GCA Report

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NEW DEVELOPMENTS

2016 Defense Bill Passed

The Senate and House have agreed to a $612 billion 2016 fiscal year National Defense Authorization Act (NDAA). Significant provisions affecting government contracting include:

1. Substantial changes to the way the Pentagon acquires goods and services giving more power to service chiefs to balance resources and priorities and making tradeoffs among cost, schedule, technical feasibility and performance on major defense acquisition decisions and taking away some of the power of the central Acquisition, Technology and Logistics office. The services will have milestone decision authority and will be held responsible for cost overruns.

2. Commercial item acquisitions will be encouraged where there will be mandatory reliance on contracting officers to make commercial item and price reasonableness determinations.

3. In addition to the two items above, industry is praising provisions that will relax the need to demonstrate value of multiyear procurements which will result in greater use of them, permitting the DOD to designate trusted suppliers and expand intellectual property protections.

4. DCAA will be prohibited from auditing non-Defense agencies unless DOD certifies it is current in its incurred cost proposal backlog. "Current" is defined as 18 months of incurred cost inventory. Most reports we have heard is that DCAA has ceased auditing non-DOD agencies where they have suspended audits they began but it is unclear whether this is a short or longer term situation. Comments indicate this is likely to continue the trend for DCAA to put more pressure on prime contractors to audit their subcontracts.

5. Language is included to expand Buy American Act provisions.

President Obama vetoed the original bill in late October, primarily on the grounds that it was using Overseas Contingency Operations (OCO) funds to circumvent earlier sequestration limits on spending. The parties negotiated a compromise that reduced $5 billion in spending where the items addressed above were not changed.

Lots of Contracting Opportunities on the Horizon

Various publications we read are touting significant contracting opportunities. Here is a sample of some:

The Small Business Administration's expansion of the mentor/protégé program to allow all small businesses to participate other than just 8(a) and economically disadvantaged firms is being praised as offering a "big opportunity" for all small businesses. Companies are being encouraged to apply to SBA district offices as soon as possible.

The newly finalized Trans-Pacific Partnership (TPP), which calls on signatory nations to open up their procurement markets to all parties to the agreement represents a "boon for US firms looking to do more business with foreign nations." Though the agreement contains extensive requirements for issuing solicitations, accepting bids, awarding contracts and other procurement processes, US agencies already largely adhere to these requirements where contractors are used to them.

Incumbent contractors are at risk of losing more major recompletes than they win in 2016 while it is good news for challengers as federal agencies restructure contracts to save money. These changes include consolidating requirements from multiple incumbent contracts, breaking up existing contracts into smaller follow-ons, shifting to a multiple-award contract strategy, setting aside more work for small businesses and other restructuring of existing contracts. Since incumbents are more likely to win when agencies issue straight follow-on recompetes these new changes will likely hurt them.

The recently passed Omnibus spending bill passed in December that increases federal discretionary budget caps by at least $50 billion will be "chock full of contracting opportunities." The legislation will contain detailed directives for agencies on how to spend the money and contractors are being urged not to wait for RFPs to come out six months from now.

The intensifying fight against Islamic State militants will probably generate more demands for contractors to support US military operations in Iraq and Syria. So far, most of the reported expenditures have been spent on base life support activities such as logistical requirements (e.g. operation of dining facilities, vehicle purchases or rentals, facilities operation support and transportation).

Employer and Government Groups Debate Pros and Cons of Recent Labor Rules

Recent presidential mandates that federal contractors provide a certain amount of paid sick leave and pay higher hourly wages than required by federal law, while widely criticized as anti-business, has gained some support in the employer community. Executive Order No. 13706, effective in 2017, requires that companies provide their employees working on federal contracts up to seven days or more of paid sick leave annually, including paid leave allowing for family care, where both full time and part time workers will earn a minimum of one hour of paid sick leave for every 30 hours they work. Executive Order No. 13658, effective Jan 1, 2016, raised the minimum wage to $10.10 per hour for workers on new and renegotiated federal prime contracts and subcontracts, raised annually for inflation, while the national average federal minimum wage is $7.25. The CEO of the Women Chamber of Commerce says the paid sick leave will be "competitively managed across all contractors" and "levels the playing field for all government suppliers" while Alissa Barron-Menza of the Business for a Fair Minimum Wage states her group is a strong supporter of the wage. Nonetheless, some people disputed the "level playing field" argument and said it may have a disparate effect on smaller firms.

A former Office of Federal Procurement Policy (OFPP) head Angela Sykes criticized Executive Order No. 13673 issued July 14 requiring businesses to disclose violations of 14 federal labor and employee laws as well as comparable state laws in the last three years to be eligible for contracts exceeding $500,000 and allows agencies to deny contracts based on that information. She states the EO will undermine the policy of maximizing contracting opportunities for small businesses and will delay procurements, blacklist ethical companies and reduce competition. The current head of OFPP Anne Rung supports the EO saying it is designed to improve contractor compliance with labor laws with the goal of making contracting more economical and efficient. She adds many small businesses will be exempt if their contracts do not exceed $500K and they can always appeal a CO decision about nonresponsibility to the SBA.

Report Says Subcontract Margins Higher Than Prime's

The third annual report on the performance of the defense acquisition policies was recently released which included statements that first tier subcontractors' profit margins were higher than primes' margins. At the median, the margins exceed 2 percentage points on development contracts (6.2% for primes, 8.3% for first tier subcontractors) while they are 7 percentage points higher on production contracts (9.0% versus 16.3% percent) during the period 2001-2015. The report expressed concern that the significantly higher profit margins may discourage fewer prime contracts resulting in a reduction of competition *(available at www.acq.osd.mil/fo/docs*).

DCAA Issues New Electronic ICE Model

In December DCAA released its second 2015 version of the ICE model which is the electronic version of the "Model Incurred Cost Proposal." This version 2.0.1e may be downloaded from DCAA's website. There was no substantive changes to the model except (1) more information from Schedule J, subcontract information, has been added such as contact information, subcontract value, performance period, costs incurred for each subcontractor and award type and (2) additional information such as prime contract value and DUNS number have been added. (*Editor's Note. Though the format of the "Model Incurr4ed Cost Proposal" needs to be strictly adhered to, there is no requirement to use the electronic ICE model. When we prepare incurred cost proposal for clients, we usually prefer not using the electronic model since the links are burdensome.*)

Suspension and Debarment Case Loads Up, Individual are Targeted

Law firms are reporting there is more suspension and debarment actions involving contractors and more fraud actions against individuals. Continuing an upward trend, the Interagency Suspension and Debarment Committee reported that the total suspensions, debarments and proposed debarments jumped 7.6 percent in FY 2014 to 4,812. The report says there has been a significant increase to suspend or debar individuals even though their companies have settled such actions. The report states companies commonly have the resources to fight assertions while individual do not. Causes cited for the increase include lower standards for proving fraud by the Fraud Enforcement and Recovery Act and recent GAO findings of lax suspension and debarment programs at many agencies prompting them to crack down.

DOD Mulls Value of Changes to Commercial Item, EVM and Audit Requirements

(Editor's Note. Though the following study is not yet leading to immediate changes we find it interesting in so much as it highlights areas that DOD is considering changes to.)

A recent study by the Defense Department's Undersecretary of acquisition, technology and logistics (AT&L) says DOD should consider eliminating non-value added requirements imposed on industry in commercial item acquisitions, earned value management (EVM), contract audits and the Truth in Negotiation Act (TINA). The recommendations followed a research study of 12 of DOD's largest contractors in the five areas.

Commercial Items. The report states defending assertions of commerciality are unnecessarily burdensome, DOD demands too much insight into costs of commercial items and DOD exerts excessive control over offerors' processes.

EVM. The report states that DOD is currently vetting a draft to the DFARS that would (a) eliminate the need for EVM data on certain contracts such as cost type, T&M/ labor hour and level of effort (b) establish a single threshold of $100 million for compliance reviews and system surveillance where $20 million to $100 million would still be subject to EVM reporting but only on an exceptional basis and (c) COs should be prohibited from using EVM performance metrics for award fees.

Contract auditing. These include (a) streamlining DFARS compliance reviews of large contractors' business systems by considering Sarbanes-Oxley audits and companies' internal controls (b) continuing to address the backlog of contract closeouts (c) streamlining forward-pricing rate audits and (d) reviewing DCAA efforts to reduce its incurred cost audit backlog and their starts and stops in audits.

TINA. Clarify guidance to reduce redundant submission of cost or pricing (CoP) data where there is "excessively frequent" updates to cost or pricing data because of uncertainty about what data is considered current. For example, CoP may be certified as of proposal submission date or other cut-off date, consider certified CoP to be "current" through a specified post-CoP date, limit resubmission of more current CoP to only those items than change over a given threshold (e.g. 10 percent). There should also be an increase to TINA thresholds for submitting certified CoP data and related exceptional circumstance waivers (http://lnk.ie/17QQ5/ e=allndia@ndia.org/http:1.usa.gov/1GXmCtW).

Proposed Rule to Streamline Audits of Voluntary Disclosure of Defective Pricing

(*Editor's Note. Defective pricing audits seem to be increasing in the midst of lower priorities on other DCAA audits. These audits are often very burdensome and can go on for many years so the following proposal may be welcomed.*)

A proposed Defense rule will allow contracting officers to choose to have less extensive audits if a contractor voluntarily discloses defective pricing. COs may request a limited scope audit unless a full scale audit 'is appropriate for the circumstances." COs will consult with DCAA on the scope of the audit and will evaluate, at a minimum, (1) completeness of the contractor's disclosure on the affected contract (2) the accuracy of the contractor's cost impact calculation for the affected contract and (3) the potential impact on other contracts and subcontracts (*Fed. Reg. Nov 20*)

Two DOD Class Deviations Issued on Tax Delinquent Contractors and Quick Closeout Procedures

The Defense Department has issued a class deviation prohibiting the use of FY 2016 funds to enter into any contract with a company that (1) has an unpaid tax liability that has been assessed for which all judicial and administrative remedies have been exhausted or lapsed and is not being paid in a timely manner or (2) was convicted of a felony criminal violation in the last 24 months. The prohibition is not required if the government has considered suspension or debarment actions and determined that further action is not needed (*Fed. Reg. Oct 19*).

A class deviation was issued to administrative contracting officers to continue exercising flexibilities to close out contracts issued in DCMA Memorandum No. 13-288. The memo called for using quick close out procedures to close out contracts, task, or delivery orders before a determination of final direct and indirect costs is made, regardless of dollar value or percentage applicable to any such contract vehicle as long as all other conditions for quick close out procedures are met (*Fed. Reg. Sept 10*).

DCAA Issues Guidance on DCMA Requests for Tailored Audits

The Defense Contract Audit Agency has issued guidance on recent trends of the Defense Contract Management Administration to request DCAA help in auditing Forward Pricing Rate Proposals (FPRP). The guidance states the scope of DCAA's support may include a

complete proposal audit to auditing a specific rate, multiple rates or pricing factors. Is is expected the two agencies would agree to a definite schedule for results and will establish a clear understanding of DCMA's needs and concerns. If the audit request is limited to reviews of individual expense accounts the memo states audit opinions on the FPRP is not to be put forward. Either way, DCAA may not be permitted to state their audits are in accordance with Government audit standards unless they are permitted to set the scope of the audit. Comments we have seen indicate that DCMA wants to limit DCAA's involvement because (1) DCAA takes too long to issue audit reports (2) DCAA has unreasonable conclusions and (3) DCMA prefers to do the audits themselves (*15-PSP-011R*).

CASES/DECISIONS

Claims Reconsideration Extends Appeal Deadline

Safe Haven submitted a claim for a task order on June 27, 2012 which the CO denied Sept 18, 2012 and another claim for a task order on July 25, 2012 which the CO denied Aug 27, 2012. Subsequently, the agency said the CO was reconsidering its denials to determine whether misconduct of an individual at the agency affected Safe Haven when it concluded no additional compensation was justified and told Safe Haven of its decision at a meeting on March 21, 2014 which Safe Haven appealed May 18, 2014. The government dismissed the appeal as being untimely, not meeting the 90 day appeal deadline. The Appeal Board disagreed stating the CO clearly expressed intent to reconsider the claim – even if the word "reconsideration" was not used – and Safe Haven relied on that that representation. The Board ruled that following a timely requested reconsideration the appeal clock starts running from zero upon issuance of a final decision. Here, the appeal clock did not start to run until March 21, 2014 making the May 18 appeal timely (*Safe Haven Enters. LLC v Dept of State, CBCA No. 3871*).

GAO Sustains IT Systems Testing Award

Tantus protested the award for IT testing asserting the agency did not properly evaluate offeror's corporate experience, past performance, proposed low labor rates and whether proposed relocation of personnel did not consider the risk of retaining three key personnel. The GAO ruled in favor of Tantus and recommended the agency reevaluate proposals and make a new source selection decision. For past performance and relevant corporate experience, the GAO stated the agency only considered contract references submitted by the offerors and did not consider past performance references contained in government-wide past performance databases as the solicitation stated would be considered. The GAO also stated the agency failed to address whether the relocation plan or lower proposed labor rates should raise concerns. The attorney representing Tantus stated while the government correctly receives the benefit of the doubt in many protests, "failure to engage should never be a litigation strategy." In addition, regardless of arguments put forth, the attorney said the best chance for protest success is to show the agency failed to follow stated evaluation criteria (*Tantus Tech. Inc., GAO, B-411608*).

Court Rules Unequal Communications Prevented Award to Protester

(*Editor's Note. Though the following case addresses unequal communication, the issue of treatment of IR&D costs makes it more interesting.*)

Independent research and development (IR&D) costs cover contractor research that is not conducted for a particular contract. Though IR&D work is not tied to a contract the results of the research can help the contractor deliver goods and services for a particular contract and when that occurs the cost of work implicitly needed for a particular contract can be treated as an indirect cost recoverable by allocating it across a range of contracts rather than a direct cost of the contract. This allows for a lower price than if the work was included in the price of the one contract. In notices to Raytheon and other offerors, the Air Force stated that FAR 31.205-18, IR&D/B&P cost, prohibited costs considered to be IR&D unallowable indirect costs when the work is implicitly required in performance of the contract or explicitly required under the terms of the contract. Raytheon challenged the Air Force's position stating it conflicted with *ATK Thiokol, Inc. v US 598 F.3d 1329* which held research and development costs are allowable as IR&D unless specifically required by the contract. In response, the Air Force agreed with Raytheon's position of the allowability of the IR&D costs and "communicated its new view to Raytheon", accepting its treatment of certain costs as IR&D but failed to communicate its position to the other two offerors. Northrup and Lockheed protested the award asserting the award to Raytheon was based on "unequal communications" and the Court agreed, citing FAR 15.306(e)(1) that bars conduct that favors one offeror over another, ruling the unequal communication justified reopening the proposal process (*Raytheon Co. v. US, 2015 WL6405390*).

Post Termination Costs are Allowable on Termination Settlement Proposal

Pros Cleaners submitted a termination settlement proposal for its commercial item laundry services contract whose price was based on $.70 per pound of completed laundry times the number of pounds completed where no hourly wages or salaries or methodologies for recovering overhead or profit were contained in the original contract proposal. Pros' termination settlement proposal included $11,607 for costs related primarily for salaries of employees' post termination time spent negotiating a settlement. The Board alluded to the two "prongs" incorporated in FAR 52.212-4, Contract Terms and Conditions – Commercial Items that included "Contractor will be paid a percentage of the contract price reflecting the percentage of work completed prior to the notice of termination plus reasonable charges…resulting from the termination." The Board ruled for Pros stating it comes down to what is allowable for a contractor to recover "under the second prong" where the record shows Pros incurred unavoidable reasonable post termination costs in attempts to settle the matter (*Pros Cleaners, ASBCAQ No 59797).*

Modification Falls Outside Scope of Order

(*Editor's Note. As a commentator on the following case has said, it reminds the government not to bypass competition requirements by using an existing contract to purchase items or services that are not covered by the contract or by extending an expired contract instead of conducting a new competition.*)

In 2013, Microsoft reseller En Point received a delivery order (DO) under its Federal Supply Schedule contract to provide software licenses, software maintenance services and technical support where in 2014 the government modified the delivery order to provide "E-Mail as a Service" (EaaS). Google products and services reseller Onix protested arguing that acquiring EaaS was fundamentally different from what the agency had previously acquired under the DO. The GAO agreed that this was an improper, out-of-scope modification because there was a material difference between the mod and En Point's DO and either a full and open competition should be held or necessary justification and approval to acquire the EaaS product for a sole source award (*Onix Networking Corp., GAO B-411841*).

Buyers Must Beware of Fixed Price Contracts

(Editor's Note. The following case should alert contractors who submit fixed price proposals on high risk contracts that they are fixed where if the government has been above board in stating facts and makes no changes in performance there is virtually no chance they can obtain compensation for costs of increased work. It should also alert contractors that price adjustment clauses must be read closely before submitting a proposal.)

Agility won a fixed price contract to provide property disposal services in Afghanistan. The solicitation for each year of work provided no estimate of property to be disposed of but only a general warning that workload could be higher and detailed data on past quantities where the only protection for increased quantities was a specially drafted price adjustment clause that provided entitlement to increased compensation if the workload was more than 150% above average for the preceding three months. Upon starting the contract Agility found there was far more property to be disposed of than it had anticipated and filed a claim for the extra work. The Court ruled against Agility stating that where one agrees to do, for a fixed sum, a thing possible to be performed it will not be excused or entitled to additional compensation because of unforeseen difficulties. The Court ruled that the agency's providing of prior data and a warning that quantities could increase was sufficient. As for the price adjustment clause the Court ruled it clearly required higher volumes for three months where here, the claim was entered the first month of performance (*Agility Defense & Gov't Svcs v US, No 13-55C*).

NEW/SMALL CONTRACTORS

Impact of Small Business Financing Decisions on Government Cost and Pricing Requirements

(Editor's Note. One of the advantages of being a small business is the considerable financial flexibility they have. Unlike publicly held companies subject to a world of constraints imposed by the investor community – keeping stock price high, maximizing profit, maintaining an ideal capital structure of debt and equity, staying within pre-established financial measurements (e.g. ROE, ROA, ROI), keeping wealth within the company, substituting short term growth for long term health, etc. - small companies can and do follow different objectives resulting in a wide variety of behavior. Owners' decisions significantly impact the cost and pricing of government contracts. Though we have dealt with similar issues several years ago we thought it would be a good idea to address these issues again with some new thoughts added. Though we reference no particular source, the small business behavior described and the impact on government requirements are based upon our

observations of hundreds of companies during our consulting engagements.)

Small Business Behavior

The unique behavior decisions facing owners of non-publicly traded companies often differ significantly from what the "ideal" business behavior would be that is described in various business textbooks. This behavior is usually no less sensible and includes:

What profit levels to maintain. Some companies may choose to maximize reported profit to satisfy banks, investors or potential buyers while other companies may choose to hire lots of family members or spend lavishly on recreation activities that can be write-offs of the business. Or, companies may choose to make heavy investments in research and development even though such high up front costs can hurt reported profit.

Ideal capital structure. Textbook financial theory prescribes ideal levels of equity versus debt to maintain which are generally followed by publicly traded firms. Maintaining this ideal capital structure is less important than other considerations to smaller, privately owned firms. For example, since most debt for small businesses require personal guarantees many smaller companies care less about capital structure and more about their personal risks, making them more reluctant to borrow. Also, equity investments are frequently disguised as debt to allow greater access to funds. Or, though financial theory prescribes matching long term borrowing to long term assets and short term borrowing to short term assets, such prescriptions go out the window when the need to finance growth spurts or keep the vendors paid motivates owners to obtain any kind of financing they can get.

Also with respect to what level to keep retained earnings, traditional finance theory prescribes keeping this equity component high while business owners have other priorities. Decisions to keep retained earnings high are usually made so wealth stays in the company and payment of taxes are kept to a minimum while decisions to keep it low are a result of either paying more expenses from the company or transferring wealth out of the company.

Use of Assets. The assets of some companies may be bloated with not only business assets but also "personal assets" while other companies may include little or no assets where owners prefer to own the assets and rent them to the business.

Essentially, many of the business decisions affecting small privately owned companies come down to the personal preferences of the owners. The first decisions owners must make are where should the wealth of the company go – how should it be split between the owners and the company. That basic decision will heavily influence whether funds remain in the company or distributed out, whether assets remain business assets are become assets owned by the owners and family and leased to the business, how much and when are taxes paid, etc.

Implication for Government Contracting

These basic decisions have major implications on the cost and pricing rules government contractors must follow:

When personal assets are part of the business

Many owners keep as many assets as possible in the business that include not only the essential assets needed to conduct business but additional ones from autos to hunting lodges and chalets. Many of these assets can be a source of additional cost recovery on government contracts as depreciation, cost of money, etc. Of course, contractors should be prepared to demonstrate the assets have a business purpose and the advantage of added cost recovery must be weighed against the resulting higher contract prices that can make contractors noncompetitive. If the owners do decide it is in their interests to keep wealth within the company yet fear their cost structure makes their government pricing too high, they may voluntarily delete the costs associated with many of their assets when computing their indirect rates.

Leasing business assets to the company

Many business owners choose to transfer wealth out of the company, buying then leasing to the company assets needed to run the business. The amount the company (government contractor) pays the owner of the asset is often problematic, especially when owners want to maximize the cashflow they receive from the business. Auditors consider such arrangements as related party or less-than-arms-length transactions and they receive considerable scrutiny. Where the contractor often rents the use of assets at market value, the government usually requires the lower of "cost of ownership" or market value. However, rental costs may be allowable when the same asset is rented to non-affiliated entities so as to constitute a commercial rate.

The allowable costs of ownership the contractor pays the related party is supposed to be the same costs as if the company owned the asset. Such costs include

depreciation, taxes, insurance, repairs and maintenance and cost of money.

Depreciation costs are primarily covered by FAR 31.205-11 and CAS 404 and 409. There is considerable latitude how these costs are computed. For example, the period of capitalization of the asset can vary depending on its "economic life". Also the method of depreciation (e.g. straight line, accelerated methods) can provide considerable latitude. The level of audit scrutiny will often vary by class of asset. Real estate arrangements are always examined (auditors will ask to see copies of leases) while other classes of assets may be scrutinized less, especially if the amounts are not significant.

If the assets are older, and fully depreciated, then cost of ownership costs must be replaced by unique rental arrangements. Like usage rates of fully depreciated assets in the company, use charges of assets owned by related parties and leased to the company need to be negotiated and documented in advance agreements. FAR 205-11 identifies the factors to determine usage rates.

Family members and friends on the payroll

Compensation of business owners of closely held firms are closely scrutinized by the government. First, "high risk" individuals have been broadened to include employees who can exercise influence over their compensation to include owners, partners, individual executives and officers as well as their family members. Auditors are told to determine if the individual level of compensation is "reasonable" where the burden of the reasonableness test often falls on the contractor to demonstrate their level of compensation is reasonable. Auditors are instructed not to limit their review to only those employees holding high level positions. Auditors attempt to determine if the level of compensation is matched to the job class and to ensure high risk individuals have the same duties as other members of the same class. For example, if the President's son is an engineer the auditor must confirm (sometimes with technical assistance) the son is not over-graded at a higher level of engineer or is overpaid for the work they perform.

Award of perks

Certain perks (e.g. memberships, etc.) will likely be scrutinized closely while others (e.g. auto leases) may not. We have seen auditors attempt to disallow many perks, claiming they are unallowable "entertainment" expenses or they should be included as compensation and then disallowed as "excess compensation" if the total exceeds certain benchmarked amounts or is a "distribution of profits." You should be able to defend the expenditures as business related. You should also be able to defend your compensation level as "reasonable" if the perks are included as compensation.

Spend on recreation

Certain recreation costs are clearly unallowable costs while others would likely be considered appropriate business expenses not considered unallowable according to FAR cost principles. For example, sporting events, golf club membership, etc. are explicitly unallowable as entertainment costs. Others may be allowable such as meals where business is conducted (unlike IRS guidelines, 100% is allowable). Others fall into gray areas and contractors take varied approaches to including or deleting such costs. Those more conservative will identify all gray area costs as unallowable while others will consider a hint of business purposes as justification for maintaining the costs are allowable. If a transaction is subject to penalties (e.g. "explicitly" unallowable costs) contractors may want to take a more conservative approach with those while other costs not subject to penalties could justify a less conservative approach.

Financial capability audits

Auditors are now instructed to conduct more frequent financial capability reviews of contractors. One of their first steps is to obtain financial statements, compute common ratios (e.g. profit margins, return on equity, return on assets, working capital levels, asset levels, etc.) and compare the results against established standards to determine if there is any financial risk. If your ratios are outside of the norm, you want to avoid any assertions that you do not have the financial wherewithal to perform your contract. The guidance followed by auditors has, in the main, been drafted to reflect sound financial decisions found in the public sector rather than less optimal but nonetheless sensible financial decisions taken by smaller business owners. If the resulting financial ratios cause concern, the auditor may need to take into account certain decisions made by the business owner. For example, if the owner chooses to minimize assets in the company and instead buys them outside the firm and leases them back then the auditor needs to reflect this in the report. Or, for instance, if return on equity is low, you may want to indicate the reasons retained earnings are higher than normal. Or, again, if equity levels are excessively low, you may need to demonstrate how certain "loans" are really disguised equity.

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

QUESTIONS AND ANSWERS

Q. I have been reading that contracting officers are not allowing allocation of G&A to direct travel costs. This can significantly affect us since direct travel is a significant cost component of many of our contracts. What do you think?

A. Though we have not seen it in our practice, we have seen a couple of blogs that allude to this situation. A few comments: First, assuming you use a total cost input base for computing your G&A rate, there is no prohibition to applying G&A to the costs that are included in the G&A base such as direct travel. Second, the CO is most likely asserting this as a negotiating ploy to lower prices it must pay (unless the contract prohibits it which would be highly unusual in our experience) so you can either push back against their assertion or agree to it as part of any negotiation. Third, if this is expected to be a recurring event, you have the option of changing your indirect rate structure by, for example, computing a G&A rate that excludes direct travel and any other direct costs. This way, you can, in effect, recover the G&A costs related to direct costs by computing a higher G&A rate that is applied to other costs that the CO would not object to.

Q. The three top Executives (CEO, President, CFO/COO) at our company never charge direct to a contract. Time is charged to Overhead and General and Administrative (approximately 50-50). It is difficult to get them to complete their timesheets. Is there any reason that they are required to complete timesheets?

A. The fact they don't charge direct should generally be a reason not to require timesheets. However, their charges to overhead versus G&A should be based on effort spent which normally would need to be documented on a timesheet. If you can determine if their activities belong to only one pool then you can assign their costs to that pool and then timesheets should not be needed.

Q. Our company is being bought by an investment firm. I know you have written about affiliation rules for determining whether multiple companies owned by the same owner can still be considered small businesses where you wrote about businesses purchased by investment firms can still be considered small businesses despite the fact that the all the businesses under the investment firm ownership umbrella exceed small business thresholds but I wasn't sure if your reporting applied to SBIRs only or all purposes. Are there any regulation citations you can provide?

A. Yes, your memory is good about SBIRs. We wrote in the recent past that for affiliation purposes, small businesses purchased by private equity and venture capital firms can still be considered small businesses for purposes of going after SBIRs (but not STTRs) despite the fact that the total amount of firms would be considered affiliated and hence not small businesses. However, the Code of Federal Regulation Part 121.103(b)(1) would indicate the exception to affiliation rules would apply in other circumstances. Section (b) addresses exceptions to affiliation coverage and section (b)(1) states "Business concerns owned in whole or in substantial part by investment companies licensed or development companies qualifying under the Small Business Investment Act of 1958, as amended, are not considered affiliates of such investment companies or development companies."

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

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