GCA REPORT

(A publication of Government Contract Associates)

March-April 1999 Vol 5, No. 2

NEW DEVELOPMENTS

Proposed Rule Changes on Progress Billing Payments

On February 10 the government issued a proposed rule on progress payment financing (Fed. Reg. 6758). The proposed rule follows two advance notices of proposed rulemaking issued to obtain comments and they will revise FAR Part 32 (Contract Financing) and related Part 52 contract clauses. Though we reported on some of these rule changes in our May-June 1998 issue as DOD changes, the following are proposed governmentwide and would:

1. *Eliminate "Paid Cost Rule".* The new rule would allow large businesses to include in their progress billings costs incurred but not yet paid as long as the payment to the subcontractor will be made in the normal course of business. Unlike small businesses that are permitted to submit subcontractor costs as they are incurred, the so called "paid cost rule" requires large businesses to actually pay subcontractors before they can include such costs in their progress payment requests. Such a change will put small and large companies on an equal footing.

2. *Increase Thresholds for Progress Payments.* The FAR dollar threshold for large businesses would be raised from $1 million to $2 million. Note the change applies only to large businesses, allowing progress payment for small businesses for contracts exceeding the simplified acquisition threshold (currently $100,000). The rule will also add a minimum dollar threshold of $2,500 for individual progress payment requests.

3. *Expand Use of Performance-Based Payments.* One of the changes emphasizes that performance based payments are the preferred method of financing – meaning their use should be considered impractical by the CO before customary methods are used. This language appears in spite of industry objections that such language would force performance-based payments on unwilling contractors. *(Editor's Note. Since performance based contracts are based on agreed to "milestones" or performance objectives, many contractors object to such payments when agreed-to milestones may be difficult to define or disputes about completion can hold up payments.)*

Another means of expanding performance based payments is the removal of the prohibition against using performance based payments on research and development contracts and contracts awarded through competitive negotiation procedures. Performance-based payments are still prohibited, however, on sealed bid procedures because the absence of communication prevents agreed to milestones.

4. *Permit Subcontractor Performance-Based Payments.* Language will be added to permit prime contractors that receive progress payments or post reimbursement type payments to use performance based payments or commercial financing payments with their subcontractors, provided the subcontracts that include such payments meet the same criteria and use provisions as those in the prime's contract.

5. *Clarify Purpose of Loss Ratio.* A loss ratio is present when the addition of total costs incurred plus estimated costs to complete exceed the contract price. The proposed language would make clear that application of a loss ratio (e.g. reduction) to a loss contract is intended to ensure that progress payments do not exceed the value of work performed.

6. *Remove requirement for CO Review of Quarterly Payments.* Another revision would remove the requirement that contractors submit quarterly financial statements under price revision contracts for comparison with progress payment requests.

7. *Remove the Limitation on General and Administrative Expenses.* This limitation is applicable to only a few contractors and applies to those that had established an inventory suspense account under Appendix A of CAS 410. Appendix A provides guidance on the transition from a cost of sales or sales base to a cost input base for purposes of allocating G&A costs.

Changes to SDB Programs

Whereas race and gender neutral programs for helping low income areas get a bigger slice of the contracting pie have accelerated (e.g. HUBZone Empowerment programs) the more traditional race and gender programs are either subsiding or changing. Recent news affecting small disadvantaged businesses (SDBs) include:

As of February 24, the Defense Department will suspend the 10 percent price evaluation adjustment for SDBs for one year. The law requires suspension of the price preference when it is established that DOD surpasses its goal to award at least 5% of its prime and subcontract dollars to SDBs (it awarded 8.7% last year).

The Department of Transportation has eliminated the across-the-board 10 percent goal for its Disadvantaged Business Enterprise (DBE) program and replaced it with one where local communities set their own DBE participation goals. Local goals must now be set on local evidence of the actual availability of qualified DBEs. There are no requirements that DBE goals be applied to all contracts, quotas are "strictly prohibited" and no state or agency will be penalized for not meeting affirmative action goals if it can show a good faith effort. In addition, once goals are met, recipients of DOT funding must use race neutral methods to meet their goals such as outreach and technical assistance, training, mentor-protégé programs and breaking up large contracts into smaller ones. Businesses that exceed small business size are excluded from the program and a new rule sets a $750,000 personal net worth ceiling that if exceeded disqualifies the individual from disadvantaged status. The new rule also seeks to streamline the process by which white male business owners who are socially and economically disadvantaged may be certified to participate in the program. The DOT is also working on state reciprocity agreements where there need only be one certification that will be recognized by all other states and localities. To ensure local transportation departments and airport authorities take their obligation seriously, they must submit annual plans to DOT (Fed. Reg. Feb. 2).

DOD Proposes a Repricing Clause; Industry Objects

The Department of Defense issued a proposed rule to amend the Defense Federal Acquisition Regulation Supplement Section 231.205-70 (External Restructing Costs) to specify that contracting officers should consider including a downward-only repricing clause in noncompetitive fixed price contracts during the period between an announcement of a business combination and the time the contractor's pricing rates are adjusted to reflect the impact of the restructuring. The purpose of the proposal is to provide assurance the DOD is able to take advantage of any restructuring savings. It is assumed that restructuring activities, such as mergers and acquisitions, commonly result in reduced costs and negotiation of fixed price contracts that do not reflect these future savings result in windfalls to contractors.

The American Bar Association has issued critical comments of the proposal saying (1) it violates the concept of a "fixed" price contract that is based upon an agreed-to fixed price and that during performance each party shares the risk of inaccurate cost estimates (2) the difficulty in isolating cost reductions from the restructuring activities as opposed to other causes and (3) if the rule is retained, the limitation to downward-only adjustments should be removed.

FAR Change Seeks to Clarify Use of Brand Names

(Editor's Note. Uncertainty over whether purchases require brand names or performance characteristics similar to brand names is a source of confusion for both contracting officers and contractors responding to solicitations.)

A proposed rule, issued in the federal register (FR 63777), would amend the FAR to provide three types of brand name purchase descriptions to contracting officers to describe their needs and provide them flexibility to achieve best value results.

1. "Brand name or equal" will include a description of the important physical, functional or performance characteristics of the brand name item that an "equal" item must meet to be acceptable for award. This type of description will be used when certain characteristics are firm requirements of the purchase.

2. "Brand name-no substitute" will be used when a certain brand name item has a feature that is an essential requirement and similar items do not meet or cannot be modified to meet the buyers' needs.

3. "Brand name as target" is to be used when there is a desirable but not firm requirement for the needed item.

The proposed rule will emphasize that use of performance specifications is still the preferred method.

DCAA Makes Changes to its Audit Manual

In January, the Defense Contract Audit Agency issued its latest edition to its contract audit manual (DCAAM) that provides audit policies and procedures to its auditors. Significant changes include:

Internal Controls (Chapter 5). With reduced manpower, DCAA has in recent years decided to focus more on proper "internal controls" rather than extensive transaction testing to ensure contractors price and cost their contracts accurately. Recent audit changes are oriented to internal controls over electronic data processing. Numerous sections in the chapter have been modified to identify new audit approaches and what constitutes adequate practices and a new section 5-1400 has been added to cover EDP systems application internal controls.

Incurred Cost Audits (Chapter 6). In 6-305 new guidance was added to ensure physical inventories are taken as early in the year as possible to ensure appropriate quantity of materials were ordered, received and used on government contracts. In 6-402, auditors are encouraged to be on the lookout for improper labor charging by conducting interviews in high risk departments and floor checks at lower risk departments. 6-414 reminds auditors that FY 1997 compensation caps apply only to contracts awarded after January 1, 1997 and reviews the changes made in FY 1998. A section in 6-609 was added to stress that it is the contracting officer, not the auditor's responsibility to impose penalties on contractors' submittals of expressly unallowable costs. 6-1007 addresses direct submission of interim public vouchers expressed in DFARS 242.803(b)(I)(C) as well as eligibility for direct billing. 6-1007.2 & .3 address adequate billing systems at both major and non major contracts. 6-1009 adds sections on reviewing a contractor's final billing and 6-1010 reviews February 1998 FAR changes to quick closeout procedures.

*Allowability of Foreign Selling Costs (*7-1306). Mentions the revision to FAR 31.205-38(c)(2) that removes the $2.5 million threshold and 110% ceiling on allowable foreign selling costs and reminds auditors that "significant effort" to export products normally sold to the U.S. government are allowable.

Deferred IR&D and B&P (7-1503). Allowability of Deferred Independent Research and Development and Bid and Proposal costs are limited to those projects that have "potential interest to DOD" and the seven broad categories of such projects identified in DFARS 231.205-18(c)(2) are identified and discussed. Also, the old ceilings limitations on IR&D/B&P costs are eliminated.

Asset Valuation Writeups (7-1705). Whether or not a contractor is CAS covered, all contracts awarded after April 24, 1998 will limit depreciation and cost of money costs on assets to the net book value not the increased write up value following an acquisition if depreciation on these assets were charged to government contracts in the most recent accounting period. If depreciation was not charged in the prior period, then the increased asset values can be used to calculate depreciation and cost of money charges to government contracts. Also, whether or not the contractor is CAS covered, the method of capitalizing the assets must be made in accordance with CAS 404.50(d). Examples of proper and improper asset capitalization are provided in Chapter 8-404.

Lobbying Costs (7-2116). Guidance has been added to ensure contractors comply with the Lobbying Disclosure Act of 1995 that includes various reporting and registration documentation if they are including lobbying costs in their indirect cost pools.

CAS Noncompliances (8-302). An added section states that the auditor may cite a contractor for a noncompliance with a cost accounting standard if they think there is currently an immaterial impact but circumstances may change later to make it material. If the auditor determines the noncompliance will never be material then they are instructed to not cite the contractor.

Cost Principles for Nonprofit Organizations (13-800). The guidance reminds auditors that OMB Circular A-122 has been extensively revised in the current version dated June 1, 1998. Numerous sections have been added that address indirect cost rates, facilities and administration (F&A) cost categories, indirect cost allocation methods and capitalization of equipment at nonprofit organizations.

DCAA Sets Criteria for Not Issuing an Adverse Report When a Corrective Action Plan is Proposed

When reporting on a contractor's accounting and management system as well as related internal controls an auditor is supposed to express an opinion that the system and internal controls are "adequate", "inadequate" or "inadequate in part". If significant deficiencies are found that the contractor has agreed to correct the auditor can use an exception to issuing an adverse opinion provided the contractor has developed an acceptable corrective action plan which can alleviate the deficiencies in a reasonable period of time. In recent guidance issued February 22, DCAA justifies the continued use of the exception because it expedites systems corrections and provides the contractor an opportunity to avoid an adverse opinion which benefits all parties. The memo is issued to address a "common misunderstanding" that any system may be accepted as long as the contractor provides a corrective action plan and clarifies when an exception is justified.

The guidance now establishes certain criteria for invoking the exception:

1. The deficiencies are not so significant that the system is totally unacceptable.
2. An adequate corrective plan existed at the time the report was issued.
3. Actions under the corrective plan can be completed in the near term.
4. The auditor can schedule a follow-up review.

Even if these four conditions are met, the auditor and supervisor still has the descretion to exercise the exception and the contractor does not have the right to demand the exception. If the auditor decides to exercise their descretion in favor of the contractor, the auditor is encouraged to point out why it was reasonable to give the contractor the benefit of the doubt (99-PAS-016('R)).

DOD Seeks to Limit Anti-Competitive Teaming Arrangements

Elimination of exclusive teaming arrangements having "the potential of resulting in inadequate competition" is the target of DOD's Acquisition head Jacques Gansler. In a January 5 memorandum, he has directed COs to scrutinize teaming arrangements on a case by case basis and intervene to assure adequate competition. He is also proposing a change to the FAR to make exclusive teaming arrangements a violation of antitrust laws.

An exclusive teaming arrangement is created when two or more companies agree – in writing, through an "understanding" or other means – to team together to pursue a DOD contract and further agree not to team with anyone else. COs are instructed in their requests for proposals and information meetings to stress that pre-established teaming at either the prime or subcontract level will be closely scrutinized. They are encouraged to seek customized solutions where, for example, one company considered essential for performance would not be allowed to be part of only one exclusive team but would make their services available to all competitors. Other means would be to include a "consent to subcontract" clause in the contract. Gansler is also asking for a change to the FAR that if such customized solutions and clauses did not work, exclusive teaming arrangements would be added to the list of prohibited antitrust practices listed in FAR 3.303(c).

BRIEFLY…

Business Class Airfare Proposal is Withdrawn

The August proposed rule we reported on that would have amended the "travel cost" cost principle (FAR 31.205-46) to allow business class airfare for flights lasting longer than 14 hours has been withdrawn. Reasons cited for the withdrawal are (1) it would create inconsistent treatment of business class and first class airfare (2) there was confusion of differing interpretations of "stopovers" and (3) the rule would create greater administrative burdens.

DOD Past Performance Use and Collection Continues Under Class Deviation

On January 29, Director of Defense Eleanor Spector extended until further notice a class deviation from FAR regarding collection and use of contractors' past performance information. Under the deviation, past performance must be an evaluation factor in all source selections for negotiated procurements of (1) systems and operations support expected to exceed $5 million (2) services, information technology or science and technology expected to exceed $1 million and (3) fuels and health care expected to exceed $100,000. The same thresholds apply to evaluating contractor performance on DOD contracts except there is no threshold for science and technology contracts. The collection and use thresholds are in lieu of FAR 15.304(c)(3) and 42.1502(a).

DCAA Alerts Auditors to Problems of a Widely Used Electronic Timekeeping Program

An alert to auditors in the form of a Memorandum for Regional Directors issued by DCAA states that a commonly used timekeeping software package (not identified) allows employees to revise the number of hours worked during a day without documenting or explaining the change. The memo reminds auditors this condition represents "an internal control deficiency within the contractor's timekeeping system". Whether it is a manual or electronic system, the memo states that adequate timekeeping requires labor hours be accurately recorded and any corrections to timekeeping records be documented with appropriate authorizations and approvals (99-PIC-012(R)).

DCAA Issues Guidance on Travel Change

As we reported last issue, the Department of Defense has issued a class deviation for DOD contractors to exclude taxes paid on lodging from maximum per diem rates in effect at time of travel as of January 1, 1999. DCAA stresses the deviation allows contractors to choose between the new method and FTR rates in effect after January, or the FTR rates and definitions in effect before January. They say the deviation does not permit different methods on a trip-by-trip basis but requires contractors to choose one or the other for all travel. The memo also reminds auditors the class deviation applies only to DOD and NASA prime and subcontracts while other government contracts must use the revised FTR rates and definitions in effect as of January 1, 1999 (99-PAC-011(R)).

Proposed FAR Rules Amends Rules on Receipt of Late Offers

A proposed rule issued in the federal register (FR 4247) would amend the FAR to eliminate inconsistent treatment of late contractor offers and would provide a single standard for receipt of late offers under commercial, sealed bids and negotiated acquisitions (FAR Parts 12, 14 and 15, respectively). FAR 52.212-1, Instructions to Offerors – Commercial Items, would allow late contractor offers to be considered if the offer was mishandled by the government. Under the proposed changes, any bid, modification, or withdrawal received late will not be considered unless (1) it is received before the award is made and (2) accepting the late offer will not delay the acquisition. Also, as a proposed change to FAR 15, a late modification to an otherwise successful proposal that makes the terms more favorable to the government may be received by the government at any time and may be accepted.

OMB Circular 76 to Guide Government Outsourcing Activities

The Government's plan to increase use of private contractors in place of government employees will likely be in accordance with rules set by the Office of Management and Budget. On March 1 the OMB proposed that the method of implementing the Federal Activities Inventory Reform (FAIR) Act should be in accordance with OMB Circular 76 and its recently revised Supplemental Handbook. FAIR, which was signed into law last October, directs agencies to submit to OMB annually a list of functions that are not inherently governmental and hence can be contracted out to the private sector. Industry representatives view FAIR as a major opportunity for private sector businesses to perform these functions that are estimated to save the Government $10-30 billion per year. The OMB Circular 76 and its revised handbook are the guidelines government agencies must use to compare bid costs on private versus public competitions. Since government costing and accounting practices do not parallel that of the private sector (e.g. depreciation, insurance, retirement benefits, overhead allocation methods, etc.) the circular seeks to establish methods of "leveling the playing field" when comparing proposal costs. The OMB is expected to issue additional guidance soon. *(Editor's Note. If firms are planning to take advantage of the government's stated interest in transfering "nonessential" work to the private sector, contractors should become familiar with OMB Circular 76.)*

Contract Administration Training Online

The government has made increased training for its contracting personnel a top priority and is turning to on-line courses as a low cost, effective method which is also available to the public. The Department of Defense has mandated 80 hours of acquisition training each year to all of its civilian and military acquisition workforce. The program will emphasize acquisition reform and cross training in new specialties. For now, information can be obtained at "http://www.acq.osd.mil/ar/". All acquisition professionals will have unlimited, free acquisition training through the Federal Acquisition Institute and courses will be delivered by using chat room technologies combined with other collaborative tools such as online testing, self-paced training and email for submitting homework. The Online University also provides access to an online reference library that includes an electronic card catalog. A few courses have already begun and access to the FAI Online University is available at http://www.faionline.com.

CASES/DECISIONS

Non-Employee's Office Qualifies as "Branch Office"

Entek won a solicitation for engineering services that required firms to be located within a 300 mile radius of certain facilities. Another firm protested alleging the branch office was really a "front" and was actually an office of an engineer (Bojanowski) whose association with the contractor was insufficient to satisfy the location requirement. The US Comptroller decision disagreed ruling that (1) the records showed Bojanowski's name to be one of the individuals it would use to do the project and (2) there was a prior letter agreement that established a "strategic relationship" with Bojanowski - he would allow the contractor to use his facilities as a branch office to receive mail and occupy space for engineering purposes and it would represent him as its employee in the capacity of Project Engineer (where compensation would be negotiated for each project). (Melvin Cohen & Assocs, Inc., Comp. Gen. Dec. B-280634.)

Can't Claim the R&D Credit – the Government's "Unlimited Rights" Prove R&D Costs are "Funded"

(Editor;s Note. The following decision is a good example of why you want to maximize your (and minimize the government's) rights over technical data – see our attempt to simplify this topic in the current issue of the GCA DIGEST.)

The Internal Revenue Service offers tax credits for certain qualified research and development expenditures. Under IRS rules "qualified" research excludes research that is funded by a grant, contract or government entity. In a recent case the IRS rejected $63 million of credits the contractor sought because it claimed they were "funded". As evidence its R&D expenditures were funded the Court pointed to the fact the contractor did not retain "substantial rights" to the R&D work – the government was given "unlimited rights" to use and disclose technical data both within the government as well as to other contractors (Lockheed Martin Corp. v. US Fed Ct. No 96-161T).

"Reason to Believe" Is Basis For Recouping Additional Costs

Contractor's technical services cost plus fixed fee contract included the "Limitation of Cost" (LOC) clause that required it to notify the government of potential cost overruns and if reported, limited the government's liability to the original estimated value of the contract. Contractor's estimated overhead rate of 95% that was used for interim billing turned out to actually be 192% due primarily to lower than expected work being issued. The contractor sought the difference, resulting in total incurred costs overrunning the estimates. The contractor did not provide notices to the government during the year and the government refused the contractor's request stating the contractor had reason to believe actual costs would exceed the estimate since funding levels for the contract was decreasing. The Board stated that the critical criteria was the LOC's term of "reason to believe" an overrun would occur. It ruled that all increased vouchers should be paid through May 31 of the year because the contractor had no reason to believe its final overhead rates would exceed its billing rates. The Board rejected the additional requested costs after June 1 stating the uncertainty of business projects and overall lower fund availability provided "ample reason to be concerned" and hence "reason to believe" its actual overhead rates would exceed billing rates (Marine Design Technologies Inc., ASBCA No. N00140-83-D-3380).

General Dynamics Seeks Breach of Contract Damages Citing Inappropriate Retroactive Executive Compensation Cap

General Dynamics entered into a cost type contract that was definitized May 9, 1996. Its executive compensation exceeded by $2.9 million compensation caps passed in 1997 that stated all executive compensation costs incurred after January 1, 1998 would apply to all contracts whether they were entered into before or after the effective date. In a test case it is suing the US government for breach of contract claiming it is inappropriate to apply subsequent regulations to a multiyear contract negotiated earlier. We will report the results.

Past Performance Risk Must Pose Real Risk to Contract Performance

The FAA examined the audit findings of DCAA and based on them removed an offeror on a time and materials contract solicitation from the competitive range. The DCAA audit report questioned (1) a contractor's new method of allocating G&A costs on a total cost input base (the proposed method was rejected in the past) (2) disallowed certain state income taxes and (3) commented on lack of funding for a pension plan. The agency cited this report as evidence of excessive risk (e.g. the G&A rate would increase material costs and the lack of pension funding would make it difficult to retain key personnel). Though agency judgement is usually not reviewed in protests and did not question the agency's judgement in this case, the GAO rejected the agency's conclusion that the deficiencies posed *excessive* risk. It evaluated the findings (e.g. most costs would be labor making material charges insignificant) and found that these audit issues were not sufficiently critical to remove the contractor from the competitive range. It stated the principle that there must be "*real risk*" to contract performance for past performance information to be invoked to remove a bidder from the competitive range (Information Systems & Networks Corp., FAA No. ORDA-98-100).

NEW/SMALL CONTRACTORS

Changes to Incurred Cost Submittals

As recently as 8-9 years ago we can remember when contractors would submit a one page incurred cost submittal proposal, often later than the required 90 days following the end of a contractor's fiscal year, wait three to four years until DCAA got around to beginning their audit at which time they would request selected data to backup the submittal. A lot has changed. Now, contractors submit proposals with increasing numbers of required schedules, are frequently submitting them in electronic format, usually turn them in on time to avoid significant late penalties and many times the submittals are not even audited. We thought we would remind our readers of these significant changes, mostly in the last year or two.

Expanding Content. We can remember when even large contractors submitted one page submittals that summarized indirect cost pools and bases. Later, sometimes years later, auditors requested whatever back up data they wanted to review. Now, DCAA requests a multitude of schedules that at last count numbered 18 and when incomplete, the submittal is often deemed incomplete. These schedules ask for detailed indirect and direct costs, both incurred and billed, in various formats, special information such as labor reconciliation and facilities cost of capital as well as written certifications, contract briefing information, lists of accounting and organization changes and subcontractor information. When the submittal is received, supplemental information (last count – 17 items) is usually quickly requested such as written information on accounting practices, executive compensation, work sites, handling unallowable costs, various financial statements, internal audit data, board of director minutes, etc.

Electronic Format. As of January 1, 1999 DCAA is disseminating to contractors an electronic incurred cost submittal package that includes detailed narrative and instructions as well as sample and blank electronic forms for all required schedules including data links between schedules. DCAA has begun one day training programs instructing contractors how to use the package. It is DCAA's goal to have all contractors submit their incurred cost proposals electronically that is intended to save time and effort for all parties.

Timeliness. Submittals were rarely made within the reguired 90 days following the end of the fiscal year because there was virtually no penalty for lateness and prompt submittals were usually not even audited in a timely manner due to a backlog of prior years. Now, the deadline has been extended another three months and both DCAA and contracting agencies are keeping on top of late submittals. Late submittals now: (1*) cause adverse past performance ratings* because they are considered indicative of poor "schedule" practices which is an explicit factor for past performance (2) *preclude direct billing* to payment offices where contractors can now direct bill invoices to paying offices if they meet certain conditions including submittal of timely indirect cost rate proposals (3) *delay profit retainage recovery* where the government must now release up to 90% of profit retained at completion of work if contractor's incurred cost submittals are not late (4) *prevent quick closeouts* where if submittals are on time contractors can use proposed rather than audited rates to close out most contracts quickly and (5) *hurt chances of awards* because DCAA has recently been asking all major agencies to use their clout in making award decisions to help the government clean up the late submittal backlog.

Less Audits/Faster Audits. In spite of the proliferation of information required, the government has reduced its audit scope for smaller contractors and is seeking to lessen the duration of the audit for all contractors. Now, contractors are divided into low and high risk categories. "Low risk" contractors are those with less than $10 million of annual auditable contracts (cost type, time and material or labor hour contracts, redeterminable) and are not considered problematic (e.g. consistently late, high questioned costs in previous audits). Such contractors, selected randomly each year, will be audited not more than once every three years and only one of three years submittals will be selected for audit (the other two years will be "desk reviewed"). The "high risk" contractors (greater than $10 million) will have each year audited but will be subject to DCAA's new "concurrent auditing" approach that seeks to lessen the length of time from submittal to audit report by accelerating certain audit steps (e.g. evaluating internal controls, reviewing selected transactions earlier) leaving reconciliation of claimed costs to accounting records and review of a few "risky" accounts for the final review.

GCA REPORT
P.O. Box 1235
Alamo, CA 94507

FIRST CLASS
U.S. Postage
PAID
CONCORD, CA
PERMIT NO 249

QUESTIONS & ANSWERS

Q. Last issue, you reported on a case where rental cost on a piece of fully depreciated equipment was not allowed for purposes of submitting a claim. We are in the process of preparing a claim where we believe it is fair to obtain payment for use of several pieces of equipment that happen to be fully depreciated. What options do we have? What regulations apply?

A. The regulations and even the case we reported on recognizes that a fair solution to a claim often requires some form of compensation for use of fully-depreciated equipment. FAR 31.205-11 explicitly forbids use of rental costs as a means of recovering these costs but provides that a "use charge" is permitted if it is calculated by considering such factors as "cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age and the amount of depreciation previously charged to Government contracts or subcontracts". In the case we reported on, the contractor did not seek a use charge based upon these factors.

In addition, FAR 31.105(d)(2) provides for use of a "predetermined schedule of construction equipment" in lieu of actual cost data. Also some decisions (Harvey C. Jones, IBCA 2070 and Tom Shaw, Inc. DOTBCA 2106) have held that use charges on fully depreciated equipment was permitted when calculations based on evidence of ownership and operating costs were presented. Commentators on these rules have pointed out that the regulations do not require contracting officers to approve these calculations but instead gives them the descretion to accept them. References to these regulations as well as pointing out that contractors are entitled to receive fair compensation for use of their equipment frequently prevail.

(Editor's Note. We came across a similar question asked below in the March issue of Contract Pricing Advisor which stimulated us to respond to the question of proper depreciation methods we are frequently asked. Our answer is our reponsibility alone.)

Q. For some of our assets, our method of depreciation differs for financial costing and income tax purposes. DCAA recently questioned our depreciation costs on the grounds that they must be consistent with our tax returns. Are they right?

A. Not Exactly. FAR 205.31-11(2) & (3) requires the depreciation method be "reasonable" which includes figures used for financial statements or that used for Federal income tax purposes. When the two differ, it requires the asset be capitalized for a period corresponding to its "useful life" (economic as opposed to its physical life) and use the methods of depreciation (straight time, sum of the years digits, etc) used for income tax purposes provided the amount does not exceed that used in books of accounts and financial statements. The useful life method is addressed in CAS 409 and hence even non-CAS covered contractors that choose to depreciate assets on the useful life method are bound by its cumbersome requirements to actually document the useful life of the asset(s) in question (e.g. keeping track of time the asset(s) is used, either in total or on a sample basis).

GCA REPORT · P.O. Box 1235 · Alamo, CA 94507 · (tel) 925-362-0712 · (fax) 925-362-0806 · Email: gcaconsult@earthlink.net

Subscription: $115 for one year, $200 for two years.