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PROFIT ON EQUITABLE ADJUSTMENTS

(*Editor's Note. In an era of budget cuts, identification of out of scope work on contracts are increasingly necessary to maintain profit levels on government contracts. The major tool for reaping revenue for out of scope work is a request for equitable adjustment on contracts. The following article addresses what profit levels may be appropriate for them and also provides some good reminders for profit levels on government contracts in general. We are basing this article on one written by Terrence O'Connor of Berenzweig Leonard LLP in the Oct 2015 issue of Contract Management.*)

The most common way to propose profit on a request for an equitable adjustment (REA) is to simply add an amount to the cost claim that is equal to the profit percentage that was used to win the contract. Considerable case law has rejected this "cut and paste" process where the emphasis is there is a major distinction between pricing overhead and profit for a competitive bid and pricing those elements on changed work. So, for example, when bidding a contractor may often lower overhead and profit rates to win the award where the contractor should not be bound to these markups for subsequent changed work.

FAR Guidelines

It takes some hunting to find where in the FAR does profit on REAs reside. It is not in FAR 43, Contract Modifications but rather in FAR Part 15, Contracting by Negotiation and specifically in FAR 15.404, Proposal Analysis.

The FAR 15-404-4 (c)(6) does allow for a limited use of this "cut and paste" approach when a change "calls for essentially the same type and mix of work as the basic contract and is relatively a small dollar value compared to the total contract value." The FAR rejects such "thoughtless" profit approaches such as negotiation of extremely low profits, use of historical averages or automatic application of predetermined percentages to total estimated costs. The reason these easy approaches are rejected is because they ignore the purpose of profit – both the government and contractors should be concerned with profit as motivator of efficient and effective contract performance. This section of the FAR 15.404-4(a)(3) makes the important point that the government occasionally needs to be reminded that "negotiations of profit that are aimed merely at reducing prices by reducing profit, without proper recognition of the function of profit, are not in the government's interest."

- **Factors to be Considered**

The basic rule is that when cost analysis is required on pricing an REA, profit should be based on six factors including the effort and cost risk. According to FAR 15.404-4(d)(1) each factor outlined in paragraphs (d)(i) through (vi) should be considered unless clearly inappropriate "whether or not a structured approach is used." Note the phrase in quotes means the six factors are to be considered whether or not a "structured approach" (discussed below) is used which normally applies to large modifications exceeding $750,000.

The six factors are:

1. "Contractor effort" which considers "the complexity of the work and resources required" where greater profit should be provided when contracts require a "high degree of professional and management skill." For example, removing asbestos in a room requires more effort than simply painting a room.

2. "Contract cost effort" addresses contract type. Here, the contractor assumes greater risk with fixed price as opposed to cost reimbursable contracts.

The other four factors do not figure significantly in equitable adjustment case law so they are only briefly identified in the article: (3) "federal socioeconomic programs" allow greater profit (4) "capital investments" where the more investment the greater the efficiency and effectiveness of contract performance (5) "cost control and other past accomplishments" provide greater profit opportunity when the prospective contractors can show it previously demonstrated its ability to perform similar tasks efficiently and effectively and (6) "independent development" where contractors invested in such efforts without government assistance.

Structured Approach

The FAR requires contracting officers to "consider" all six factors but does not assign weights to any factors. Rather weights get assigned by each agency when they set up their "structured approach." Generally, agencies have taken the six profit factors and set up a spreadsheet-like

approach for applying them. One common approach is called "weighted guidelines" where agencies assign weights – actually a range of weights – to each factor. Generally the "contractor effort" and "contract cost effort" are the most important factors and get the most attention in determining profit. Each percent is applied to a relevant estimated cost (e.g. factor one percent applied to labor and overhead) and the total profit for each factor is added up.

Amount of Profit

Some contractors believe the law limits profit to 10 percent. This is not necessarily true where the amount may limit negotiated fee on some types of contracts where 10 percent would apply but others 15 percent on estimated costs. The 10 percent limit applies only to CPFF contracts except CPFF contracts for experimental, development or research profit is limited to 15 percent. These limits do not apply to FFP contracts. The FAR fee limits are a negotiated fee and apply to estimated costs, not incurred costs. The negotiated fee means a contractor with a $110,000 CPFF contract ($100K estimated costs and $10K in estimated profit) means it still gets $10K fee even if the actual amount of costs were $50K.

As for time-and-material (T&M) or labor hour (LH) contracts opinions vary about profit levels. One court case stated the 10 percent limit should apply while a respected government law treatise (Formation of Government Contracts by Cibinic and Nash) states the 10 percent limit on CPFF contracts does not apply to T&M/LH contracts.

Profit limits are also a bit confusing because most often the CO and contractor need not agree on profit. FAR 15-405(b) and FAR 31.102 emphasize that a CO should not be "preoccupied with any single element" of a proposal but rather should focus "on the total price the parties agree to" which translates into the CO should not be preoccupied with profit because it is only one component of the total price.

What Does Case Law Say

Three lessons seem to come through in the court and appeals board cases: (1) there is more focus on "contractor effort" than contract risk factors, perhaps because the work is finished by the time a REA is filed (2) weighted guidelines are considered but the courts are not bound by them and (3) profit determinations can go either way, up or down from the profit on the underlying contract.

Addressing the third point the authors provide examples of both higher and lower profit than the underlying contract. Telcom and its subcontractor, Fleetwood were entitled to profit rates of 10 and 12 percent on its REA despite 1 percent profit rate on its underlying contract because considerable additional work was required. In a decision ruling the opposite direction, the government awarded Doyle a 5 percent profit compared to a 10 percent rate on the underlying contract because Doyle hired a subcontractor to do the additional work in Alaska where the board ruled that since the work was already completed when it submitted its REA, the only risk to Doyle was liability for a warranty period.

Case Study…

NEW INDIRECT RATE STRUCTURE FOR A GOVERNMENT CONTRACTOR

(Editor's Note. The following article represents our continuing practice to include real life consulting engagements in our newsletters. We disguise the numbers and refer to our client as "Contractor".

Background

Contractor is primarily a commercial operation conducting research and development for high tech solutions and asked us to recommend an indirect rate structure to be able to price indirect costs on an upcoming $40 federal million contract. The contract will include some direct labor costs but will largely consist of direct subcontract work of others. Since they are new to the federal marketplace, we provided a fairly detailed primer on pricing federal contracts. The information we provided included: (1) methods the government uses to ensure pricing is "fair and reasonable" including commercial item designation, competitive bids and cost build up pricing (which would apply to Contractor's contract) (2) types of contracts that the government awards where the current contract would likely be either T&M or cost reimbursable (3) government pricing is based on the total cost concept where all costs are considered to be included in price (4) types of indirect cost rates that are typical of companies like Contractor where the requirements provide considerable flexibility and (5) typical range of indirect cost rates (e.g. 50-100% for overhead, 10-20% for G&A, 3-5% for subcontract handling).

Deferred IR&D

Since a significant amount of its costs represented independent research and development activities, we provided the basic rules for deferred IR&D which allows companies to charge future government contracts for prior incurred IR&D. Government accounting rules provide a relatively unknown opportunity to defer IR&D costs

under certain circumstances despite the general accounting requirements (both in GAAP and government accounting) to recognize such costs in the year they were incurred. FAR 31.205-18(d) provides that IR&D costs incurred in a previous accounting period are allowable in subsequent periods. Five conditions must exist:

1. a contractor has developed a specific product at its own risk in anticipation of recovering those costs in the sale of the item.

2. the total IR&D costs applicable to the product must be identifiable

3. the proration of the IR&D costs must be "reasonable" meaning the allocation of the costs are equitable in the government's opinion

4. the contractor must have had no government business when the IR&D costs were incurred or else the IR&D costs must never have been allocated to government contracts

5. no current IR&D costs for any project can be allocated to government contracts except for the deferred costs related to the specific project.

When deferred IR&D costs are recognized, the contract (except for fixed price) must include a specific provision setting forth the amount of deferred IR&D costs that are allocable to the contract. The negotiation memorandum will state the conditions pertaining to the situation.

Also, pertinent court cases have ruled that for deferred IR&D costs to be allowable, they must first be capitalized and then amortized (though unclear from the regulations, treatment of deferred IR&D costs for government accounting purposes may be different than those treatments for financial reporting or even tax purposes).

Discussion of Appropriate Rates for Contractor

At least five indirect rate combinations were considered (e.g. one rate, direct labor plus fringe benefit base) where two indirect cost rates make the most sense for Contractor: (1) an overhead rate applied to direct labor plus a general and administrative (G&A) rate applied to all direct costs and overhead or (2) an overhead rate applied to direct labor, a G&A rate applied to a value added base of direct labor, overhead and ODCs excluding direct subcontract/contract costs and a subcontract handling rate where the later would be applied to all direct subcontractor and contractor costs.

Contractors' projected costs for 2015 represent some highly unusual circumstances which pose some unique problems. The problems stems from the fact that Contractor's activities are primarily research oriented where there are no direct funded contracts and hence it incurs very few direct costs which means there are few costs to apply indirect cost rates to. Almost all of its labor costs are indirect – independent research and development (IR&D), administrative, executive, etc. The DOD contract will have eight Contractor employees directly involved with its tasks. With the exception of this new contract, virtually all of Contractor's subcontract/contract costs are also indirect, primarily in support of IR&D efforts, which government accounting rules consider G&A. Almost all of Contractor's expenses would be considered indirect where some would be considered G&A such as IR&D and marketing related expenses while most other costs can be considered either overhead or G&A expenses. If a subcontract handling fee is used, separate indirect subcontract handling costs (the handling pool) would need to be carved out of the G&A or overhead costs.

Overhead and G&A Rate Option

Based on its 2015 budget I computed an overhead and G&A rate . I assumed an estimate of direct labor costs and direct subcontract/contract costs from the new contract of $1,600,000 and $8 Million, respectively. The result is a 540% overhead rate (dividing overhead costs by direct labor) and a 55% G&A rate (dividing G&A costs by all other costs excluding the G&A costs). Such rates would, of course, be looked upon as bizarre by the government. Applying these unusually high rates to its projected direct labor and ODCs on the DOD contract will most certainly be resisted by the government (I can hear them say "I don't care what your indirect cost rates are, I will not pay these amounts"). They would also eat up a large share of funded resources which would not allow Contractor to finish the work it planned to perform.

Accordingly, Contractor can consider a few options to reduce these indirect cost rates and still remain compliant with government accounting rules. One alternative is to simply offer lower rates (e.g. 70% overhead and 10% G&A). The problem with this is that proposed rates are likely to be audited on a $40 million contract so the proposed amounts need to be identified in projected cost schedules that use appropriate cost methodology. Otherwise, the auditor will opine that there is no support for the proposed numbers and could question the entire amount.

Alternatively, Contractor can offer a "Management Concession" to both the overhead and G&A pool amounts. The concession amounts to a voluntary reduction of pool costs. So, as I have shown, if we reduce the overhead pool by $8.3 million (that would be the management concession) the overhead rate goes from 540% to 75%. Similarly, if we reduce the G&A pool by $17.5 million, the estimated

G&A rate goes from 45% to 15%. The advantage of the management concession approach is the auditor starts their audit (or at least is supposed to) at the costs we show before the concession is made so even if some of those costs are questioned it would be highly unlikely that they would come close to the amount of concessions we offer. In addition, the existence of such a high concession could result in an audit of reduced scope.

A third alternative to reduce indirect cost rates would be for Contractor to treat its IR&D costs as "deferred IR&D." It appears as if it meets the conditions for doing so – e.g. IR&D costs are identifiable, Contractor neither had any government contracts when the costs were incurred nor had they been allocated to government contracts. Contractor will need to identify the IR&D costs, capitalize them and either exclude them from the current estimated proposed costs or assign an amortized amount to the current G&A expense pool. The advantage of this alternative is that Contractor does not have to recognize its current IR&D costs, which is what it wants to do anyhow, and still be able to charge the government for items developed through this IR&D effort at a later date. Be aware if this approach is taken, Contractor should negotiate an agreement with the government that would be incorporated into this contract and subsequent government work and should document its accounting practices in a written policy.

Subcontract Handling Rate

An alternative to having two rates – overhead and G&A – would be adopting a third rate we can call a subcontract handling rate (SHR). The SHR is often adopted when a company's computed G&A rate is higher than either it wants to offer or what the government will accept, which is certainly the case with Contractor. It has the advantage of basing a proposed handling rate on actual estimated costs. A SHR is commonly in the 3-5% range. The pool consists of indirect costs related to managing and administering the company's subcontract/contract costs. Normally, such support costs need to be separately identified (either by timesheets or dedicated employees assigned to this category) where they are carved out of the overhead and G&A costs identified above. This pool of costs are normally divided by the company's direct subcontract/contract costs. The resulting SHR would then be applied to the contract's estimated direct subcontract costs (e.g. $8 Million in my assumption).

I computed a SHR in the amount of 3.0%. It is based on the assumption that Contractor identifies an amount of indirect labor associated with the handling effort ($150K), applied fringe benefit costs ($50K) and additional costs of $40K. This 3.0% rate would then be applied to all proposed direct subcontract/contract costs. G&A rates would not apply to direct subcontract/contract costs. Carving out the $150K labor from overhead would result in a lower overhead rate – 510% compared to the 540% – while G&A would increase substantially since a big part of the G&A base (denominator) has been removed and now becomes the SHR base. I computed a new G&A rate where I applied an assumed management concession to the overhead and G&A rates to bring them closer in line with desirable rates.

Conclusion

At this time, I do not have a preference for either option. I anticipate there will be some discussion where we can discuss the pros and cons and choose one of the options. For example, use of a handling rate has the advantage of recovering a small amount (3.0% in my calculation) on subcontract/contract costs that can be justified on a cost build-up basis but use of a SHR requires identifying the handling pool costs which can be an administrative burden and if not properly done, can be questioned by an auditor.

TRAVEL AND RELOCATION DECISIONS

(*Editor's Note. Though only three parts of the Federal Travel Regulation provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidentals and conditions justifying payment of up to 300% of per diem rates – many contractors choose to follow the Federal Travel Regulation either because some contracts call for incorporation of it or auditors and contractors consider it to be the basis for determining "reasonableness." This article is a continuation of our effort to present new decisions likely to affect contractors' travel and relocation expenses.*)

Relocation Expenses are Reimbursable Before Formal Offer of Employment is Made if Clear Intent to Employ is Present

Kristina was finishing her studies and was to go to Pax River after her graduation in May. In March, the facility's representative sent her an email saying the HR office had been "directed to support hiring action." On May 13 another rep told her the HR office would be "contacting her within this week to extend a tentative offer with final offer subject to completing the normal pre-employment security check." This tentative offer was finally extended in writing on June 6 followed by a formal offer on June 27 and travel orders the next day. Kritina's lease on her apartment ended at the end of May where she rented a truck, packed her belongings and drove to Pax River incurring $2,382 of truck rental, fuel, tools lodging, meals and per diem

while driving across the country. The agency denied her claim for reimbursement on the grounds that she moved before receiving orders to do so and before the agency had "manifested a clear administrative intent to make an offer of employment." The Board ruled for Kritina stating that generally relocation expenses are reimbursable only if they are incurred after the individual receives their travel orders but an exception to this rule is made where prior to issuing travel orders the agency "manifested a clear administrative intent to hire the individual and have her move to the initial duty station at government expense." The facility transmitted to her through increasingly specific communications before the travel orders that she would indeed be hired. By May 13 – before leaving – that commitment "became concrete" with the promise an offer would be extended by the end of the week. The fact the offer was only tentative "is of no consequence" for its becoming final was contingent on merely completion of routine actions (*CBCA 3847-RELO*).

Erroneous Travel Orders Do Not Obligate Government to Pay

The Government issued temporary travel orders for Amir, his wife and daughter, who was 21 years old, to evacuate Egypt following a change in government and go to Virginia, the temporary safe haven location. The government denied reimbursement of lodging and per diem expenses of $5,541 for his daughter citing the Dept. of State Standardized Regulations (DSSR) that covers evacuations from assigned ports of duty which limits payments to children of eligible employees who are unmarried and under the age of 21 or who are over 21 but incapacitated. Though he did not dispute the interpretation of the DSSR Amir asserted his daughter's date of birth was expressly referenced on the evacuation travel orders and he relied on these orders when he incurred the expenses for his daughter. The Board ruled that on numerous occasions it has recognized that erroneous travel orders reflecting mistaken assumptions on the part of authorizing officials cannot obligate the Government to expend money contrary to regulation even though they sympathized with Amir (*CBCA 4657-TRAV*).

Long Term Lease Requires Different Calculation Than a Month-to-Month Lease

During her temporary duty in Washington DC from March 1 to June 28, Katherine signed a 4 month lease for an apartment, requiring her to rent the apartment for four months. Though there was no dispute as to reimbursement of lodging costs for the first three months, Katherine took five days of approved leave (the government misconstrued the duration of her leave as 10 days, adding weekends on either end of the leave period). Citing Federal Travel Regulation examples, the government divided her total June rent of $5,580 by twenty finding that the cost of $294 exceeded the maximum daily rate of $224 prescribed by the GSA and questioned the excess amount over $224 for June. The Board disagreed with the government stating the example they followed assumed a month-to-month lease where if true their approach would be correct, but they stated the rental agreement was for a four-month period. In this case, Katherine was entitled to per diem for 115 days (120 originally authorized minus the five days of leave) where the daily rate for her lodging should be the entire period ($23,912) divided by 115 resulting in a daily rate of $207.93 which was below the $224 per day that was authorized. Even if they accepted the government theory of 10 days off, the daily rate would be $217.38 ($23,912 divided by 110), still less than the maximum rate (*CBCA 4035-TRAV*).

Entitled to Termination Lease Expenses

Though his initial lease had expired, Kyle was renting his apartment on a month-to-month lease that required a written notice to the landlord, at least sixty days prior to the end of the lease. On April 28 Kyle accepted his new job with the government and provided notice to his landlord of his intent to vacate the premises on May18 to report to his new duty station the next day. Kyle seeks reimbursement for the $2,204 he paid the landlord for the period May 18 through June 28 in accordance with his lease. The government refused to pay stating it was not authorized to pay extra rent by Kyle and argued the rent paid was not for an early termination of the lease but rather a regular rent payment. The Board sided with Kyle stating an employee transferred from one duty station to another is entitled to reimbursement of the cost of the settlement of an unexpired lease as part of his relocation expenses. It ruled Kyle timely terminated his lease and stated the lease required a sixty-day notice and as a result Kyle incurred the obligation to pay the unexpired lease expenses as he claims and hence is entitled to be paid for those expenses (*CBCA 3932*).

Purchaser's Home Inspection Tests are Not Reimbursable

Jeffrey purchased a new home at his new duty station in Arizona. His purchase contract provided he had 10 days to conduct home inspection and termite inspection "at the Buyer's expense" and he sought reimbursement of $498 for the two inspections he conducted. The Board sided with the government in their denial of the expenses stating previous decisions had allowed reimbursement of home and termite inspections "only to the extent they are customarily paid by the purchaser at a new official station…or are required by Federal, State or local law; or by the lender as a precondition to sale or purchase." The

Board ruled though the inspections were prudent, Jeffrey provided no evidence the tests met these conditions for reimbursement. In response to an assertion they were required under the contract and he was required under Arizona law to pay for them, the Board ruled Jeffrey provided no evidence they were required by law only that the purchaser had a 10-day period to conduct all "desired" inspections (*CBCA 4558-RELO*).

Entitled to Lodging Expense That Includes Complementary Breakfast and Currency Exchange Fees

Christopher incurred lodging expenses at his new temporary quarters in Germany of 160 euros per night. The Air Force asserted the hotel bill was labeled "Arrangement" not lodging and upon inquiry was informed the charge included a 19.90 euro breakfast fee and hence deducted the expense amount charged by the hotel. Christopher informed the Air Force the information it received was incorrect after submitting a letter from the hotel claiming the 160 euro charge was for the room only where the breakfast was complimentary. The Board ruled that if the Air Force had separately paid Christopher for breakfast (no evidence for this was presented) it may be able to recover amounts so paid but based on the record before it Christopher is entitled to the room charge of 160 euros per night. As for the foreign currency conversion fee, the Air Force stated the DSSR, that covers overseas temporary travel expenses, provides that expenses not directly related to lodging and meals are not reimbursable but the Board disagreed stating this regulation does not prohibit reimbursement of the foreign conversion charge made by his credit card company (*CBCA-4365-RELO*) .

Collective Bargaining Agreement Covers Relocation Cost Grievances

Derrick submitted costs associated with his purchase of a home as part of his permanent relocation and submitted a claim when the agency denied his costs. In responding to the claim, the agency notified the appeals board that Derrick was represented by the American Federation of Government Employees and as such was subject to a collective bargaining agreement (CBA) that was in place at the time of his relocation. The agency asserted the CBA is the exclusive procedure available to employees for processing, resolving and settling of grievances where it was determined that relocation reimbursement is not an area that is excluded by the CBA. The Board agreed with the agency asserting where employment conditions are governed by a collective agreement that is the "exclusive administrative procedure for resolving grievances" and hence it dismissed the claim stating it lacked authority to settle the claim (*CBCA 4412-RELO*).

Agency Has Discretion in Approving or Disapproving a TQSE Extension

Stephen received orders for a permanent change of station (PCS) directing him to report for duty on May 23, 2014 where his orders authorized 21 days of temporary quarters subsistence expenses (TQSE). As part of his duties he was required to attend officer training school (OTS) from July 1 through Sept 9 and he submitted a request for a 15 day extension stating he was unable to secure a residence until his return from OTS. Though he could not move into the new residence earlier because it was not yet built he did not mention this in his request. The Air Force denied his extension request asserting he could extend his TQSE only if the need arose from "circumstances beyond his control" or "compelling reason" according to the FTR. In his appeal, the board ruled that he did not have to show a "compelling reason" to justify the extension because this condition only applies when someone seeks an extension of TQSE after the first 60 days where an additional 60 days can be granted only if the compelling reason is there. Here, the initial 21 days and request for an additional 15 days fell within the first 60 days where the "compelling reason" was not needed. Nonetheless, the Board ruled it was within the discretionary power of the Air Force to decide whether to grant the extension. The Board quoted the JTR as providing TSQE is intended for use "when it is necessary" for the employee to occupy temporary quarters. Since Stephen provided no explanation for why the extension was necessary, the Air Force has discretion in deciding not to provide an extension (*CBCA 4395-RELO*).

IMPLEMENTING SOUND PRICING STRATEGIES INTO YOUR GOVERNMENT CONTRACTS

(*Editor's Note. The following article is a continuation of our series that discuss how important general business management ideas affect government contractors' practices. The idea addressed here is how businesses should examine their discount practices with the intention of modifying them to be able to squeeze out small revenue increases that translate into significant profit enhancements. As we mention a lot, there is considerable flexibility in how contractors can incorporate many of the lessons discussed below. The source of this article is from the McKinsey consulting firm's November 2015 issue of the McKinsey Quarterly written by Michael Mann, Eric Roeger and Craig Zawada as well as our experience helping clients maximize their pricing proposals.)*

The article alludes to the long term trend of downward pressure on prices whether it be from periodic sluggish

economic growth, new purchasing power of bigger retailers (e.g. Walmart), the internet that provides greater transparency of prices and the role of low cost foreign competitors. These forces have led to a voluminous number of discounts, incentives, and other price reductions to maintain or even increase volume. In the midst of this long term trend the writers talk about raising prices, not across the board, but rather to get prices right for each customer, one transaction at a time. The idea of this "transaction pricing" approach is to figure out the real price you charge customers after accounting for a host of discounts, allowances, rebates and other deductions where only then can you determine how much money, if any, you are making and whether you are charging the right price. Many companies in prior times focused on robust demand from booming times or cost cutting programs to maintain profit during down times. In these times there is less options for meeting booming demand and cost cutting has already generated most of the benefits to be achieved there. However, most companies are unaware of the untapped opportunities available for superior pricing transactions. Attention to this is one of the keys for surviving downturns and flourishing when upturns arrive.

The writers emphasize that the fastest and most effective way for companies to increase their profit is to price right. They provide an analysis showing how a price rise of 1 percent generates an 8 percent increase in operating profit, an impact that is nearly 50 percent greater than a 1 percent fall in direct costs such as labor and materials. Unfortunately the sword cuts both ways where a decrease of 1 percent on average has the opposite effect, bringing down operating profit 8 percent with all other factors remaining equal. Companies often believe they can make up for the lower profit by increasing volume on lower prices but this rarely happens. They show that volume would have to rise by 18.7 percent to offset the profit impact of a 5 percent price cut where they assert that demand rarely increases that substantially to increase volume.

In order to find an additional 1 percent or more in pricing the writers introduce a pricing tool called the pocket price waterfall that shows how much revenue companies really keep from their transactions. They state companies can find an additional amount by first looking at what part of the list price of their products or services they actually pocket from each transaction. Significant amounts of money typically leak away from list prices or base prices as customers receive discounts, incentives, promotions or other give aways to win contracts and maintain their volume. The writers use an example of a global lighting supplier to show what remains after all discounts and incentives are tallied. Every light bulb sold has a list price but after a series of discounts on each invoice the average price is 33% lower than the standard list price where an additional 17% of revenue discounts not shown on an invoice resulted in an average pocket price of about half the standard list price.

A conscious attention to all of the elements of the pocket price waterfall can result in finding and capturing an additional 1 percent or more of their realized prices. An adjustment of any discount or element along the waterfall – either on or off the invoice – is capable of improving prices on a transaction by transaction basis. Of course, the amount and type of discounts offered may differ significantly from costumer to customer and even order to order. At the lighting company, some bulbs were sold at a pocket price of less than 30 percent while others at 90 percent and more. This large range appears quite spectacular but is not at all unusual where the authors state they have seen price bands between the higher price up to five or six times greater than the lowest. The lighting company explained the width of its pocket price band saying it was a result of a conscious decision to reward high-volume customers with deeper discounts which in theory was justified not only to court such customers but also by a lower cost to serve them. However, a close examination showed many large customers received relatively modest discounts, resulting in high pocket prices while a lot of smaller buyers received greater discounts where a lot of small buyers received much greater discounts than their size of business would warrant. A few of these customers received large discounts because there were special circumstances like being in a highly competitive or depressed market but most received them because they had long-standing ties to the company and knew which employees to call to get extra discounts or freebies.

The lighting company attacked the problem from three directions. First, it instructed its sales force to bring into line – or drop – the smaller distributors getting unacceptably high discounts. Within 12 months, 85 percent of these accounts were being priced in more appropriate ways and new accounts replaced most of the remainder. Second, the company launched an intensive program to stimulate sales at larger accounts for which higher pocket prices had been realized. Finally, it controlled transaction prices by initiating stricter rules and greater approval authority. In the first year thereafter, the average pocket price rose by 3.6 percent and operating profit by 51 percent.

Implications for Government Contract Pricing

- **Need to Know the Economic Characteristics of Where Government Business Resides**

The article encourages a closer look at pricing considerations oriented to high versus low volume customers. For

example, if most government contracts represent high volume, high profit sectors then there should be greater effort at generating additional marginal business from those contracts. But, for example, if they represent low volume, low profit business then there needs to be a thorough analysis of the types of discounts and freebies the government receives and more aggressive moves to increase the marginal profit on that business, even if it means the risk of losing it.

- **Lower Pricing Offerings Do Not Often Generate More Volume**

As in the commercial world, government contractors are commonly faced with pressure to lower prices over either prior contracts or initial pricing. Of course, when it comes to a choice between lower prices and not receiving the business the choice may be clear. However, when it is believed that a lower price can generate more revenue the article, based on extensive experience of its authors, indicate such tactics rarely work. They assert lower prices clearly results in significant profit decreases and usually do not result in greater volume of business. These assumptions need to be explicitly addressed by the company, especially for larger government customers

- **More Scrutiny Over Government Contract Pricing**

It is quite common to loose oversight over company decisions on pricing government as well as commercial business. Procedures get frozen where, for example, pricing becomes a mechanical practice where less and less financial analysis is paid to these decisions or lower dollar contracts are relegated to less scrutiny. It is quite common to continue providing various price reductions when they are no longer needed. Various price reductions that were once offered to high volume government customers may no longer be needed or justified as they become lower volume customers. New solicitations for government work should not be responded to by dusting off the old proposals but new terms should be considered. The article, with the success story it provides, stresses that pricing decisions need to be re-examined by varied sections of the company, not just, say pricing groups with little to no input by others. Pricing of government contracts needs to become an issue of great analysis and receive a greater priority.

- **Commercial Pricing**

If your products and services can qualify as commercial items then you have significant opportunities to apply many of the prescriptions of pocket pricing. As we have discussed in prior articles, if you do not yet have products and services that qualify for commercial item status, you can begin establishing that identify before you start offering such items to the government. Creating commercial item status can be accelerated by pursuing GSA multiple schedule rates or multiple agency offerings, engaging in competitive pricing opportunities, teaming with or acquiring firms that offer items that can be considered commercial or that have lower costs or can provide higher value to existing products and services.

The Price Reduction clause for GSA contracts requires that offered prices be comparable to prices offered by identified companies where the regulations allow for adjustments to those offered prices based on such factors as volume, delivery, etc. Not all companies need to be identified but only selected ones. Comparable companies you select should have pricing closer to what you want to charge after establishing desirable prices suggested here.

- **Skills in Preparing REAs are Critical Here**

Many products and services offered to the government are more complex than say lighting bulbs. Many companies are used to differentiating themselves by offering customized products, bundling product and service packages with each sale, offering unique solutions packages, providing unique packaging to fit, for example, warehouse shelves or providing unique forms of logistical and technical support. It is common for an initial RFP not to envision all of these items at the time it is issued but nonetheless many of these features become needed during contract performance. Whereas the government client may attempt to receive these items for free, company personnel must be adept at recognizing these "out of scope" products and services as contract performance proceeds. Recognition of the elements of pocket pricing and recognition how they impact a firm's profitability will help sensitize the company to identify out of scope items that need to be priced separately through contract modifications.

These need to be separately identified for initial pricing. If "freebies" are offered then they should be a result of conscious choice and need to be highlighted in order to receive credit on your proposals. As the contract is performed, many of these customized requests are made where there must be wide-spread recognition by key personnel that these requests often represent an REA.

Better Pricing

- **Direct Versus Indirect Expenses**

When company products and services do not qualify for commercial item pricing but instead require cost build up approaches, the company must be adapt at pricing these pocket items on government contracts, whether they are for initial pricing or REA purposes. If "freebies" are offered you need to show their costs. To do so, it is best to identify these costs as direct but this can pose a

problem because many of the items in the pocket price model are buried in indirect costs pools. So, for example, freight, packaging, warehousing, services and technical support costs are usually elements of overhead rather than direct costs allocated to individual contracts so the contractor needs to have accounting practices where some otherwise indirect costs can be considered direct. Many contractors believe this is not possible since CAS 402 and FAR provisions require that like costs incurred under like circumstances must be treated consistently as direct or indirect. However, when similar costs are different or are incurred under different circumstances, then the normal treatment of indirect costs can be considered direct. To do so, it is best to document such varied treatment in your in your written accounting policies.

- **Indirect Rate Structure**

An alternative to treating these pocket costs as direct is altering the manner of allocating these indirect costs to government contracts. The accounting rules allow for considerable flexibility when deciding how to group indirect costs and how to allocate them to government contracts. Whereas many of these costs may have been considered to be overhead, allocated on a direct labor base, many of these costs can be grouped into G&A, handling or separate government cost pools and allocated over different bases. These accounting changes may be warranted if sufficient amount of government contract business exists or alternatively, a different cost structure is possible for one large contract as a special allocation. We have addressed these issues in the past so use our key word search feature to find more detailed information or feel free to contact us to discuss.

SMALL BUSINESS ISSUES WHEN GOVERNMENT CONTRACTORS MERGE

(*Editor's Note. Since mergers and acquisitions (M&A) are becoming an increasing source of competitive advantage to win contracts, our consulting practice has been involved in numerous due diligence efforts needed for these transactions. One of the key areas involving the acquisition of small businesses either by large companies or other small businesses is the concern to avoid assertions that the two resulting entities are "affiliated" which can adversely affect both current contracts and new contract work. We came across an excellent article addressing this issue which we believe will be quite relevant to either companies considering or going through the M&A process or doing business with such firms. The article is from the August 2014 issue of Briefing Papers written by Daniel Chudd and Damien Sprecht of the law firm of Jenner & Block LLP and includes some of our insights from conducting M&A due diligence consulting engagements.*)

Mergers and acquisitions (M&A) are a normal part of business where advantages are many (e.g. a buyer receives targeted access to clients, intellectual property, new technologies and desirable management skills). However, the authors warn that companies holding government contracts face special risks and pitfalls where failure to recognize relevant issues can jeopardize contract eligibility, lead to terminations and risk penalties and fines worth more than the contracts themselves.

Avoiding Affiliation in the Letter of Intent

In determining a firm's size the Small Business Administration will look at the aggregate employee count or revenue along with those of the firm's affiliates. The SBA will consider not only parents, subsidiaries and sister corporations as affiliates but will go further to find that two entities are affiliated if one has the power to control the other through ownership, management or contractual relations. So, for example, two concerns may be affiliated if they are owned by immediate family members, share controlling board members or are economically dependent on each other even if the two are not part of the same corporate hierarchy. *(See our article in the 4Q09 issue of the GCA DIGEST for a more detailed analysis of what makes two companies affiliated.)* When a small business is acquired by a large one SBA regulations require that the small business recertify its size status where if the combined entity does not meet the small business size standard, it will no longer be eligible for new set-asides. The authors address how to delay this determination.

A firm's status as a small business is one of its most important assets where it provides opportunities to win limited competition set-aside contracts that, under certain circumstances discussed below, will allow contracts to continue to be performed even after a business is acquired by a large business. Consequently it is in both the buyer and seller's interest to delay as long as possible the transition to being a large business where the first step of the M&A – letter of intent – must be established to minimize their risks.

In most cases the purchase agreement is not the first document executed by the parties but rather a letter of intent (LOI) is used to memorialize key provisions of a transaction. LOIs typically include nondisclosure provisions, covenants to negotiate in good faith and exclusivity provisions to prevent the target from negotiating with other potential buyers, price terms and statements that the LOI is nonbinding. Since considerable time may elapse before a purchase agreement is in place it behooves

the parties to ensure the LOI is not used to demonstrate affiliation.

The problem is there are no bright lines for when a LOI can be a basis for determining whether the buyer and seller are affiliated. Language that the LOI terms are not binding will not necessarily prevent the SBA from asserting affiliation because the SBA regulations treat "agreement in principle" as having been concluded even if the purchase agreement has not been signed. However, there is a safe harbor for LOIs that are "agreements to open or continue negotiations toward the possibility of a merger or sale of stock at some later date" where such agreements are not considered an "agreement in principle.". There have been many cases that have ruled that the LOI is an "agreement in principle" where there are other cases showing the LOI is not. For example, an agreement in principle was ruled to exist where the LOI included key terms of the potential purchase agreement such as price, affirmative language the acquisition would be executed and an exclusivity clause. Another finding that the LOI was an agreement in principle was when subsequent language in the purchases agreement was included in the LOI. However, in contrast, courts have stated affiliation does not exist ruling that negotiations do not, in itself, mean there is affiliation or there is no tangible evidence that the seller has accepted the buyer's offer. One case sought to set boundaries for avoiding affiliation based on an LOI where the authors use these guidelines to recommend the following be excluded from LOIs: (1) exact price terms where sufficiently wide price ranges may be acceptable (2) executing an LOI too close to the time of a final agreement (3) exclusivity clauses and (4) affirmative statement the parties intend to execute an agreement based on the LOI terms. To increase chances the LOI will not create affiliation the authors add a few more suggestions: (a) multiple express statements of the conditionality and nonbinding nature of the agreement (b) language providing for future negotiation between the parties (c) provision conditioning the LOI on a future, more definite offer and (d) contingencies on due diligence and the provision of information by the seller.

Small Business Diligence

Once the parties agree to an LOI, full scale diligence can begin. In addition to normal compliance issues in government contracts there are specific regulations applicable to small business set aside contracts where there are now harsh penalties for misrepresentation of small business size standards.

The first challenge is identifying contracts that implicate small business regulations such as set aside contracts and contracts awarded using socioeconomic pricing preferences. In general, contracts will indicate set-aside status on the cover page but care must be taken because the front page may contain incomplete or misleading information. If there is uncertainty, a review of the clauses would contain evidence the contract is a set-aside or, at least, a partial set-aside. So, set aside clauses include FAR 52.219-7, 17, 27, 28, 30 or 3. If even one of these clauses are present that is strong evidence that the contract is a set-aside.

Evaluating Manufacturing Contract Compliance

If a small business set-aside supply contract is identified buyers should ensure they assess the seller's compliance with SBA rules on manufacturing. Specifically, the awardee of a set-aside contract must provide products they manufacture themselves. However, this does not mean the small business must provide all components of the end product but that it must perform more than "minimal operations" upon the end item. The minimal operations test will not be met if merely unpacking, modifying, on-site assembly, installing and integrating components occurs. In evaluating whether the operations are minimal the SBA will consider (1) the proportion of total value in the end item added by the small business (2) importance of the elements added considering the function of the end item regardless of value and (3) the business's technical capabilities, facilities and equipment, production or assembly line processes, labeling of products and product warranties.

The SBA regs do provide a small exception – "non-manufacturer rule" to this rule for small business product distributors as long as they have (a) less than 500 employees (b) are engaged primarily in retail or wholesale trade (c) normally sell the type of item being supplied (d) take ownership or possession of the times and (e) supply goods by US small businesses. All five prongs must be met to fit within this non-manufacturer rule. The SBA may also issue waivers allowing small businesses to provide goods manufactured by large businesses if the contracting officer determines that no small business manufacturer or processor reasonably can be expected to offer a product meeting the specifications or that no small business manufacturer of the product or class of products is available to participate in the government marketplace.

Evaluating Services Contract Compliance

Set-aside service contacts have their own limitations where the SBA requires that 50% of the cost of a small business set aside contract be performed by that firm's own employees. Importantly, limitations on subcontracting do not apply to contracts awarded to small businesses where there was unrestricted competition. The only exception was when

the awardee is a HUBZone businesses that benefitted from that program's price preference.

A nuance of this rule is related to multiple award contracts (MACs). Under total or partial set-aside MACs subcontracts are based on the base period and then, separately, each option period. This allows small business to perform task orders under which they would violate the limitations so long as the aggregate of all work subcontracted over the period of the contract does not exceed 50% of the cost of the contract.

Be aware that the National Defense Authorization Act for 2013 modified the rules for subcontracting under service contracts but as of this writing the modification has not yet been implemented in the regulations. Previously, subcontracting percentage was calculated based on the cost of work performed by employees which required contractors to separate out the cost of personnel. The 2013 NDAA revised the calculation method from personnel costs to "total contract price." This revision will ultimately reduce the amount of work that can be subcontracted because nonlabor costs such as materials and supplies are no longer excluded but it will reduce the burden of determining compliance for small contractors and potential acquirers.

It is also worth noting that some small business programs may have their own contracting rules. For example, under the 8(a) program the SBA may grant certain waivers on subcontracting limitations. Also under the HUBZone program, it must keep below the 50% subcontracting amount if it received a price preference but if the firm chose to waive the price preference under a full and open competition, the HUBZone firm would not be subject to the limitation.

Careful review of subcontracts and teaming arrangements will be needed to identify concern areas if it becomes apparent that a large subcontractor is guaranteed work share beyond 50%.

Assessing the Value of Current Set-Asides

In general, the conventional wisdom that small business contracts have little or no value in a merger or acquisition is incorrect. In most circumstances, incumbent work can transfer to a buyer, regardless of size. Some buyers have discovered, however, that loss of size status makes it difficult to retain work after the initial period of performance has expired.

Long term contracts are one of the most valuable assets of a small business seller but not all of these contracts have value to a larger business owner. In general, size is determined before award of a set aside contract. As a result, a small business can continue to perform a set-aside contract even if it grows to be other than small. If a small business is acquired by or acquires another business this baseline rule does not apply and the business must recertify its size. Notably, the government is not required to terminate the contract based on recertification as other than small. Instead, it can continue placing orders and exercising options but the government can no longer claim small business credit for those orders and options which eliminates an incentive to place those orders.

Though the baseline rule that small business set-aside contracts can continue to be performed by a large acquirer, each of the small business socioeconomic programs have their own unique transfer rule. The most restrictive rules apply to the 8(a) program that clearly states an 8(a) contract must be performed by the participant that received the award where the contract is to be terminated unless a waiver is granted by the SBA. When ownership or assets are transferred, the 8(a) participants must "immediately" notify the SBA in writing where such an agreement may include an oral agreement. Since 8(a) contracts are so difficult to transfer the participants must think strategically if a sale is anticipated. However, if a transaction involves a similarly situated owner – say a disabled veteran owned company or 8(a) company - the contract work can continue and the government can still claim credit.

Multiple Award Contracts

In recent years indefinite delivery, indefinite quantity (IDIQ) contracts have proliferated resulting in multiple awardees where because they involve future task or delivery orders pose a challenge to small business transactions.

A change in size status does not necessarily mean the set-aside IDIQ contracts must be terminated or that options cannot be exercised. However, some of these contracts contain "off ramp" clauses requiring that any business that becomes other than small as a result of M&A will become ineligible for future awards. Other IDIQ contracts will nonetheless state though they will be ineligible for future orders for small business set-asides they will be allowed to "graduate" to compete for orders among large contract awardees. This will help large businesses who were initially left out of the multiple award contract to acquire a small business contract holder and thus be eligible for awards.

It certainly behooves the buyer to examine these "off ramp" and "graduation" provisions during their due diligence. It will also help in the future where, for example, even if there is a "off ramp" clause a CO may be approached to see whether the agency would be amenable to modifying the contract to allow continued performance or "graduation" status. It is also worth being mindful that the text of the

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contract is not the only consideration. Even if a large company may continue to hold a MAS IDIQ contract, the CO may set aside and require size recertification for specific task and delivery orders where the resulting non-small firm may lose the ability to compete for that order.

The Purchase Agreement

The authors advise that the purchase agreement should provide some protection to the buyer in case incorrect representations of small business status result in reductions in work due to loss of size status. Also, since penalties for violating the False Claims Act can include damages exceeding the entire contract value, indemnities should be included that are separate from general indemnification liabilities.

Minority Investment Issues

Though we have been addressing acquisitions of small businesses, a few words about minority investments would be helpful. Generally, a minority investment will result in a finding of affiliation when an investor controls "a block of voting stock which is large compared to other outstanding blocks of voting stock." There is no clear rule on when a minority share is "large." One case found that a surprisingly low amount of 17% was sufficient to indicate control, a lower figure than 50% or even 20% commonly considered to be the thresholds for control. It is not a defense against affiliation when one minority investor holds an equal percentage of stock compared to the founder where if that is the case, decisions have held that both investors control the entity. Though it is common for minority investors to insist on certain controls usually in the form of negative covenants such as consent to obtain significant debt, pay dividends, issue additional stock, determine compensation levels, etc. such controls can often create affiliation. However, some cases have found that minority shareholders may retain some power to veto unusual or "extraordinary" actions that are designed to protect its interests without resulting in affiliations. Acceptable negative controls without being affiliated have included the power to veto issuance of additional stock, amendment to the charter or bylaws, entry into substantially different businesses, adding new members to a limited liability company and dissolution of the company.

Venture Capital Investments

Be aware that small companies owned by private equity, venture capital operating companies or hedge funds are still considered small businesses and hence eligible for set asides even though the total of all companies may exceed small business thresholds.

INDEX

PROFIT ON EQUITABLE ADJUSTMENTS................ 1

NEW INDIRECT RATE STRUCTURE FOR A GOVERNMENT CONTRACTOR............................... 2

TRAVEL AND RELOCATION DECISIONS 4

IMPLEMENTING SOUND PRICING STRATEGIES INTO YOUR GOVERNMENT CONTRACT............ 6

SMALL BUSINESS ISSUES WHEN GOVERNMENT CONTRACTORS MERGE... 9

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