GCA REPORT

(A publication of Government Contract Associates)

May-June 1999 Vol 5, No. 3

NEW DEVELOPMENTS

FAC 97-11 FAR Changes

Recent changes to the Federal Acquisition Regulation in the form of Federal Acquisition Circular (FAC) 97-11 were recently released to be effective May 3. Significant changes include:

Recruitment Cost Principle. This final rule amends FAR 31.205-1 (Public Relations and Advertising) and 31.205-34 (Recruitment Costs) by stating that allowability of advertising in connection with recruitment is addressed in the later cost principle. FAR 31.205-34 now disallows costs of help-wanted advertising that does not describe specific positions or that includes irrelevant material (e.g. extensive illustrations or descriptions of the company's products or capabilities). In addition, language related to excess compensation has been removed from FAR 31.205-34 because the subject is covered by FAR 31.205-6 (Compensation for Personal Services). Specifically, the change eliminates references to unallowability of actions to "pirate" an employee from another firm. Now, "pirating" in itself is not considered unallowable as long as the compensation is not unreasonable.

Senior Executive Compensation. An interim rule was issued to address some confusion over what senior managers in multi-segment companies are covered by recent salary caps on executive compensation. The change expands the number of employees from only those employees working at headquarters or for a segment that reports directly to headquarters. As of January 2, 1999, regardless of when the contract was awarded, "senior executive" is defined as the "five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters" (FAR 31.205-6(p)(2)(ii)(B)).

Electronic Funds Transfer. This final rule replaces an earlier interim rule with some changes (FAR 32.1103). The final rule implements Public Law 104-134 that requires payment by EFT in most circumstances except (a) where the payment office has no ability to make such payment (b) payment is to be received outside the US or Puerto Rico (c) the contract is paid in other currency than the dollar (d) the contract is classified (e) the contract is awarded as part of emergency operations (f) the agency does not expect to make more than one payment to the same recipient within one year and (g) the need for the items is so great the government would be harmed unless payment is made by non-EFT methods. The rule recognizes that information can be obtained either before contract award as a condition of award or after award as a normal performance duty. Also, the new rule changes the location where the government will receive EFT information from the earlier submittal of information to payment offices to information contained in the Central Contractor Registration database. A revised FAR 52.232-33 clause (Payment by EFT-Central Contractor Registration) now requires EFT information be included in the CCR database and a new clause FAR 52.232-34 (Payment by EFT – Other than CCR) be used when a payment office uses a source other than the CCR database.

Waiver of Subcontractor Cost or Pricing Data. The change clarifies that waivers to submitting cost and pricing data at the prime contract level (e.g. price is determined to be fair and reasonable without submitting such data) do not automatically apply to subcontractors. The final rule states that a subcontractor is required to submit cost or pricing data even if the prime is granted a waiver unless an exception (e.g. the item qualifies for a commercial item under FAR Part 12) applies to the subcontract.

Very Small Business Concerns. The interim rule sanctions the Small Business Administration's Very Small Business Pilot Program intended to improve access to government contract opportunities to companies with less than $1 million in annual revenue and 15 employees (FAR Part19.5). The program will set aside certain acquisitions between $2,500 and $50,000 for very small businesses and the program will be limited to the geographic areas served by the existing 10 SBA district offices (New Mexico; Los Angeles, Santa Barbara and Ventura counties; Massachusetts; Kentucky; surrounding counties of Columbus, OH; Louisianna; Michigan; surrounding counties of Philadelphia, PA; surrounding counties of El Paso, TX and; surrounding counties of Santa Ana, CA).

DOD and OFPP Preview Their Past Performance Guides

As we have reported in the past (see especially our extended discussion of Past Performance in the Second Quarter1998 issue of the GCA DIGEST), evaluation of firms' past performance has become a critical factor in award decisions. Government agencies are currently developing means to implement this factor and representatives of two important agencies, Department of Defense and the Office of Federal Procurement Policy (which sets policy followed by most government agencies) recently previewed their respective agency's best practices guide at a recent Public Contracts Law Section of the American Bar Association. Publication of their guides are due out soon.

Key Differences. (1) The use of OFPP guides are intended to be "suggested" or "encouraged" while DOD's best practices guide is intended to be "policy" (2) OFPP will prohibit disclosure of information collected under past performance rules under the Freedom of Information Act requests while DOD says it will likely not prohibit such disclosure because such disclosure does not merit FOIA protection (3) DOD says it is likely to require its contracting officers and offerors to discuss all past performance not just adverse information while OPFF will not prescribe one method over the other and (4) OFPP will place the burden of collecting past performance references on the government while DOD will place the burden on contractors to ensure all references return past performance questionnaires to the procuring agency.

OFPP Best Practices. OFPP will recommend evaluation of contractors' past performance on contracts worth $100,000 or more on the following elements: technical quality, timeliness, cost control, business relations/ management, key personnel and subcontracts. OFPP will not require detailed discussions with all offerors and will set limits on both the quality and quantity of references to be collected. OFPP will use a five-point performance rating system where contractors will be rated on a scale of one to five. A "1" ("unsatisfactory" or "poor") means a contractor's performance "did not meet" some contract requirements while a "5" ("excellent" or "outstanding") signifies a contractor's performance "meets contractual requirements and exceeds many to the Government's benefit". A rating of "3" ("satisfactory" or "good") indicates performance meets contractual requirements. *(Editor's Note. OFPP's new rating system has already met with industry resistance where industry members of the audience complained the new system will grant only an "average" grade for performance meeting all contract specifications which can impose a significant burden on contractors to meet unspecified performance goals beyond those outlined in the contract.)*

DOD Best Practices. DOD has put forth the need to provide an agency official (referred to as an "ombudsman") to review a CO's initial assessment and one proposal has gone so far as to mark all initial past performance assessments as "draft" until a clear review by a person independent of the CO is made. Delays on the publication of the guide has occurred because of defining who has ownership of the assessments. It seems their position is that DOD is the owner which drives their position that contractors cannot publicize their "good" past performance but DOD is not barred from releasing past performance information under FOIA. Industry is likely to strenously fight DOD's apparent ownership claims.

DCAA To Disallow Prior R&D Costs on Other Transaction Agreements

The Defense Contract Audit Agency recently issued guidance to its auditors on the allowability of past research and development costs on other transaction agreements (OTAs). OTAs are an increasingly used procurement instrument that are typically cost sharing arrangements between contractors and the government to develop a weapons system or some important technology. They are usually cost reimburseable arrangements and are not subject to the FAR (except for some covered by FAR 31 cost principles). Contractors often include as their share of contributions prior costs expended to develop a product or technology. DCAA has issued guidance saying that costs incurred before entering into an OTA are unacceptable for satisfying the contractor's required cost share. DCAA notes that a cost is incurred only once and cannot be incurred a second time (MRD 99-PFC-038R).

OFPP Issues Guidance on Increasing Small Business Contract Opportunities

The Office of Federal Procurement is proposing to change its current policies related to contracting with small business to incorporate recent regulations changes. The proposed revisions to Policy Letter 99-1 will (1) increase the annual governmentwide goal for prime contract awards to small businesses to 23 percent (up from 20 percent) and add a 3 percent HUBZone (historically underutilized business zone) small business goal to be phased in over five years (2) establish a 5 percent women-owned small business goal and (3) maintain the governmentwide 5 percent goals for prime

and subcontract awards to small disadvantaged businesses.

In a separate action, the OFPP issued its long awaited proposed guidance to increase subcontracting opportunities for small, small disadvantaged and women owned small businesses to offset the trend to consolidate – known as "bundling" – prior small contracts into large consolidated ones. The proposed policy, which will replace OFPP Policy Letters 80-1, 80-2 and 80-4, establishes minimum requirements for promoting subcontracting opportunities, leaving it to agencies to establish additional requirements. The new guidance addresses:

Solicitation and Subcontracting Plan Requirements. In addition to current FAR requirements affecting subcontracting plans contracting officers will have to (1) state in solicitations that the estimated value of indefinite delivery contracts/task order and delivery order contracts will be used to determine if a subcontract plan is required (2) if an offeror proposes lower goals than those targeted in the solicitation, they must explain why they cannot achieve the stated goals (3) advise offerors of sources of information on potential small business, SDBs and women owned subcontractors (4) encourage offerors to synopsize contract opportunities in the Commerce Business Daily or advertise in other media (5) require offerors to identify other contracts that had subcontracting plans and COs to determine whether their goals were achieved (6) follow the FAR requirement to submit a subcontracting plan on all contracts expected to exceed $500,000 ($1 million for construction contracts of public facilities) unless the acquisition is reserved for a small business and (7) require offerors to review, approve and monitor their subcontractors' subcontracting plans.

Contract Modifications. As long as the original contract did not require a subcontracting plan, a subsequent modification that brings the contract value above the threshold will not trigger the requirement unless the modification itself exceeds the threshold. Also a subcontracting plan is not required of a former small business prime contractor that during contract performance no longer meets the small business criteria.

Subcontract Performance on Evaluations. When past performance is used in source selections, the CO may obtain information from contract offices concerning an offeror's past performance. Even if past performance is not used, COs may use offeror's performance as an evaluation factor for selecting a contractor (certain agencies such as DOD,Coast Guard and NASA require subcontracting plans be a factor in evaluating bids). The guidance recommends (does not require) that the subcontracting plan be a separate and significant factor for selection of a bidder.

Awards and Penalties. Contracting activities may establish an awards program, offer alternative payment schedules and reduce inspection monitoring and auditing for prime contractors doing an outstanding job of promoting small businesses, SDBs and WOSBs. Penalties may include (1) when included as a contract clause, invoking the Liquidated Damages clauses and assessing damages if certain percentages are not met or (2) making enforcement of subcontracting plans a critical factor in CO's performance evaluation.

NASA Authorizes 125 SBIRs; Eliminates Cost and Pricing Data on Phase 2 SBIRs

As we indicated in the First Quarter 1999 issue of the GCA DIGEST, Small Business Innovation Research projects are a highly successful and popular vehicle for the government to obtain technology benefits at a low cost. SBIRs are typically issued as Phase 1, not to exceed $100,000, six month research projects and when technical viability is demonstrated, followed by Phase 2 projects with values not to exceed $750,000. As an indication of their popularity, the National Aeronautics and Space Administration has selected 125 Phase 2 SBIR proposals awarded to 113 small high technology firms located in 26 states.

NASA has also issued a final rule to its NASA Federal Acquisition Regulation to provide a waiver to the FAR15.403 requirement to submit "cost and pricing data" for SBIR Phase 2 contracts. NASA believes the waiver will promote greater small business participation in R&D by eliminating the often onerous requirements associated with cost or pricing data. Contracting officers still have the authority to request other than cost or pricing data and as a practical matter, contractors will still need to substantiate their costs for either proposal evaluations or incurred cost submittals.

BRIEFLY…

Helpful Web Sites

We have included as a special "FLASH" attachment a compilation of useful web sites related to contracting with the federal government. In addition there is a state and local government jumpstation (http://www.fedmarket.com/statejump.html) with links to state and local procurement locations. The source is a reprint from an article by Frank Jacobson in the March 1999 issue of Contract Management.

Vehicle Mileage Reimbursement Reduction

A final General Services Administration rule, effective April 1, has decreased the mileage reimbursement rates for privately owned vehicles on official travel to reflect current lower costs of auto operation resulting from its own cost studies. The mileage allowance for use of privately owned vehicles has decreased from 32.5 cents to 31 center per mile (Fed Reg 15630).

DOD Issues Final Repricing Rule

In spite of industry objections, the Department of Defense issued a final rule to amend the Defense Federal Acquisition Regulation Supplement Section 231.205-70 (External Restructuring Costs) that specifies COs should consider including a downward-only repricing clause in noncompetitive fixed price contracts negotiated during the period when the contractor's pricing rates are adjusted to reflect the impact of restructuring costs. Restructuring costs, resulting from various business combinations, often result in cost reductions but a significant lapse of time can occur between the time the combination is announced and the contractor can reflect the cost savings in lower overhead rates and contract prices. Without the reopener clause, the government can not reprice its fixed price contracts after they are awarded. In an apparent concession to industry objections, the final rule includes a statement that "the decision to use the repricing clause will depend on the particular circumstances involved" including (1) when the restructuring took place (2) when the restructuring savings will begin to be realized (3) the contract performance period (4) whether the contracting parties can make a reasonable estimate of the impact of the savings on the contract and (5) the size of the dollar impact on the contract.

Proposed Bill to Narrow Criteria for Classifying Workers as Independent Contractors

A bill with both big labor union and Republican support was recently introduced in Congress to limit employee discretion in classifying employees as independent contractors. The bill would reduce the criteria in the US tax code that determines independent contractor status from the current 24-factor test to a three-factor test. Under the bill, workers would be considered employees and not independent contractors unless (1) their employers have no right to control them (2) they can make their services available to others and (3) they have the potential to generate profits and bear significant risk of loss. All employers would have to follow the same three factor test, eliminating the widely different classification practices of firms that "misclassify" employees as independent contractors to avoid paying various payroll related taxes and benefits.

Private SDB Certifiers Named

After June 3, self certification of firms as small disadvantaged businesses (SDBs) will end and be replaced by formal certification by the Small Business Administration. The SBA has announced its selection of 62 private organizations that are to help certify firms requesting federal status as SDBs. The private groups will screen and analyze SDB applications in the areas of ownership and control while the SBA will continue determining social and economic disadvantage as well as firm size. Though there has been considerable emphasis to decrease SDB set-asides, SDBs in numerous agencies still receive up to 10 percent price evaluation adjustments and large firms still receive considerable evaluation credits and financial incentives to include SDB subcontracts for their federal work.. To qualify as an SDB, a firm must receive formal certification from the SBA and be listed in the agency's on line database, Pro-Net. The list of private certifiers are located at http://pro-net.sba.gov.

CASES/DECISIONS

Contractor Not Entitled to Price Increase for State Tax Imposed During Contract Performance

Contractor was awarded a sealed-bid, firm-fixed price contract to construct a pipeline through an Arizona Indian reservation. The contract contained the standard clause 52.229-3, "Federal, State and Local Taxes", that states the contract price includes all applicable federal, state and local taxes imposed and collected on the contract date and provides that the contract price will be increased for any after-imposed *federal* taxes not included in the contract price. The clause contains no provision for increasing the price for after-imposed *state* taxes. During contract performance Arizona later imposed a state tax (transaction privledge tax) and the CO denied the contractor's attempt to increase the contract price.

In its appeal, the contractor relied heavily on a dissenting opinion in a R.B. Hazard, Inc. case that stated the FAR Council made a draft error when it failed to provide

contractors relief for after-imposed state and local taxes and that it was unfair to make contractors bear the burden of such taxes and that their contract should be increased under the "constructive change" theory. The Department of Interior Board of Contract Appeals stated it agrees that the contractor takes a serious risk and questions the fairness of why the contractor rather than the government should bear the burden of such after-imposed taxes. Nevertheless, the Board sided with the government stating the clause is unambiguous and regardless of its fairness, allows the contractor to be relieved of only federal, not state or local taxes (Cannon Structures, Inc. IBCA 3968-98).

(Editor's Note. It should be noted that FAR 52.229-4 clause that is used for noncompetitive negotiated contracts as opposed to the clause applicable to sealed-bid contracts, does provide relief for after-imposed state and local taxes. Contractors must be careful to consider what taxes to include in its bids and as we have seen in the past, cannot rely on government officials' opinions on what taxes are exempt. At the same time, the clause can provide benefit to contractors because when a state or local tax is later revoked, the contract price cannot be reduced.)

Use of Commercial Components Do Not Qualify Product as a Commercial Item

(Editor's Note. We are starting to see some cases defining in practical terms what qualifies as a "commercial item".)

The negotiated fixed price proposal called for supply of "commercial off-the-shell equipment" stands used to assemble and test aircraft components and offered the FAR 52.204-1 definitions of "commercial items". Chant's proposal was excluded from the competitive range on the grounds its stand did not qualify as a commercial item. In its protest, the Comp. Gen. sustained the government's position finding that Chant provided no evidence its proposed stand had ever been offered for sale, lease or license to the general public or otherwise complied with the definition of a commercial item. Instead, Chant is merely offering to fabricate – for the first time after contract award – a customized stand complying with the solicitation's specifications while using commercial off-the-shelf- components. Further evidence its stand was not a commercial item was Chant's failure to provide a copy of a standard commercial warranty or commercial off-the-shelf operating and maintenance manuals for its equipment. Though it was true Chant had designed and fabricated several other types of stands for the government, there is no evidence in its proposal that these other items were ever commercially available or that the proposed stand evolved from any of these other items through advances in technology or performance and would be available in time to satisfy the solicitation's delivery requirements.

(Editor's Note. Had Chant's proposed test stand actually been a commercial item, the mere fact it had to be customized to meet solicitation requirements would not necessarily have prevented consideration of the proposal. FAR 52.202-1(c)(3) permits modifcations of a type customarily available in the marketplace or minor modifications of a type not customarily available.

Contractor Justifies Use of Proposed Uncompensated Overtime

(Editor's Note. The following decision demonstrates accounting and management systems as well as experience documentation contractors should have in place to support use of uncompensated overtime.)

The protester was challenging an award on the grounds the government failed to properly take into account the awardee's proposed uncompensated overtime, claiming its cost realism analysis for a cost-plus-fixed-fee contract for management services did not take into account the loss of qualified personnel as well as questionable assumptions about labor rates. The Comp. Gen. rejected the protest. It stated the RFP specifically did not prohibit use of UOT but required contractors to include their policies on such overtime, what effect these policies might have on the current contract and include a history of rates for employees who have performed such overtime. The contractor provided this information to DCAA along with an explanation of how its accounting systems are used to track such overtime which both DCAA and the Comp. Gen. found to be adequate (Systems Integration & Research, Inc. Presearch Inc. Comptroller General Decision Nos. B-279759.2 & B-279759).

Discussions Requirement Does Not Include "Spoon-Feeding" Offerors

(Editor's Note. The new FAR Part 15.306(d)(3) section of discussions states the CO must indicate to each offeror still being considered for award "significnat weaknesses, deficiencies and other aspects of its proposal" the CO believes could be altered or explained to materially enhance its potential to win. The following provides an indication of how detailed this discussion must be.)

In its Department of Housing and Urban Development request for proposals on a fixed price, indefinitie quantity contract to provide real estate assessment and analysis services, offerors were asked to provide evidence of qualifications of key staff and to supply job descriptions, resumes and/or organizational charts reflecting key

personnel. During its discussions, the agency requested D&A provide (a) assurance it had the capacity to perform the contract and (b) a breakdown of costs supporting its proposed price to assure adequate resources would be devoted to the contract. When it was subsequently dropped from the competitive range, HUD informed the offeror at its debriefing it found significant weaknesses in the offerors' failure to provide information regarding (1) experience of proposed key personnel and (2) how it would mange its subcontractors. In its protest, D&A claimed HUD had improperly failed to inform it about its concerns in these two areas. The Comp. Gen. ruled that while an agency is required to conduct meaningful discussions leading an offeror into the areas of its proposal that must be amplified or revised, an agency is not required to "spoon-feed" an offeror as to each and every item that could be revised to improve its proposal. In this case, both the proposal evaluation criteria and proposal preparation instructions to offerors were detailed and clear in the problem areas (Du & Assocs., Inc.Comp. Gen. Dec. B280283).

Can Recover for Faulty Drawing Despite Clause Requiring it to Identify Defects

(Editor's Note. The following illustrates the ability to obtain an equitable adjustment in contract price when defective drawings must be changed.)

During performance of its fixed price contract to manufacture, test and deliver skid mounted floodlights, the contractor prepared numerous engineering change proposals (ECP) to correct the defective government-furnished technical data package on which the contractor used to prepare its bid. It sought a contract price increase for the ECPs and the government refused arguing recovery should be denied because the contract contained an "Engineering Drawings" clause obligating the contractor to identify and revise incorrect drawings and develop new ones. Citing two cases (Parsons of Cal. ASBCA 20867 and Radionics, Inc., ASBCA 22727) the Armed Services Board of Contract Appeals ruled the contractor is entitled to an equitable adjustment under the standard "Changes" clause for ECPs prepared to resolve problems identified in a defective technical data package and such recovery is not barred by language requiring identification of drawing errors (Essex Electro Engineers, Inc. ASBCA 49915).

(Editor's Note. Some contracts have additional provisions to the "Engineering Drawings" clause that state a contractor must review technical data packages and determine needed corrections and goes on to expressly state such defects will not be grounds for increasing the contract price. When these contract provisions are present, decisions have been made that prevent recovery of cost of correcting defects.)

Agency Erred in Basing its Award Decision on Solely Mathematical Computations of Technical, Price Scores

In the protest considered here, the contract was to supply commercial item eyeglasses and services to the Department of Veterans Affairs. Offerors were told technical and past performance factors combined would be weighted equally in making an award. The protestor of the award was the low cost offeror receiving maximum points for its price and was third high on technical merit while the awardee with nine points more had a price 12 percent higher. The GAO found that the award was based solely on adding up the scores for the technical factors and price and making the award on the total score.

Though it was for commercial items, negotiation procedures were used and hence under such procedures the government is not required to make the award on the lowest price unless the solicitation specifies price will be the determinative factor. When a price/technical tradeoff is made the source selection decision must be documented and such documentation must include the rationale for any tradeoffs including the benefits associated with additional costs. Though a mathematical formula could be used if it was explicitly put forward in the solicitation no such insertion existed and the GAO concluded the FAR Part 15 requirement for a rationale of any tradeoffs was not met because it is "clear that purely mathematical tradeoffs are not acceptable" (Opti-Lite Optical, GAO, B-281693).

QUESTIONS & ANSWERS

Q. We were given a contract to produce about 1,000 units of a critical component on missles. The government recently terminated half of the units and I am not sure whether to submit a partial termination settlement proposal or a request for an equitable adjustment to the contract price. What alternative will give our firm the greatest recovery?

A. It largely depends on whether the contract was terminated after producing a lot of the items or shortly after contract award. If, for example, your 1,000 unit contract was priced at $1,000 per unit and you produced 500 units yet already incurred the majority of costs (say $750,000) including engineering, ramp up, inefficiencies, etc. you would likely be better off submitting a termination settlement proposal where most if not all

the costs incurred for the 500 terminated units could be recouped (see our detailed article in the First Quarter 1999 issue of the GCA DIGEST, "Getting the Most Out of Your Termination Settlement"). If the partial termination occurred soon after award, a request for a price adjustment on the remaining items would likely yield more. This is because it is unreasonable to expect unit costs to be the same when the contract has been cut in half (e.g. absorption of fixed overhead) whereas the termination settlement would likely be modest.

Alternatively, you may want to consider preparing *both* a partial termination for convenience proposal to recoup the costs associated with the terminated portion of the contract *and* a request for an equitable adjustment to recover the additional unit costs associated with the reduction of units. Of course, we recommend conducting an analysis of all options discussed and comparing the results.

Q. In a recent bid, we submitted our proposal by fax and subsequently found out the agency did not receive it so we lost out in spite of the fact we were the low cost bidder. Can we fight it?

A. You do not provide enough information to give a definitive answer but in general, you are out of luck. A recent protest case submitted to the General Accounting Office (Advanced Seal Technology, Inc. B-280980) addressed such issues as (1) who has the burden of making sure an agency receives a fax and (2) who is at fault when there is an occasional mistake by the agency.

Though the GAO ruled on the specifics of the case it established some general points. First the GAO squarely puts the burden of getting the fax to the government on the bidder – "firms submitting quotations have a duty to see that their quotations reach the designated government office on time" and they have ruled that evidence of sumbitted quotations on, for example, a telephone bill is inadequate proof the government received the bid. The GAO also established that agencies should be forgiven for occasionally loosing a fax – while it may be unfortunate that an agency occasionally looses a fax and that agencies must have procedures in place to minimize the possibility of loss, "the occasional negligent loss of a quotation by an agency does not entitle the quoter to any relief". It appears you would have to demonstrate definite proof of sending the fax and show the agency had some systemic problems in receiving faxes. The case underscores the common sense approach of following up all fax submittals with verification that it was received.

NEW/SMALL CONTRACTORS

Accounting Practices: The Commercial vs Government World

Clients frequently ask us to provide a write-up describing how their firm's normal financial accounting practices differ from those required for federal contract cost and pricing purposes. Contracting with the federal government and local government financed with federal funds differs in many ways from commercial contracting. Firms aware of these differences and prepared to comply with the rules can achieve profitable results while firms unaware of these differences can become very frustrated and angry at the contracting process. Except for the specialist within a firm, most personnel (including accounting personnel and even senior financial managers) are often unaware of the requirements in this area. The following is intended as a generic description (e.g. elimination of specific concerns unique to a particular organization) suitable for distribution to those individuals within a firm needing a general understanding of how contractor accounting differs from that normally encountered for financial reporting purposes.

1. **Cost Accumulation by Contract.** Cost accounting theory refers to "final cost objectives" as the final point where costs are accumulated. Whereas such final cost objectives vary widely in the commercial environment (e.g. product or service lines, geographic location, etc.) government cost accounting rules emphasize that government work usually defines final cost objectives as either the contract or separately funded delivery orders incorporated in a contract. A government contractor must demonstrate it has the ability to identify, accumulate and report its direct and indirect costs at this level.

2. **GAAP vs Government Cost Accounting Requirements.** Though there is ample overlap between Generally Accepted Accounting Principles and accounting practices dictated by the Government, the body of acquisition regulations, cost allocation principles and Board of Contract Appeals decisions are often at odds with GAAP. Thus there is often the need to have the infamous two sets of books, one for government contract accounting and one for financial reporting (actually three if your recording for tax purposes differ).

3. **Increased Cost of Contracting Requirements.** Contractors spend more time in conferences, negotiations, submitting accounting data, supporting challenged costs, record keeping and security activity in government contracts than commercial work. The effect of these requirements are primarily felt in areas

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

traditionally considered indirect costs. The contractor must decide how to recoup these costs.

4. **Problems of Cost Recovery.** Other costs normally associated with doing business (e.g. interest, charitable contributions, entertainment, etc.) are not recoverable on government contracts. Numerous regulations, court cases, auditor guidance, and experts' opinions determine what is and is not recoverable. Contractors must demonstrate they can identify, isolate and report on these "unallowable" costs and assure government auditors they are not charged to government contracts.

5. **Full Absorption of Costs.** In the commercial world, G&A and home office expenses are normally not allocated to final cost objectives. In addition, costs are frequently lumped with G&A for lack of a clear-cut relationship between the cost and service. In government contracting, total cost is the primary determination of price so all indirect costs must be allocated to the contract in specific ways.

6. **Indirect Cost Rates.** Commercial firms usually accumulate indirect costs into one or two cost pools and recoup these costs on a "multiplier" basis adjusted for what the "market will bear". Government regulations provide both wide discretion and specific rules for recouping these costs. Decisions will have to be made on whether to expand or reduce the number of indirect cost rates (e.g. G&A, single or multiple overhead, service centers, subcontractor or material handling, etc.) and on the method of allocating them to cost objectives.

7. **Pressure to Reduce Overhead Rates.** The Government's budget cuts and frequent public allegations of waste and inefficiencies of contractors causes procurement authorities to seek lower overhead rates from its contractors. This pressure is transferred to contractors to lower their rates by either cutting costs or reclassifying indirect costs as direct costs within the constraints of government cost accounting rules.

8. **Need to Keep Adequate Documentation.** Upon award of its first government contract, a government contractor's existing accounting procedures and practices may not cover many cost categories and cost accounting practices that arise. Each new cost and cost accounting practice requires a decision. For example, costs previously lumped into overhead or G&A may need to be assigned to the individual project level while other costs normally identified at the project level may need to be lumped into G&A. Decisions are often made on an ad hoc basis without a prior consistent rationale. If a contractor must justify an earlier decision to a government auditor (often after the original decision maker has left), it is often too late to reconstruct necessary documentation which can make an earlier decision invalid. Keeping proper documentation is critical.

9. **Government Challenges to Contractors' Accounting Methods.** Government auditors and contracting officers often challenge costs the contractor has assigned to a contract on grounds of "reasonableness". When other alternatives exist, the auditor often challenges the contractor's method when another method would result in lower costs to the government. A method that appears acceptable now can be considered unacceptable at a later date. This adversarial, retroactive, one way affair often works to the disadvantage of the contractor and can often be countered by proactively negotiating areas of potential disagreement.

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.