "unable to mitigate" an OCI, another approach shall be used but the proposed rule does not address a preference for any alternative approaches.

6. Waivers. In response to some cases, the new rule provides that a waiver may be granted after trying to "feasibly" resolve all conflicts. This rare act of granting

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a waiver will now be subject to challenge on the basis the agency did not reasonably take all feasible steps to resolve conflicts.

7. Impact on Discussions. Based on a case, the preamble to the proposed rule states that communications with offerors regarding OCIs should not be considered "discussions" because such exchanges do not result in changes to an awardee's proposal. However, there may very well be instances when exchanges regarding COI do result in changes to a proposal so it is unclear what would happen then.

8. Other comments.

a. Like the current rule, the definitions of "technical assistance" and "system engineering" continue to be somewhat vague. Though contracts for these services may not be difficult to identify, these types of services are common in other types of contracts.

b. The proposed rule requiring COs to consider the award of a major subsystem by a prime to other business units or affiliates can have significant effects on a prime's make or buy decisions. Nonetheless, the rule provides little guidance here e.g. what should a CO do.

c. The proposed rule prohibits contractors or affiliates to participate in the development or "construction" of a weapons system if it was involved in SETA contracts but this term "construction" is vague e.g. does it mean "production."

d. The proposed rule does not address how existing SETA contracts should be addressed. Is it to apply to contracts initiated after the effective date or are the requirements intended to apply to existing contracts.

e. The proposed rule establishes "limited exceptions" to the SETA prohibition to ensure DOD has access to systems from highly qualified contractors. So a contractor may participate as a contractor or major subcontractor for development or construction of a weapon system if it has a SETA contract but there is no guidance for how a mitigation plan in such circumstances should be devised.

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