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DCAA ISSUES GUIDANCE ON BLENDED COMPENSATION CAPS

(Editor's Note. The following article addresses compensation caps applicable to contractors who are subject to compensation caps established by the Office of Federal Procurement Policy (OFPP). Generally, the OFPP caps established by the government apply to larger companies (variously defined as those with $50 million in revenue) where lower caps may apply to smaller companies based on discretion of DCAA. Where we address the caps established by OFPP here, there is as yet no guidance on how smaller companies will be affected.)

The Bipartisan Budget Act of 2013 established a limitation of $487,000 on all contractor compensation on FAR based awards made on or after June 24, 2014. Because different, higher rates applied to periods prior to this date, contractors may want to adjust rates applicable to their contracts where they have the option to compute a blended compensation cap if advantageous. The DCAA memo includes copies of guidance issued by the Defense Contract Management Agency (DCMA) Oct 25, 2014 "Use of Blended Rates to Implement Multiple Compensation Caps" which establishes that a blended compensation cap may be used if contractors believe the approach is beneficial and if it does, states an advance agreement needs to be in place and that DCAA will complete an audit of the data used to compute the rates. The DCAA memo also includes more detailed guidance by DCMA issued Jan. 29, 2016 in the form of a Q&A format that provides background information, discusses blending methodologies for final incurred cost proposals (ICPs), interim billing and forward pricing rates and more detailed information. The memo concludes, again in a Q&A format, with the responsibilities of DCAA to review proposed blended rates.

DCMA Jan 29, 2016 Memo

By far, the most significant information in using a blended rate approach is in the Jan 29 memo issued by DCMA."Use of Blended Rates to Implement Multiple Compensation Caps."

- **Background**

The memo starts by stating executive compensation caps are implemented at FAR 31.205-6(p) where now contractors are subject to multiple versions of that provision within the same accounting period. That is due to the fact the government has established varied compensation caps in different periods. Before 2012, all US government contracts entered into prior to Dec. 31, 2011 were subject to a compensation cap of $952,308 on the five most highly compensated employees in management positions at each home office and segment whether or not the home office or segment reports directly to the contractor's headquarters. The caps for 2010 were $693,951 and for 2011 $763,029, The executive comp caps of $953,308 for contracts awarded from Jan 1, 2012 through June 23, 2014 applied to all employees performing DOD, NASA or Coast Guard contracts but applied only to the top five executives for all remaining agencies. All US government contracts awarded by all agencies on or after June 24, 2014 are subject to the $487,000 total executive compensation cap. (Note: The OFPP has not published the caps applicable to 2013 and 2014 prior to June 24 limitations so the $953,308 amount is presumed to apply.)

- **Blended Compensation Cap**

The policy states the cap amount for each year should be calculated as a weighted average by blending the separate cap amounts based on the contract actions entered into before June 24, 2014 and after that date. For ICPs, a blended cap is to be calculated based on the proportion of dollars actually *incurred* on contracts awarded before and on or after June 24th. For interim billing and forward pricing rates contractors are to identify the estimated universe of contracts or contract actions.

- **Implementation**

When a contractor chooses to use a blended cap, the ACO must execute an advanced agreement as provided in FAR 31.109. The DCMA guidance provides a

pro forma template for the advance agreement. The guidance for implementing the blended compensation cap is presented in a Q&A format of 17 questions. The most significant include:

Is blending a cost considered to be an accounting change?
No. Contractors will continue using their existing cost accounting practices for applying the cap.

Must all contractors use the blended rate?
No. It is optional where other methods are also acceptable such as using the new compensation cap effective on June 24 for the entire year regardless of date of contract award.

Which contracts and subcontracts are considered to be "affected contracts" to be included in the dollar amounts?
Contracts subject to FAR 31.2 cost principles (e.g. fixed price, fixed price incentive, cost reimbursement, etc.). Contracts not subject to FAR 31.2 are excluded such as contracts for commercial items and non-US government customers. Foreign military sales are included but not those direct sales to other government are excluded. For forward pricing rates, contract awards that have already been priced (referred to as backlog) are not to be used.

Can you supply an illustration?
For ICPs, take the following steps.

Step 1: Identify the dollar amounts incurred for the year for contract and subcontracts awarded prior to June 24, 2014 and from those awarded on or after June 24. This constitutes 100 percent of contract dollars for final overhead cost calculations. Determine the percentage attributed to each period. In the illustration provided, contracts awarded prior to June 24 are $900,000 and for those awarded on or after June 24, 2014 are $100,000. Thus the dollars awarded prior to June 24th are 90% ($900,000/$1,000,000) and 10% for those awarded after June 24th ($100,000/$1,000,000).

Step 2. Identify the cap amount pertinent to each contract award period. In the illustration the cap amount for "old" contract awarded before June 24, 2014 is $952,000 for "new" contracts awarded on or after June 24 is $487,000 (this assumes the contractor is on a calendar year).

Step 3. Multiply each cap amount by the respective contract dollar amount percentage determined by Step 1 and add the two amounts. The result is the blended cap rate the contractor applies for the year as part of its established cost accounting period. In the illustration, the contractor calculates a blended rate for 2014 of $906,000. This is the weighted average of the two cap amounts: ($952,000 x 90%) + ($487,000 x 10%) = $906,000.

For forward pricing rates take the following steps:

Step 1: Identify the dollar amounts proposed to be priced for each year included for contracts and subcontracts awarded prior to June 24, 2014 and for contracts and subcontracts awarded after June 24th. This amount represents 100 percent of estimated proposed dollars. Determine the percentage of each amount. In the illustration, for 2015 the proposed dollars to be awarded in 2015 for contract awarded prior to June 24, 2014 is $10,000 and dollars proposed to be awarded in 2015 on or after June 24, 2014 are $190,000 for a total of $200,000. The dollars for contracts awarded prior to June 24, 2014 are 5% of the total ($10,000/$200,000) and those awarded on or after June 24th are 95% ($190,000/$200,000). Note for forward pricing rates, contract dollars already priced (backlog) are not affected by the forward pricing rates and should therefore be excluded.

Step 2. Identify the cap amount pertinent to each contract period. In the illustration, the cap amounts for "old" contracts awarded before June 24, 2014 is $952,000 and for "new" contracts is $487,000.

Step 3. Multiply each cap amount by the respective contract dollar amount percentage determined in Step 1 and add the two amounts. This is the blended compensation cap the contractor can apply for the year. In the illustration, the blended amount is $510,000 based on: ($952,000 x 5%) + ($487,000 x (95%) = $510.250. The illustration proceeds to compute blended rates for four out years using the same methodology.

Are blended rates to be used by the contractor as a whole, by division, segment?
The advanced agreement will identify what level the caps will apply.

How long can the contractor use blended rates?
The length of time the contractor uses blended rates depends on whether the contractor continues to incur or price costs affected on contracts awarded prior to June 24, 2014.

How often will blended caps be calculated?
At least twice a year. The first calculation for the year is to establish forward pricing and proposed interim billing rates that are based on a forecast of the proportion of

dollars for contracts awarded prior to June 24, 2014 and for those after. The second calculation for the year is to establish final rates based on actual proportion of dollar amounts awarded prior to June 24, 2014 and after that date. Further, other forward pricing or provisional billing rates may be needed when a contractor is awarded a significant contract not anticipated under the first forecast.

Are delivery orders under a Basic Ordering Agreement (BOA) issued before June 24, 3024 or after June 24, 2014 to be considered to be prior to or after June. 24th?
Since a BOA is not considered to be a contract, each delivery order is considered a new contract and the period of when they were awarded will determine whether they are included in prior or post June 24th contract dollars. *Task orders issued under an IDIQ contract?* An IDIQ is considered to be a contract so each task or delivery order under that contract continues to rely on that original contract and hence for calculating a blended rate the orders are considered to be on the award date of the IDIQ contract. *Contract modification?* Modifications are not considered to be contracts so it would be subject to the time of the initial contract. *Contract options?* Properly exercised options are priced under the cap in effect at the time the original contract was awarded. However, if the exercise of the option results in a new contract on or after June 24, 2014 the new contract is subject to FAR 31.2 on or after June 24, 2014.

What coordination with DCAA is needed and what if DCAA questions some costs?
Prior to signing the advance agreement DCMA must invite DCAA to review the computation of the blended rate. If DCAA does conduct a review and questions some costs, the ACO is required to "clearly address" DCAA's findings. DCAA will provide "non-audit services" related to the proposed advance agreement to ensure it complies with DCMA guidance and after execution of the agreement, DCAA will audit the forward pricing, provisional billing and ICP to ensure compensation costs do not exceed allowable amounts.

ADOPTING SOUND BUSINESS DECISIONS IN A BUDGET CUTTING ENVIRONMENT

(Editor's Note. Though most of our articles relate to the specialized area of cost, pricing and contracting rules affecting government contractors we also keep up to date on general business thinking. When we encounter general business ideas that affect decisions that government contractors must consider we like to prepare articles relevant to our contractor readers. Along those lines one of the favorite newsletters we subscribe to is The McKinsey Quarterly, the journal of the notable general management consulting firm McKinsey & Co. where we have adopted a McKinsey article written during the recent business recession that should provide insights into how to manage the current slow down in government business we are facing.)

Getting prices right in an economic downturn is always a challenge as decreased demand, excess capacity, and greater attention to price conspires to drive down prices. However, in the environment that McKinsey addresses not only is demand weaker making it harder to maintain prices but significantly more volatile input costs put companies in the middle. What is a business to do? They have to manage profitability of individual customers and transactions more precisely, develop greater insights into their customers' changing needs and price sensitivities and understand the types of economic factors affecting their own industries as well as their suppliers.

The authors have put forth five tactics aimed at maintaining the best balance possible between sales volume and profit margins. What are these tactics and how do they affect contractors who must compete in the government arena of significant budget cuts is our area of concern.

1. Watch for sudden shifts in price structure. Companies need to be vigilant in monitoring pricing policies that reduce revenue such as volume discounts, rebates and cash discounts as well as costs to service customers such as freight and sales support expenses. In a business downturn environment, uncertain costs and declining demand can cause these elements to change dramatically. For example, volatile fuel costs put pressure on delivery costs or declining orders may mean customers are receiving volume discounts they are no longer entitled to. Techniques such as pocket margin waterfalls we discussed in the 4Q15 issue of the DIGEST should be used that show how much revenue companies keep from their transactions where then companies can adjust their pricing accordingly e.g. adding a fuel surcharge to every order.

Implications for Government Contractors. This waterfall analysis would be helpful to analyze government contracts so that when solicitations for new work are issued new terms may be proposed. Favorable terms granted in times where orders were higher may no longer be sustainable. For example, delivery scheduling or

discount terms may need to be changed. You may want to resist pricing certain items where there is significant price and cost volatility or conversely, aggressively price items where there is less volatility. Also, in this environment where commodity prices can vary widely, you will want to try and negotiate reopener clauses on fixed price contracts. Contractors will also need to bone up on rules allowing for requests for equitable adjustments of fixed price contracts when out of scope effort is sought by the government and how and when to present these requests.

2. Monitor customer-level profitability. Companies should use transaction-level data to measure the profitability of each customer. By doing so, companies can detect the cost to serve particular customers where, for example, declining order volumes are pushing those customers below desirable profit levels. In most downturns many customer groups are becoming simultaneously smaller and more costly to serve. For example, one company found that 20 percent of its customers had fallen below desirable profitability levels forcing it to either raise prices selectively and where possible, lower service costs by decreasing delivery frequency, reducing sales support or fulfilling orders through alternative channels.

Implications. Government contracts and subcontracts, contract line items, and task and delivery orders should be scrutinized for profitability. Need to monitor and change overhead rate levels (e.g. decreased facilities utilization, increased contract administration effort) should be considered more carefully in this environment. The government provides a unique opportunity to adjust terms and prices because prices are often based on cost buildup analyses rather than what the market will bear. As more precision in monitoring profitability occurs you may find the need to either offer less or change the price of certain items offered in the past. Or, if the cost of favorable provisions are included in indirect cost pools you may want to negotiate their reimbursement as direct costs instead. Adoption of such accounting techniques as creating service and cost centers that will more accurately track certain categories of expenses and allow for direct costing of these categories should be considered.

3. Adjust to changing customer needs. Downturns commonly create changes in customer needs and in the benefits they value when choosing a supplier. The best companies are constantly assessing, through market research and careful listening through daily contacts how economics is changing for their customers so they can react quickly by adjusting prices and benefits accordingly. For example, a resins supplier who had developed a fast curing resin to expedite flow through speed when the economy was strong now developed a less costly resin that cures slower which helps suppliers decrease their costs when product flowtime is less critical under lower demand. While other suppliers are raising prices many customers see the cost advantage of the slower curing resin. As a result, the suppler is able to maintain its profit margins while selling an alterative resin at a lower price.

Implications. When more and more contractors seek government business to make up for sagging revenues they will often offer lower prices to fill up their excess capacity. Careful assessments of government needs will be more important than ever where in this period of intense price pressure there will be a premium on the ability to lower cost processes or offer lower tech employee resources that will provide government customers adequate quality for their needs at a lower cost. Careful attention to both customer needs and potential competitors' technologies are critical. Adjusting overhead rates and creative "low-ball" bidding become more important. Alternatives of using different types of personnel (e.g. temporary employees, different categories of employees who may receive different fringe benefit packages, contract employees, off-sight arrangements) should be considered to be more competitive.

4. Monitor your industry's microeconomics. Radical shifts in costs and demand throw previous market pricing mechanisms into chaos where responding carefully requires a keen understanding of the microeconomic forces at play. For example, a building supply company saw demand plummet with the housing market yet saw costs increase rapidly and had to make a reassessment of his supply, demand and cost dynamics. His analysis led to the conclusion to cut capacity at a plant in an area where decreased supply would not cause a local shortage but lower capacity would mean less price decreases in the area.

Implications. Adjustments of these types will definitely affect overhead rates. For example, capacity (e.g. personnel, facilities, computers) may be reduced and government contractors will need to decide how to treat the resulting excess capacity (see article below). If a proposed contract is highly price sensitive these types of costs can be voluntarily deleted from overhead rates while for less price sensitive prices they can remain.

5. Study your suppliers. The volatility in this market requires companies to not only examine the economic

factors in their industry but also for their suppliers. For example, a specialty metals firm analyzed the supply, demand and cost factors for one of its main suppliers and after doing so, predicted an industry-wide 15 percent price increase three months before it occurred. Suspecting an unusually high price increase, the company added clauses covering the supplier's cost increases to its customer contracts, a move that would have been resisted had the price increase been announced. As a result, the move established an industry precedent for passing cost increases through to its customers.

Implications. Under these circumstances the government may become receptive to reopener clauses especially when the likelihood of a substantial price increase is low. There will be the need to line up lower cost subcontractors. Also, contractors will need to bone up on recent FAR changes on how subcontract labor may be charged on prime contracts (e.g. prime contract rates, blended rates, flow-through costs).

Knowing your cost principles and cost accounting standards…

(Editor's Note. Close to 20 years ago we started featuring a series of articles that explored in some depth key FAR cost principles and cost accounting standards applicable to most contractors. The series was very popular with our subscribers and over time we have received requests to continue it. Since we wrote the articles there have been many changes that have affected the content of the original articles such as new cases, FAR and CAS changes, guidelines issued by DCAA and DCMA and just more expert opinions on the meaning of them so we thought it would be a good idea to continue the series where we have updated the original articles to reflect subsequent changes. Here is the first of many more to come.)

IDLE FACILITIES AND IDLE CAPACITY

(Editor's Note. In addition to being a common cost element reflected in contractors' incurred cost and forward pricing proposals, idle facilities and idle capacity is often a significant cost component of termination settlement proposals and requests for equitable price adjustments. Whether these costs are motivated by reduced workload or desire to create economies and efficiencies, many contractors are doing more with less these days. However, when they are unable to dispose of the assets they originally acquired, contractors are often quite surprised to find the costs of the assets are being disallowed while if they did not attempt to streamline operations the same costs might not be questioned. Since many contractors have or will be confronted with these issues during this period of budget cuts we thought it would be a good time to closely examine (1) the cost principle related to idle facilities (2) how related board decisions clarify the principles (3) guidance auditors are asked to follow and (4) suggest some ways to handle the costs to maximize recovery of them for the longest period. We have used a classic article by Frank Knapp in the discontinued Government Contract Costs, Pricing & Accounting Report (May 1993) with updates from Mathew Bender's Accounting for Government Contracts, Karen Manos's Government Contract Costs and Pricing as well as the Defense Contract Audit Agency's Contract Audit Manual.)

Definition. FAR 31.205-17 defines "facilities" as land, plant, equipment or other tangible assets owned or leased by the contractor. "Capacity" refers to the unused capacity of partially used facilities where "unused" is the difference between what was used in an accounting period versus what a facility would use under 100 percent operating time on one shift less normal operation disruptions (e.g. set-up, repair, rework, etc.). A multiple shift basis could be substituted if it could be shown to be normal usage for the facility.

Types of cost. Before discussing questions of allowability and allocability, FAR 31.205-17 identifies the type of cost attributable to idle facilities or capacity as rent, depreciation, repair, maintenance, property taxes and insurance costs. In *General Dynamics (ASBCA 19607),* other costs under appropriate circumstances can qualify such as salaries, wages and fringe benefits of maintenance and security personnel as well as travel and communication expenses related to managing activities associated with idle facilities.

- **Allowability**

Costs that arise from idle facilities are unallowable unless they meet one of the following criteria:

1. The facilities were necessary when acquired but are now idle because of changes that could not be foreseen (because, for example, of unforeseen changes in government requirements, production economics, reorganization or terminations).

2. The facilities are necessary to meet workload fluctuations.

If these conditions are met the costs of idle facilities are not allowable indefinitely but only for a reasonable

time – usually one year – depending on the actions taken to avoid them. We will look at a few of these considerations in more detail.

"Necessary When Acquired." The Appeals Boards have interpreted "necessary" as a "reasonable expenditure" which is appropriate for conducting business *(Boeing Co. ASBCA 13625).* Thus allowability hinges on whether the contractor can demonstrate it made a reasonable business decision at the time the facility was bought or leased *(General Dynamics ASBCA 19607).* Board decisions have ruled that the business decisions may be based on (1) anticipated increases in business *(Vare Industries, ASBCA 12126)* (2) need to expand facilities to produce at a rate to provide economies of scale to compete in a particular market *(Raytheon ASBCA 32419)* and (3) the unique characteristics of a product preclude use of its other facilities *(Aerojet-General, ASBCA 15703).* However, another case – *Hercules Inc., ASBCA 18382* – ruled that the costs of idle facilities were unallowable when they were not needed when obtained (they were acquired to enter a new market but the new business could have been handled by existing facilities) and hence the new facilities were considered a calculated business risk the contractor chose to take rather than a necessary action.

Length of Time. After determining the costs were necessary, how long the costs are to be allowed must be addressed. This is the most contentious issue we encounter. FAR 31.205-17(b)(2) suggests the period "generally" should not exceed one year. As a practical matter, when left to its own judgment, DCAA interprets the one year as a maximum period while Board Decisions offer opportunities to go beyond one year. For example, in *Aerojet Corp. (ASBCA 15707)* the Board allowed more than three years and two in half year in *General Dynamic* where, the Board ruled a showing of "diligent or reasonable efforts" to dispose of facilities "permits recovery of costs for a longer period." The Board went further recognizing that diligent efforts to mitigate the costs may be unsuccessful for several years resulting in extending the period of allowability. The board has not decided what constitutes "reasonable effort" though the authors indicate the "prudent business person" standard should apply and be decided on a case-by-case basis.

Workload Fluctuations. FAR 31.205-17(b)(1) permits contracts to treat idle facilities costs as allowable if they are necessary to meet fluctuations in workload. Board decisions provide little guidance to when this condition is met, leaving such determinations to be made on an individual basis. The discussion above related to "necessary" can be used and in one case – *Aeroject-General Corp.* – has validated the principle that facilities need not be used continuously for them to be allowable. Facilities used intermittently for research and development or to store unused equipment and machinery meet the non-continuous principle *(Cook Electric Co. ASBCA 17100).*

To better ensure recovery of idle facilities costs, the authors recommend contractors maintain detailed records of all efforts taken to use, lease or dispose of those facilities. The records should document unique circumstances such as environmental problems, the local real estate market (e.g. preventing subleasing or only partial recovery of lease costs). Also, market projections, production schedules or other information useful to justify a decision to retain facilities to meet expected fluctuations in workload should be kept.

Idle Capacity

Under FAR 31.205-17(c), the costs of idle capacity are viewed as normal costs of doing business and are considered a factor in the normal fluctuations of usage or overhead. Like idle facilities, they are allowable provided the capacity (a) "is necessary" or (b) "was originally reasonable and not subject to reduction or elimination by subletting, renting or sale." The cost principle does advise that widespread idle capacity in a plant or group of assets may be considered idle facilities, subject to the same rules as idle facilities. In Fiesta Leasing and Sales *(ABCA 29311),* buses were partially unused following a termination and hence was considered idle capacity.

There have been some cases ruling on when capacity is considered idle but there is no clear guidance. In *AVCO Construction (ASBCA 10858),* 13 percent of the company's capacity was considered idle and hence unallowable. In *Cook Electric,* the Appeals Board ruled that buildings with less than 25 percent idle capacity did not give rise to unallowable costs but higher amounts did. When the government suggested idle capacity existed due to excessively high overhead rates, the Board ruled in *Stanley Aviation Corp. (ASBCA 12292)* that high overhead rates, in themselves, did not establish the existence of idle capacity.

Standby Costs. Standby costs, which are costs incurred to maintain a facility at a capacity higher than currently needed, are usually allowable if reasonable. In *Big*

Three Industries, Inc. (ASBCA 16949), the Board allowed standby costs when the government reduced its contract needs but failed to notify the contractor who presumably could have taken action to either reduce costs or obtain other business with better notification. In *Fred D. Wright Co. (ASBCA 7200),* the board ruled reasonable standby costs were allowed, because the standby costs were for the government's convenience.

- **Allocability**

Once a facility becomes idle the basis for allocating the facility's continuing costs becomes an issue. The *Aerojet-General* decision established that consistency with past practices should be seriously considered. The case established other criteria to be considered when establishing an appropriate allocation base: (1) the relationship of the work previously performed at the idle facility to the contractor's other work (2) historical relationship of the idle facility with other business units within the company and (3) the effect of reactivating the facility would have on the contractor's other work.

In *General Dynamics,* the Appeals Board endorsed the principle that idle facility costs can be likened to independent research and development/bid and proposal costs characterized as normal costs of an ongoing business and hence allocated on a broad base (e.g. G&A base). The Board rejected the government's attempt to restrict allocation of the costs to only those contracts directly related to the closed facility, reasoning such an approach would systematically deny recovery of otherwise allowable costs. The Board said the criteria for allocations should be what is "equitable", indicating "burdening small firms with large extraneous sums" was inappropriate.

The authors say that DCAA guidance on how to treat environmental cleanup costs incurred at contractors' previous sites constitutes sound guidance on how to allocate idle facilities costs. In that guidance (*DCAA MRD No. 92-PAD163IR, October 14, 1992)*, DCAA suggests that continuing cleanup costs from closed sites be assigned to the business unit where the remaining work of the closed site was transferred and included in that unit's G&A expense pool. If no work remains from the site that was closed then the guidance suggests the site costs be transferred to the next higher group or home office and be included in the residual expense pool of the office and then be allocated just like any other residual pool expense.

- **DCAA Guidance**

DCAA audit guidance in Chapter 7-1906.3a of the Contract Audit Manual addresses only the length of time issue. Other references related to idle facilities (e.g. depreciation costs of idle facilities) reference the FAR cost principle only. In our experience, we rarely see DCAA allow a period longer than one year for otherwise allowable idle facilities costs unless there was a prior agreement with the ACO. Interestingly, the guidance explicitly recognizes the validity of extending the period beyond one year and provides some detailed conditions and criteria for extending this period. It states the regulation provides the CO with flexibility to accept a longer period. It urges auditors to recommend the CO obtain justification for a longer period when the facilities are expected to be idle for more than one year. The guidance specifies, at a minimum, the proper justification to extend the period should document: (1) whether the facility will be needed in the future and why (2) if not needed, what actions are being taken to lease or dispose of the facility and (3) an estimate of time to lease or dispose of the facility based on current market conditions, surveys of real estate prices, public record of real estate sales for similar facilities, etc.

REVIEW OF 2015 PROCUREMENT AND COSTING ISSUES

(Editor's Note. We usually review prior year decisions once a year where we discuss specific cases affecting such areas as grounds for protesting award decisions and proper evaluations of proposals. In this issue we will try a different tact where we will cite general lessons from the cases that the author cites. We will provide an allusion to one of the numerous cases discussed if further research is desired. This article is based on the January 2016 issue of Briefing Papers written by Miki Schrader, Counsel to the Dept. of Agriculture Appeals Board.)

Grounds for Winning Protests

1. Be prepared to show you are an "interested party." That is, that you are an actual or perspective offeror whose direct economic interest would be affected by the award or failure to receive the award *(Computer World Services, COI Federal Inc.)*. Also to demonstrate you have standing you should be prepared to show (1) you had a "substantial chance" of receiving the contract (Cylos

Corp) (2) there was "prejudice" in the award decision (i.e. must show that but for the alleged errors in the procurement you would have had more than a mere possibility of receiving the contract award *(Electronic On-Ramp, Inc.)* and (3) that there was a "nontrivial competitive injury" *(Raymond Express Intl LLC)*.

2. Be sure to include in the protest a detailed statement of the legal and factual bases for your protest that is sufficient for the GAO to conclude the agency violated a statute or regulation *(Santa Rita LLC)*.

3. If you plan to challenge the CO's affirmative determination of an offeror's responsibility make sure you have available specific information the CO unreasonably failed to consider *(US21, Inc.)*.

4. If you are challenging a task order under an IDIQ contract, make sure the value of the task order is over $10 million, including all options *(Karthik Consulting, LLC)*. However, if you can show the task order increases the scope, period or maximum value of the contract under which the order is issued, the Court will take jurisdiction *(Visual Connections LLC)*.

5. Take care to file protests timely after learning the basis for the protest (i.e. before the date for submission of proposal for a preaward protest – *Glenn Mar Construction* - within 10 days of an agency report – *Health Innovation & Tech. Venture* - or within 10 days of the debriefing (Jay *Shapiro & Assocs)*.

6. Bear in mind that agencies must prepare full and complete documentation of their evaluation decisions so protests will be sustained if the GAO cannot determine the decision was supportable from the documentation *(DKW Communications)*.

7. If you are successful in your protest, to be eligible for recovery of your protest costs be sure to carefully itemize your costs, document claim carefully, provide detailed evidence in support of your claim and present it within 60 days *(System Studies & Simulation)*.

8. The Court will entertain jurisdiction over the "implied-in-fact" government promise to consider offers fairly and honestly *(XP Vehicles, Inc)*.

9. Though the Court will be available to challenge NAICS code applicability to a solicitation it will not consider it first until all administrative remedies have occurred *(Palladian Partners)*.

10. When preparing your proposal address specific technical requirements because the agencies will not take at face value general assurances of compliance with technical requirements *(A&T Systems)*.

11. The Court will not take jurisdiction over contract administration matters as bid protests *(Coast Professional Inc.)*

Evaluating Proposals

1. The GAO will not review modifications to a contract unless it is beyond the scope of the contract i.e. resulted in an alteration of the work so dramatic it effectively required the contractor to perform duties materially different than those originally bargained for *(Schott Gov't Svcs)*.

2. Where a solicitation specifies a brand name or equal product, ensure you provide either the brand specified or sufficient descriptive information on an equal product or risk being rejected *(American Material Handling, Inc.)*

3. Challenges to the terms of a solicitation are rarely successful even if they placed maximum risk on contractors *(Phoenx Environmental Design)*. Never take exception to stated solicitation requirements so as to create doubt you are offering to comply with the solicitation without exception *(CI Filing Systems)*.

4. It is the contractors' responsibility to make sure the bid/offer arrives in a timely fashion *(Northstar Location Svcs)*.

5. If you allege unequal treatment in a technical evaluation be prepared to show the differences in ratings did not stem from differences between offerors' proposals *(Raytheon Co. Space & Airborne Systems)*.

6. If organizational conflict of interest is asserted, make sure to identify "hard facts" describing the OCI where mere inference or suspicion is not sufficient *(SRM Group)*. Be prepared to assume the consequences of OCI rules where COs have the authority to remove you from later competitions for perceptions of unfair competitive advantage when you have assisted in developing early stages of procurements *(IBM)*.

7. When given the option to provide past performance references it is wise to provide current information and to ensure the references will cooperate in providing information *(Green Earthworks Construction)*.

8. Keep in mind that relief for a mistake in bid is limited and will not be granted for a mistake in judgement *(RAK Contractors LLC)*.

9. Below cost pricing on fixed price contracts are generally not prohibited *(AGE Logistics)*. Also unbalanced offers (e.g. price understated for some work and overstated for other) are generally acceptable unless there is risk the agency will not obtain lower pricing *(InfoZen Inc.)*.

10. Agencies have fairly wide latitude to cancel a solicitation based on concerns it may result in flawed competition so protests of cancellations are likely to be unsuccessful *(Lockheed Martin Corp; Integrity National Corp)*. Also challenges that a solicitation is unduly restrictive of competition is unlikely to be successful *(Gov't & Military Certification Systems)*.

Requests for Equitable Adjustments, Claims and Terminations

1. If you want to recover for the government negligent estimate you must prove there was a disparity between the estimate and actual volume of work performed *(Agility Defense & Gov't Svcs)*.

2. Before making a claim for reformation based on a mutual mistake make sure the contract does not place the risk of mistake on you *(Fort Howard Senior Living)*.

3. It is vital you make sure the individual with whom you deal with has authority to contract or make changes to your contract *(Liberty Ammunition, Inc.)*

4. To prove a constructive change occurred, you must demonstrate the government was at fault and a change to the contract occurred *(Mountain Chief Mgt. Svcs)*.

5. To recover for a breach of the government duty to cooperate, you must link the breach to specific delays or damages *(Weston/Bean Joint Venture)*.

6. To recover for Eichleay damages, the contractor has the burden to demonstrate there was a government-caused delay and that it was on standby. Keep adequate records to meet this burden *(Alderman Building Co.)*

7. The contractor carries the burden to demonstrate the amount by which a change increased the costs of performing a contract *(Columbia Construction)*.

8. Do not use any type of modifying language when quantifying your claim or you run the risk of violating the "sum certain" requirement *(ARI University Heights)*.

9. Be aware that defects in a claim certification can be cured but lack of certification for claims over $100,000 cannot be. Take care to use proper certification language and affix an original signature *(Estes Express Lines)*.

10. An appeal will not be timely if you file with a board more than 90 days after you receive the CO's final decision or with the COFC more than 12 months after you receive the CO's final decision *(Gov't Svcs. Corp.)*. Even if you believe the CO is reconsidering a final decision file within the 90 day or 12 month deadlines *(Comprehensive Community Health & Psych. Svcs)*.

11. It is never a good idea to refuse to perform and you should continue to provide adequate assurances of performance to a cure notice *(Vanguard Construction)*.

12. Keep in mind that a failure to pass a first article test is equivalent to a failure to meet contract delivery date under the "Default" clause *(Military Aircraft Parts)*.

13 Note a contractor's recovery in a termination for convenience is the contractor's actual costs plus a reasonable profit and though the burden to demonstrate the costs are not as high as in a customary contract you must still demonstrate entitlement to recovery *(Environmental Safety Consultants)*.

14. Recognize that equitable estoppel invoked against the government is rarely successful these days unless you can show some affirmative misconduct on the part of the government *(Solaria Corp.)*

15. Always maintain and provide actual cost information on damages or risk failure to recover anything *(DMS Imaging)*. It is probably wise not to attempt recovery on a total cost basis unless you have solid proof of recovering on that basis *(ELB Facilities Svcs)*.

16. To recover attorney fees and expenses under EAJA you need to demonstrate you qualify by showing you are a prevailing party, allege the government's position was not substantially justified and file the application within 30 days *(WHR Group)*.

17. Guard against broad release language in contract modification and be sure to include reservations of future claims, especially of cumulative-effect claims *(New Araq Ahd. Co.)*

18. If you want to incorporate material in your contract by reference you must precisely and explicitly identify

the material and clearly indicate that the purpose of the reference is to incorporate the material into your contract *(Kiewit—Turner, A Joint Venture)*.

19. File a notice of appeal from the CO's "final decision" even if the decision does not give proper notice of your appeal rights. Otherwise the Coourt may rule there was no prejudice *(Dynport Vaccine Co.)*

20. The Government cannot disallow post termination costs incurred by a subcontractor to support the Government's audit and settlement of the subcontractors final indirect cost rates. The Board cited FAR 31.205-42(b): "Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable" *(Group Health Inc.)*.

21. To ensure you can recover your contract administration costs, make sure they are costs related to negotiating a settlement, not costs of litigation, and make sure you have a system in place to segregate these costs and document that these costs are for the purpose of furthering the negotiation process *(ServiTodo)*.

Oldie but goodie…

FINANCIAL ACCOUNTING TREATMENT OF GOVERNMENT CONTRACTS

(Editor's Note. Though our newsletters focus on contract costing and pricing requirements rather than on financial or tax requirements, we are often asked about financial accounting issues unique to government contractors. Since many of our subscribers are in financial and accounting positions, we thought we would address some of the financial accounting issues government contractors commonly face. In this article we will focus on completed contract and percentage of completion methods while in the next couple of issues we will discuss selected financial accounting and tax issues unique to government contractors. Though much of the discussion in these articles are based on our experience as consultants and former financial and accounting managers, we are particularly indebted to the excellent Mathew Bender text "Accounting for Government Contracts" edited by Lane Anderson.)

Determining when to recognize revenues and costs are key accounting issues all organizations face. Such issues are particularly important to Government contractors because their contracts frequently extend into multiple accounting periods requiring measuring results of long transactions in relatively short accounting periods. Government contracts are particularly difficult since contract performance must be reevaluated and estimates of revenue, cost and contract performance must be relied upon. There are two accounting methods generally used for government contracts - the completed-contract (CC) method and the percentage-of-completion (PC) method.

The principle advantage of the CC method is income is reported on final results rather than periodic estimates while its chief disadvantage is revenue is not reported until the year of completion which distorts income recognition. The advantage of the PC method is that income is recognized as work progresses rather than all at once at contract completion while the disadvantage is the necessity of relying on estimates for recognizing revenue and costs.

Completed-Contract Method

The CC method recognizes income only upon completion (or substantial completion) of a contract. All costs incurred during contract performance as well as related revenues are deferred until the contract is complete and the costs and revenues are recognized. (For income tax reporting purposes, the Internal Revenue has put severe limits on use of this method.)

A contract is considered complete if the remaining costs to be incurred and potential risk to the contractor are insignificant. Examples of completeness include delivery of product or service deliverables, acceptance by customer, when the contractor leaves the work site or when the contractor has complied with all performance specifications. Contractors may define their own criteria for completeness as long as they follow it consistently.

The basic steps in accounting for contracts under the CC method are:

1. All allocable direct and indirect costs are charged to a work-in-progress account which is treated as an asset.

2. Billings, progress payments and advances are credited to an account usually called "advances on work in progress" which is a liability.

3. At interim balance sheet dates, the excess of the work-in-progress account over the advances account is classified as a current asset. Excess of advances over work-in-progress would be classified as a current liability.

4. Losses must be recognized in full in the year they are discovered. Losses occur whenever the estimated costs to complete a contract plus all cost incurred to date exceed estimated future revenues plus the sum of billings, advances and progress billings. If the contract is profitable, this profit cannot be recognized until the contract is completed.

5. Upon completion of the contract the gross profit or loss is recognized according to the simple formula: contract revenue minus total costs equal gross profit or loss.

An example of journal entries for a contract whose first year incurred costs were $1,000,000, progress billing were $750,000 and collections from billings were $600,000 would be:

1. Contracts in progress	$1,000,000	
Various Accounts		$1,000,000
2. Accounts Receivable	750,000	
Billings on Contracts in progress		750,000
3. Cash	600,000	
Accounts Receivable		600,000

In the last year where total incurred costs were $4,500,000 and profit was $500,000 the journal entries, in addition to that years recording of it annual incurred costs, progress billings and collections would be:

Billings on contracts In progress	$5,000,000	
Contracts-in-progress		$4,500,000
Realized gross profit		500,000

Percentage-of-Completion Method

Under the PC method, contract revenue and costs are recognized periodically over the life of the contract. The percentage of completion existing at any given time should be based on (1) the relationship between the costs incurred to date to the total estimated costs (2) engineering estimates of the work performed to date relative to the total work required or (3) some other measure that is appropriate to the work performed. Interim billings are ordinarily not one of the measures used.
The first method above is the most common approach and the expected profit on the contract is then assigned to each period based on the costs incurred through the end of that period. The problem with this approach is two-fold: it assumes the contractor earns profit as costs are incurred – in effect, each dollar spent produces the same amount of profit – whereas in fact significant up-front dollars may be expended with little or no progress being made toward completing the contract. Secondly, total costs is the denominator and total costs are difficult to estimate. When significant upfront dollars are expended a percentage of completion based on engineering estimates may be superior. Another common method, particularly when there is a high volume of deliverables and not an extensive lead time before deliverables begin, is to use the unit-of-delivery method where sales and costs of sales are measured as units are delivered.

The basic steps for accounting for contracts under the PC method include:

1. Like the CC method, all direct and indirect costs are charged to a work-in-progress account and billing, progress payments and advances are credited to an "advances on work in progress" account.

2. The estimated gross profit earned in each accounting period is charged to the work-in-progress account and credited to realized gross profits in the income statement. Gross profit is calculated under the following formula: Total estimated profit or loss times percentage of completion equals profit or loss recognized to date. When changes to estimates of future costs arise, the necessary adjustments should be made in the year the estimates are revised. For example, assuming estimated total costs for a three year contract to be $4,500,000, incurred cost of $1,125,000 and $3,375,000 in the first two years respectively and estimated gross profit of $500,000 with a change in profit estimate the third year to $450,000:

Year 1 Gross Profit
$1,125,000 X $500,000 = $125,000
$4,500,000

Year 2 Gross Profit
$3,375,000 X $500,000 = $400,000
$4,500,000

Less Year 1 Profit	125,000
	275,000

Year 3 Gross Profit

Gross Profit	450,000
Less Prior Years	400,000
	50,000

3. An estimated loss on the total contract is recognized immediately in the year it is discovered and any previous gross profit or loss reported in prior years must be deducted from the total estimated loss.

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The first three journal entries under the PC method are the same as under the CC method while the PC method recognizes the gross profit as follows:

Year 1		
Contracts in progress	$125,000	
Realized gross profit		$125,000
Year 3		
Contract in progress	50,000	
Realized gross profit		50,000
Billings on contracts		
In progress	5,000,000	
Contract in progress		5,000,000

Selection of the Most Appropriate Method

Both methods are used widely and a contractor can use different methods for different contracts so long as the facts of each contract warrant the method chosen. Several factors should be considered:

Type of Contract. For cost type contracts, the fact that a fee is paid in addition to costs makes the contract a low risk one plus the normal uncertainties associated with estimating costs would suggest the CC method be used. Conversely, since fixed price contracts have greater risk of loss and estimates to completions tend to be less accurate suggests the use of PC methods.

Duration of Contract. The problems associated with income recognition occur primarily with long term contracts while short term contracts rarely present such problems. As a rule of thumb, contracts lasting two or three years should use the CC method while longer term contracts should use the PC method.

Reliability of Cost Estimates. The reliability of cost estimates can vary widely depending on such factors as estimating techniques used, complexity of the contract, scope of work and problems arising during performance. When reasonably reliable estimates are available, the PC method is preferred; otherwise, use the CC method.

Nature of Product or Services. Little experience on producing a particular product or performing a new service or a large project to design, develop or produce a single product can significantly affect ability to estimate costs or riskiness of loss and hence affect the method selected.

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GCA DIGEST 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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