GCA DIGEST

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Case Study…

EXCESS COMPENSATION

(Editor's Note. Our consulting practice often includes engagements to provide litigation support, expert witness testimony and due diligence help in acquisitions of certain companies. In the following real life case study, those roles were combined where we provided expert witness opinion in a litigation of whether an executive's compensation would be allowed by the government and if not, how that amount would affect the earlier agreed-to price of the acquisition and whether the buyer (our client) owed the seller sums it agreed to earlier. We thought it would be instructive to recount some of the arguments we put forth in our assertions that compensation to one of the seller's executives would be questioned and hence would be non-recoverable. We have disguised the identity of the parties, the data and even some of the issues so as not to risk divulging who our client is.)

Background

Contractor is a small business HUBZone company where for the last five years, Joe was employed by Contractor as Chief Operating Officer (COO) who was tasked with managing a large contract (HUBZone set aside contract) he helped bring in as well as oversee the other contracts he helped "develop" and supervise. Contractor entered into employment agreements with Joe where he was paid both salaries and generous bonuses. Specifically:

1. Each year Joe was paid a salary in the range of $200K-300K plus a bonus. The first year salary started at $180K and increased to $280K during the year when the large contract was awarded.

2. The bonus consisted of 25% of the Contractor's pre-tax profit generated by the large contract plus 8% of the contribution profit (revenue minus direct costs) of all the other contracts he oversaw and helped "develop." Bonuses ranged from $400-$1.2 million each year.

3. The earned bonus would be paid for the entire period the contracts were in effect and Joe would be paid his bonuses whether he was still employed or not.

4. Each year the company provided a written employment agreement between it and Joe. Contractor also had a written bonus policy where bonuses were specified as a range of percentage of salary for different categories of employees (e.g. 50% for owners, 10-20% for executives) and the basis of earning the bonus was specified for each level of employee (e.g. for executives, 50% of the bonus was based on meeting predetermined financial objectives, 20% was earned if safety objectives were met and 30% was earned if quality goals were met). The policy excluded bonuses on contracts in loss positions.

5. DCAA started auditing four years of its incurred cost proposals (ICPs) and finished one year where it questioned $450K of Joe's compensation that year. DCAA's approach for evaluating Joes compensation consisted of two steps: (a) it compared Joe's total compensation against that year's Office of Federal Procurement Policy cap (I will call this the "OFPP approach") and questioned the difference and (b) used its approach for high risk employees in closely held companies (which I will call the "Small Business approach") where it computed on average of benchmarked compensation from four compensation surveys, added a 10% range of reasonableness and questioned the different between its survey results and the remaining non-questioned costs from Step One. DCAA also recommended imposition of penalties on the questioned compensation costs. Contractor asserted its financial performance was superior and stated the 75 percentile should be used where it is not clear whether DCAA accepted this assertion.

Evaluation

- **The FAR and DCAA Contract Audit Manual**

Bonus evaluation. FAR 31.205-6(f), Bonuses and Incentive Compensation and DCAA Contract Audit Manual (DCAM) Chapter 7-2123 address bonuses. FAR states "(i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before services are rendered or pursuant to an established plan or policy followed by the contractors so consistently as to imply, in effect, an agreement to make

such payments; and (ii) Basis for the award is supported." Often the word "or" is taken to mean "and" by auditors. If there is not a written agreement *and* a written company policy addressing bonuses, bonuses are often questioned as unallowable. Contractor has both annual employee agreements and a bonus policy.

FAR 31.205-6(a) provides general guidelines for allowable compensation such as it must be for work performed in the current year (1), total compensation must be reasonable for work performed (2), and must not be a distribution of profits (ii)B). The two approaches are addressed where compensation for certain individuals "give rise to the need for special consideration" (6)(i) where those individuals are part of "closely held corporations" (6)(i)(A). FAR 31.205-6(b) distinguishes between the OFPP approach in FAR 31.205-6(p) and the Small Business approach (FAR 31.205-6(b)(2) where "high risk" employees at closely held companies must be evaluated for allowable compensation where such factors as company size, industry and geographic area must be considered. Chapter 6-414 of the DCAA Contract Audit Manual provides additional information of both approaches where the OFPP approach for each year is discussed while the Small Business approach provides more examples than the FAR for what employees may be covered by that approach (e.g. executives who are employed by closely held firms who can provide an "undue influence" in determining the amount of their compensation) and more detail about how compensation surveys will be used to determine levels of "reasonable compensation."

- **Offer Letter Versus Amount Paid**

Contrary to the subsequent employment agreements and actual compensation amounts paid, Joe's offer letter was compliant with both the FAR and DCAM criteria for reasonable compensation. His base salary was set at $125K plus up to 20% of base salary bonus. The applicable OFPP cap for his first year was $546,689 and using the Grant Thorton's 13th Annual Government Contractor Industry Survey benchmarked to the third highest executive position at the 50th percentile for a company with $1-10 million in revenue the amount was $160K, above the maximum salary and bonus he was offered.

- **Salary Increase**

Though I found no problem with the amount of salary paid to Joe, the huge increase in salary the first year would not be allowed. Without a special provision such as an advanced agreement with the government an increase of salary from $180K to $280K for the same position in the same year would likely be considered excessive. The fact there was no written policy addressing salary increases would be further evidence such a large increase for the same position in the same year is excessive.

- **Bonus**

Joe's employment agreements and actual compensation for bonuses is the major problem. When evaluating bonuses, the government gets "two bites of the apple" – it can determine whether the bonus amount in itself is reasonable and then it can determine whether the bonus, when added to other components of compensation, is reasonable. We discuss both bites below.

The salary plus bonuses amounts provided in each year exceeded the OFPP cap amounts by $200K-$1 million for each year. For example, the OFPP cap for 2009 was $693K while the amount of salary and bonus was $1.1 million. Recognizing this potential exposure, the controller voluntarily decreased the difference between OFPP caps and amount paid each year in its incurred cost proposals. In 2009, for example, it claimed $693K for Joe, eliminating the excess amount between the cap and amount paid. However, since Contractor was a small closely held business, it should have reduced Joe's compensation by the amount reserved for the Small Business approach, not the OFPP approach. A rough estimate using two surveys in my possession, I estimated the amount that should have been questioned as unreasonable compensation using DCAA's Small Business approach ranged from $300K-$900K per year, including the $450K DCAA found in the year of its audit.

Other Problems with its Bonus Amount

In addition to applying the wrong approach to determining what was a reasonable compensation amount, there are several problems with the bonus itself that would make it unallowable even if the total amount of compensation was reasonable.

1. The bonus amount was inconsistent with its bonus policy.

a. Contrary to the bonus policy that provided a range of bonus amounts for executives (up to 20% of salary for non-owner executives), Joe's bonus had no limit. Neither its employment agreement nor actual payments limited the amounts of bonuses Joe was entitled to.

b. Contrary to the proper policy that pegged the bonus as a percent of salary, Joe's bonus was pegged to profit (e.g. 25% of the pretax profit of the large contract, 8% of contribution profit for other contracts). This

represented a distribution of profit which the FAR 31.205-6(a) explicitly rejects.

c. Whereas the bonus policy adheres to the "basis of award" criteria of allowability in the FAR 31.205-6(a) (e.g. 20% for achieving safety goals) there was no specification for the basis of award. That is, the amount of bonus was purely a percentage of profit where no basis of award was identified.

d. Payment of bonus on contribution, as opposed to profit, allows payment of a bonus on a contract in a loss position, which is contrary to its bonus policy. Since contribution includes not only profit but also indirect costs, Joe's bonus could (and actually did) include bonuses on loss contacts. For example, if its overhead rate is 70% and profit rate is 2%, it could be paid a bonus of 8% of the overhead which would exceed the 2% of profit earned.

e. The bonuses paid each year far exceeds the bonus policy ceilings that cap non-owners' bonuses at 20% of salary which far exceeded the amounts earned by the owners.

2. "Developed" is too vague a term.

The condition for earning the 8% of bonus paid on other contracts developed by Joe is not precise enough. "Developed" is too vague a term where more precise conditions need to be identified.

3. There were bonus payments in years it was not earned.

Contrary to FAR 31.206-6(a) that limits bonus payments to only the year earned, the payment of bonuses for the duration of the contract periods was a clear violation of this. In addition, payment of bonuses even if terminated violates FAR section 6(a) that limits payment of bonuses to current employees.

4. The deferred bonus exception does not apply.

The only possible way of getting around the third point above was if Contractor had established a deferred compensation plan in accordance with FAR 31.205-6(k) and CAS 415, In that way, compensation earned in a prior year could be paid in subsequent years. However, there were significant problems here.

a. There was no such plan in place. One of the criteria for allowing the payments is that a deferred compensation plan is in existence which must have been approved by the CO (CAS 415, which applies to non-CAS covered contracts). No such plan existed.

b. The amounts of the deferred payments would have been disallowed because they would have been added to the already excess compensation amounts that were disallowed. Deferred comp plans require subsequent year payments be discounted and recognized in the years earned, not the years paid. Since each year included excess compensation, adding the deferred amounts would simply add to the unallowed amounts.

5. Percentile amount.

In the year audited, Contractor provided an analysis showing that due to the large contract being started during the year its ICP was being audited, it was entitled to be benchmarked not at the default rate of 50 percentile but that its superior financial performance (e.g. revenue and profit growth compared to prior years) justified using a 75 percentile amount. The fact of superior financial performance during the year being audited is indisputable. However, subsequent years generally did not result in increases over the prior year (in fact, most years had decreases in revenue and profit over the prior year). DCAM 6-414 provides not only for higher percentile amounts in years of financial performance superiority but also for a corresponding lower percentile amounts than the default 50 percentile when average performance is low. Those lower percentile amounts would apply to most of the subsequent years.

- **Penalties apply**

Certain unallowable costs are considered "expressly unallowable" when they are "under a cost principle in the FAR or an agency supplement that defines the allowability of specific selected costs" (FAR 42.709-3). FAR 42.709-1 provides that when a contractor claims costs in either an incurred cost proposal (ICP), a forward pricing proposal or a provisional billing rate proposal those costs are subject to a penalty equal to 100% of the amount claimed (also in FAR 52.243-3, Penalties for Unallowable Costs). Once a contracting officer rules that a penalty should be imposed, a subsequent claim of the same costs by the contractor in its proposals is then subject to an additional penalty, this time equal to 300% of the questioned costs, that is three times the amount of costs claimed. The DCAA audit report stated the disallowed amount of $450K was subject to penalties in accordance with FAR 42.709. The contracting officer confirmed its decision to impose penalties in its rate letter and subsequent demand letter. The question is not whether Contractor is subject to penalties on each year of unallowable executive compensation (they are) but whether the subsequent penalties would be 100% or 300% of the questioned amounts.

Conclusion

Taking into account the probable unallowable costs included in its ICPs plus 100% penalties indicates an amount in excess of $5 million paid to Joe would likely be subject to being returned to the government. This amount represents a substantial potential liability that should not only have a significant impact on the proposed acquisition price but puts the company into financial jeopardy which could adversely affect its ability to perform on current contracts.

Knowing Your Cost Principles…

DEPRECIATION COSTS

(Editor's Note. There have been some changes to depreciation rules, mostly through court cases, since we last wrote about this topic. We have been impressed on how knowledge of depreciation rules have helped our clients and readers recover costs they would not be entitled to had they not known about government accounting rules covering depreciation. For example, some of our clients have been able to recover equipment depreciation costs over a relatively short contract period of 2-3 years (versus 5-7 years under IRS rules) using unique rules allowing recovery over the "economic life" of the asset or direct charging of depreciation costs has allowed for greater cost recovery than standard indirect costs. Our focus is oriented to what can be expected from DCAA reviews of depreciation costs since that largely defines the practical meaning of the rules. We have drawn on numerous texts, the Defense Contract Audit Manual and our experience as consultants to government contractors.)

Depreciation costs are often significant and government regulations provide considerable latitude on how and when to recognize the expenses for pricing and costing government contracts. Whether firms want to maximize or minimize cost recovery, several ways of flexibly treating depreciation expenses come to mind:

1. Asset cost – various initial costs may be capitalized or expensed
2. Asset life – e.g. IRS guidelines, "economic life," contract period
3. Method of depreciation – straight line, various accelerated methods
4. Direct versus indirect charging
5. Where to assign the expense - cost center, plant, company, which indirect cost pool
6. Differentiating assets – dedicated assets for different types of contracts versus pooled assets for all work
7. Method of ownership - capital versus operating lease, related party versus non-related parties
8. Treatment of fully depreciated assets – e.g. charge out rates
9. Estimates for salvage value
10. Improvements – capitalized as betterments or expensed as patchwork repairs

Some of the rules and guidance auditors follow are intended to somewhat limit so-called "inequitable" cost and pricing actions but still considerable latitude exists. We will discuss the basic rules for depreciation and allude to those significant areas auditors can be expected to look at.

General Rules

FAR 31.205-11 governs the allowability of depreciation costs. Contractors subject to cost accounting standards must comply with CAS 409, Depreciation of Tangible Capital Assets and CAS 404, Capitalization of Tangible Assets. In the few cases where CAS conflicts with FAR (e.g. demonstration of economic or useful lives, valuation of assets after a business combination), CAS will supersede a conflict with FAR for CAS covered contracts only. We will focus on the FAR rather than CAS because there are not that many conflicts and most contractors are not subject to the more detailed requirements of CAS 409 and 404.

Normal depreciation is generally considered allowable contract costs if they are reasonable and allocable. When depreciation expenses are treated the same for financial and income tax purposes, costs are considered reasonable under FAR 31.205-11(d) if the contractor follows its policies and procedures which must be (1) consistent with those followed in the same cost center for non-government businesses (2) are reflected in the contractor's books of accounts for financial reporting and (3) used for federal income tax purposes. Even when these conditions are met, DCAA reminds its auditors that "inequitable charges to the government" may still occur and certain depreciation costs may need to be questioned.

Since 1986, the Internal Revenue Code has been periodically revised to allow use of accelerated methods of depreciation to defer payment of taxes and improve cash flow. When contractors choose to take advantage of these IRS changes, the amount of depreciation charged may differ for financial reporting and income tax purposes. Where book and tax methods differ, FAR 31.205-11(e) allows contractors to follow IRS methods of depreciation as long as the resulting expense does not exceed the

amount recognized for book/financial statements. If a dispute occurs, auditors will tell you that the mere fact the IRS does not specifically reject use of a particular depreciation method does not establish the acceptability of that method for government costing purposes.

Allocation Requirements. CAS generally covers cost allocation issues and even when not CAS covered, the standards provide contractors a level of legitimacy if they follow CAS allocation prescriptions. CAS 409 does provide for direct charging of depreciation costs as long as the charges are made on a usage basis (e.g. units-of-production method) and the depreciation costs of similar assets used for similar purposes are charged in the same manner. The standard also recognizes that depreciation charges not only may but must be included in service center costs. That is, when tangible capital assets are part of a function or an organizational unit whose costs are charged directly to cost objectives on the basis of services provided, then the depreciation costs of those assets must be included in the service center costs. When not direct charged or part of a service center, the standard recognizes that the "normal procedure" is to include depreciation costs in appropriate indirect cost pools. FAR does not conflict with CAS but it recognizes that depreciation expenses are usually allocated to contracts as an indirect cost.

DCAA audit guidance in DCAM 7-404.1 states that depreciation is usually an indirect expense and states it is preferable to have depreciation recorded at the lowest organization level as possible such as the department or cost center level so that the cost is identifiable as closely as possible with the benefiting work or activity. Auditors are advised that plant or company-wide rates may not be equitable because, for example, government work may be performed in only a part of the facilities or the contractor may be replacing assets faster in a part of the plant performing primarily commercial work than where government work is performed. When plant or company rates are used, auditors are advised to make sufficient tests to determine that the end results are substantially the same as those achieved by more refined methods.

Other Considerations.

Life of asset. The depreciation expense of an asset should be based on the estimated useful life of an asset. Though the government has traditionally preferred the use of physical lives of assets for computing depreciation, American Electronics Laboratories (ASBCA No. 9879) established that economic life of assets is acceptable. The physical life, economic life and technical life have all been held to be acceptable for measuring the service life of an asset. The FAR has established that useful lives should be assigned as provided in the IRS's asset depreciation range (ADR) guidelines. Even though the IRS has switched to the Accelerated Cost Recovery System (ACRS), which are usually shorter periods, ADR is preferred for government cost and pricing. ACRS is acceptable for contract costing purposes if it is also used for non-government work in the same cost center and is used for both financial accounting and income tax purposes. If ACRS is not used for both financial accounting and tax purposes it can be used for contract costing if (1) the ACRS recovery period is the same as the useful life and (2) ACRS is used for non-government work. In any case, allowable depreciation cannot exceed amounts used for financial accounting though some exceptions can be allowed. It should also be recognized that it is not uncommon to have a contract that limits depreciation to, for example, common practices established in a particular industry.

Acceptable depreciation methods. With the general proviso that "inequities" can still occur, DCAA considers both asset lives and methods of depreciation that are consistent with the ADR system to be compatible with FAR 31.205-11(d). If ADR is not followed, only the straight line, declining balance or the sum-of-the-years digits methods are considered reasonable within certain limitations (e.g. only the straight-line method can be used if the depreciation period is less than three years, IRS guidelines for using the 200 percent declining balance must be followed, etc.).

Residual values. In computing depreciable assets, government auditors follow IRS guidelines in allowing the residual value of an asset to be ignored if it is less than 10 percent of the original amount capitalized (this provision has been accepted as part of the CAS),

Government provided assets. No depreciation, rental or use charge is allowed on property obtained from the government at no cost to the contractor or obtained at no cost from an organization under common control.

Depreciation at other than cost. Depreciation based on the price paid for assets acquired from an organization under common control is permitted if the practice is consistently applied and if the price is based on established prices or adequate price competition. This does not apply if the price paid exceeds the price the seller would have charged its most favored customer or if the contracting officer determines the price is unreasonable.

Fully depreciated assets. Use charges for fully depreciated assets are allowable provided the charges are negotiated and documented in an advance agreement. In computing a reasonable use charge consideration should be given to: (1) the replacement cost and estimated useful life at the time of negotiation (2) the effect of increased maintenance costs and decreased efficiency because of the age of the asset and (3) the amount of previous depreciation charges made to the government contracts and subcontracts. In practice, established commercial practices of setting charge out rates are commonly accepted. Board decisions have established that use charges need not be recorded in the contractor's books and records to be allowable on government contracts.

Asset valuations. As a result of a merger or acquisition contractors may be required to value their assets at fair market value in accordance with Accounting Principles Board Option No. 16, "Business Combinations." However, the new and usually higher valuations may not create depreciation charges greater than what would have been incurred had no merger or acquisition taken place. In 1996, CAS 404 was revised to preclude any write-up or write-down of assets based on a business combination. This created a conflict between the FAR and CAS because the FAR required a write-down of assets where the CAS did not permit such a write-down. The conflict was resolved in 1998 when the FAR was revised to match the CAS. DCAA, however, has taken the position that if an asset write-down occurs allowable depreciation is based on the written-down value of the acquired asset.

Sale leasebacks and related party transactions. Depreciation under sale-leaseback arrangements is limited to constructive ownership costs meaning allowable costs are limited to what would have been incurred had the asset been purchased. Similarly, the costs of leases between related parties are also limited to the constructive costs of the assets unless leasing of similar assets to non-related parties is part of their business.

Foreign exchange rates. Depreciation costs initially recorded in a foreign currency will be required to be converted to US dollars if the contract is payable in US dollars. The question of what is the appropriate currency exchange rates was addressed in General Electric Company (ASBCA 44646) where the Board denied use of the historical exchange rate and required use of the current rate. This decision was reversed by a higher court that ruled depreciation charges had to be based on average historic exchange rates. The Court stated both the FAR and CAS were silent on the matter but that Financial Accounting Standard 52 required use of the historic exchange rates.

Investment tax credits. As a matter of policy, the Department of Defense does not deduct the amount of any investment tax credit from the depreciable value of assets or require that such credits be used to offset contract costs.

MAKING DIVESTMENTS CORRECTLY GENERATES EXCEPTIONAL FINANCIAL RESULTS

(Editor's Note. Mergers and acquisitions (M&A) have become a hot topic where firms are finding it desirable to merge with another company to expand their capabilities, enter new markets, extend technological expertise or attract key personnel. In addition to M&A, we are, interestingly, seeing the other side of M&A in our consulting practice – divesting companies or parts of companies. As part of our series on addressing important business management ideas and how they affect government contractors we came across two articles on divestments written by the consulting staff of the international consulting firm Bain & Company – one in the June 17th issue of Bain Brief "Everybody Wins in Divestitures" and the other from the Oct 2008 issue of the Harvard Business Review, "How the Best Divest.")

Executives often hesitate to sell non-core businesses for many reasons. Some are reluctant to shed revenue, are concerned about how the market will value smaller companies and are not sure what to do with "stranded costs." They worry about selling too early where they reason they need an additional year or two to improve things. Others have a hard time accepting the fact that someone else may realize some of the value they are unable to generate while others view divestitures as a hassle where there is a lot of work involved in an unfamiliar area. Companies that fail to divest non-performing parts of their company portfolio continue to tie up management time and precious resources in businesses that are not playing to win. When they finally decide to sell they do so at the wrong time or the wrong manner resulting in expensive mistakes. The authors point to several statistics that clearly show that good sellers of companies consistently generate earnings far in excess of their competitors and when done right, companies can clean up their company portfolio of companies, command an optimal price and create a catalyzing event for improving the remaining business.

All the authors have extensive experience helping many firms in diverse industries divest. They say the best results are achieved using the following steps:

1. Companies need to proactively manage their portfolio. What businesses contribute to your core business and regularly assess them for fit. What businesses have the ability to win? Which ones have the right resources and capabilities to take advantage of their potential? By assessing your portfolio you can identify what business units would deliver more value in someone else's hands.

2. Thoroughly plan and prepare to optimize value. When faced with an underperforming company there is usually three choices – sell, milk or transform. Most companies tend to take the "milk" strategy where they are unwilling to sell but unable to support the level of investment to thrive, often holding on until the unit has lost much of the value it once had. They don't ask what is best for the company but react to the business cycle where they are reluctant to sell assets when business is good where they might get prices at their highs but they can't wait to sell when the economy slows, when values fall and buyers dry up.

3. They suggest a divestment candidate must fall short on two criteria – they must not be core to the company's strategy nor provide more value to the company than in the hands of someone else.

4. Timing is essential. Just as they should not wait too long, neither should they race to sell an asset. 6 to 12 months is about the right length of time to establish the blueprint for selling the unit. This gives you time to improve the value of the business while you still own it and demonstrate its value to the potential buyer to achieve a higher price.

5. Consider exceptions to the rules. The authors caution companies to not be sentimental over long held companies. They point to Roche who sold the companies that had made them – fragrance and vitamin business – to focus on pharmaceuticals. They also caution that just because a business is not core does not mean it should automatically be sold. Disney repurchased its retail stores to be able to keep its brand image where it realized it could provide the most profitability while Coca Cola kept its legacy fountain business because it provide excellent distribution and other advantages to its core soft drinks business. A large defense/aerospace company was preparing for a sale and increasing its value where its aggressive marketing and cost initiatives led it to realize its growth and cost opportunities were greater than when it embarked on its sale after which it developed synergies with its other businesses to create added value and kept the company.

6. Apply the fit and value test For fit, management asks is keeping the business essential to position the company for long term growth and profitability while judging value, is the business worth more held in the company's portfolio than anywhere else. Considering fit and value will better allow them to sell at the right time.

7. Plan for De-Integration. Once it is decided to sell, what type of separation is best to implement steps to generate maximum value? Do we sell the whole business or a piece of it? Sometimes its simple – who will pay the highest price. But, Ford sold Jaguar and Land Rover not to a company with a wide range of overlapping products such as GM or BMW but rather to a less entrenched Indian Tata Motors where there is less competitive pressure on its existing lines. Sellers may have the choice to sell to strategic buyers (other companies who may benefit) or private equity or other financial buyers.

Implications for Government Contractors

Divestitures of contractors create numerous changes that will affect a large range of compliance issues that are unique to government contractors. Divestments involve changes to products, clients and facilities; efforts to improve economies and efficiencies both before and after divestment; changes to the organization structure; dealing with stranded costs; how the deal is structured; staffing changes and how key people are compensated and procurement practices. The following are some examples of issues we have faced in our consulting practice when working with divesting clients.

1. Organizational Units. Divestments will usually affect products and geographic regions of the new company. A determination of what assets are transferred to the divested unit versus stays with the existing company usually result in some organization changes of the remaining company by product line, geographic area, commercial versus government, etc. Whereas separate business units may have existed prior to the divestments, remaining businesses may reorganize into different separate business or consolidated into fewer ones. Remember, organizational units for accounting purposes need not be the same thing as legal entities.

2. How products and contracts are accounted for. The organizational changes provide opportunities to evaluate how the remaining products and services should be

costed and priced. This usually represents an excellent time to examine your existing accounting practices (e.g. indirect rate structure, direct versus indirect costing) where you have the opportunity to alter your existing practices. Almost always, improvements can be made and changes adopted. An evaluation might result in adopting additional indirect rates (multiple overhead rates, separate overhead rates at different facilities, adoption of material/ subcontract handling rates) or eliminations of others (one overhead rate across multiple regions). Changes to the composition of pools and bases are also quite common. As we frequently advise, decisions need to be based not just on cost accounting considerations but, more importantly, on pricing decisions where some items need to be priced as low as possible and hence have minimal indirect cost allocations while others have flexibility in maxing out cost allocations. Some of these changes will be considered accounting changes (you may want to argue they are not sometimes) where the process of gaining acceptance by the government will need to be managed.

3. Cross company systems and processes commonly become unraveled where new ways must be considered. Sometimes shared service arrangements are created both across the remaining companies and even between divested and non-divested businesses. For example, it is not unusual to establish sharing arrangements for divested and non-divested units during a transition period. This may be a time to consider adopting service or cost centers that provide services across organizational entities. To avoid basing services on cost incurred, these centers can provide services on negotiated unit rates which auditors strongly prefer and may simplify prior cost-based accounting practices.

4. The need to provide a compelling logic for buyers and employees will inevitably translate into implementing actions to improve the profitability of the divested candidates. Care needs to be taken to characterize these changes as "internal restructuring" activities to improve efficiencies, which are allowable costs, compared to re-organizational activities resulting from a change in company structure. Clear distinctions, probably including a written policy, needs to be adopted.

4. Keeping people charged up to keep the company humming both before and after divestiture often means compensation must be devised to generate the incentives. We find at least three categories of employees may need unique compensation schemes where (a) the 2-3 most senior people need to be incentivized to make sure the deal goes through (b) key executives need to have retention packages to stay and (c) remaining employees need severance packages where each package must be structured to maximize chances of being allowed to avoid both questioned costs and penalties.

5. Organizational changes, both before and after the divestment, will change the type of corporate services to be provided. Usually, divestments will require new practices related to home office or intermediate home office allocations where new methods of allocating these expenses between organization units need to be devised. Even smaller companies need to decide how to share the costs and allocate those costs to its government contracts where, for example, normal G&A costs incurred by one business unit may need to be shared between two or more, requiring a new allocation methodology.

6. Stranded costs. Companies commonly get stuck with stranded costs after the divestiture such as IT systems, back office operations and infrastructure used to support higher volume before the sale. High performers will proactively plan on dealing with these stranded costs and plan on such things as optimizing their supply chain, negotiating temporary service agreements, implementing separate IT systems for each business and provide smaller overhead and G&A expenses for a more focused company.

7. How the deal is structured will affect the company. For example, under IRS rules the so-called reverse Morris Trust is often popular where the divested company is spun off as a separate company and then merged with the buyer where the seller retains some ownership. The result is both owners benefit if the company does well where recent examples include the Heinz spin-off of North American Pet Foods and StarKist to Del Monte, Disney's divestiture of ABC Radio to Citadel Broadcasting and Kraft Foods deal to divest Post to Ralcorp. The joint ownership relationship will need to generate compliant accounting practices for joint ventures and teaming arrangements.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2016

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and the Comptroller General say they are, we are continuing our practice of summarizing some of the significant decisions last year affecting grounds for successful protests of award decisions, what is considered proper evaluations of proposals and selected cost issues.

This article is based on the January 2017 issue of Briefing Papers written by Miki Shager, Counsel to the Department of Agriculture Board of Contract Appeals. We have referenced the cases in the event our readers want to study them.)

Protests of Award Decisions

Considerations in winning protests. To have standing to protest a procurement, a protester must be an interested party – an actual or prospective offeror whose direct economic interest would be affected by the award or failure to obtain the award. A protester is an interested party where there is a reasonable possibility its proposal would be in line for award if the protest is sustained. An example of an interested party is one who claims none of the awardees are eligible for award *(Protect the Force)*. Examples of not being an interested party include not in line for award even if allegations are correct or sustained *(Digital Spec)*, eliminated from the competitive range *(VMD Systems)*, cannot challenge a task order of less than $10 million and if it did not hold the IDIQ contract *(Latvian Connection)* and did not recertify its small business status and therefore was ineligible *(Technica Corp.)*. Other considerations is if you are challenging a CO's determination of non-responsibility, make sure you have available the specific information the CO unreasonably failed to consider *(Gaver Industries)*. Make sure filing protests are timely where the GAO rarely grants exceptions to timeliness rules *(Choctaw Staffing)* such as before the date for submission of proposals *(National Disability Rights Network)*, within 10 days of an agency report *(DynCorp)* or within 10 days of the debriefing *(Carl, Amber, Brian, Isiah & Assocs.)*. Bear in mind that agencies must prepare full and complete documentation of evaluation decisions where protests will be sustained if the decision is not supportable *(Sterling Medical Corp)*. Finally, if you are successful in your protest, make sure you carefully itemize your costs, document them, provide detailed evidence and present your claim to the agency within 60 days *(Cascadian American Enterprise)* to recover your protest costs.

To avoid *"bait and switch"* allegations do not propose personnel you do not have a reasonable basis to believe you will be providing during performance *(Patricio Enterprise)*. An offer is considered unbalanced if it is based on prices significantly less than cost for some items and more on others and there is reasonable doubt the resulting price will result in the lowest overall price. An agency is not required to reject an offer solely because it is unbalanced. If it is mathematically unbalanced but not materially unbalanced and did not pose a risk the government would pay a higher price or the contractor receives an undue benefit then it is not unbalanced *(Ultimate Concrete)*. To prevail in a protest, the protester must show that one of more prices in the proposal is overstated where it is insufficient to show that a line item is understated *(Marine Terminal Corp.)*

Below cost pricing is not prohibited and the government cannot withhold an award from a responsible bidder because it is low or below cost *(B&B Medical Services)*. An offeror can, in its business judgment, submit a low or below cost offer *(i4 Now Solutions)* and in the absence of a requirement to perform a price realism analysis of a fixed price contract there is nothing objectionable about awarding a firm with below cost prices *(CALNET)* if its low rates and high discounts do not impair performance *(Alamo City)*.

- Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in assessing proposals where agencies have broad discretion in the selection of evaluation criteria but must identify the factors and subfactors that will be used to select offers *(BOSH Global)*. Though agencies must disclose evaluation criteria and their relative importance they need not disclose standards or guidelines for rating specific features *(Alliant SB)*. Agencies have broad discretion to determine their needs where the weight and significance of the prime, subcontractors or team members are matters of agency discretion *(AMEL Technologies)*. An agency must amend its solicitation for goods or services when the agency changes its requirements or terms and conditions *(Intelsat General Corp)*.

Several criteria for proper evaluation of proposals were addressed in 2016:

1. Agencies must treat all offerors equally and evaluate their proposals evenhandedly against the solicitations requirements and evaluation criteria *(Progressive Industries)*.

An agency should consider the impact of a corporate restructuring when the transaction is imminent *(Lockheed Martin)* and the agency correctly considered the risk of a restructuring during a competition when it properly considered whether the same resources would be available, whether the offeror can still perform *(Honeywell Technology)* and whether it had the same resources and relevant past performance *(UnitedHealth Military)*.

2. Agencies must evaluate proposals according to the criteria established in the solicitation *(National Air*

Cargo). Protester proposed a specialist with a background in accounting and finance which is not similar to the work under the contract *(Dee Monbo CPA).* The agency must evaluate a proposal based on the enumerated evaluation factors in the solicitation *(PAE Aviation)* but may properly take into account specific but not expressly identified matters that are logically encompassed and related to the evaluation criteria *(Adino).* Also, technical evaluators have wide latitude in assigning ratings reflecting their subjective judgments of an offeror's relative merits *(Complete Packaging).*

3. Agencies must consider cost or price in evaluating competing proposals *(Worldwide Language).* Several protests were sustained when there was no evidence the agency meaningfully considered cost or pricing even though price was of less importance than nonprice factors.

4. Use of price realism analyses when evaluating an offeror's low price under a fixed price solicitation is not considered unreasonable when made for the purpose of measuring the offeror's understanding of the requirements or assessing the risk in the proposal *(AAR Defense).* Price reasonableness analysis involves whether prices are too high while realism analysis involves whether prices are too low *(i4 Now Solutions).* Absent a solicitation provision agencies are neither required nor permitted to conduct one when awarding a fixed price contract (Avon Protections Systems).

5. Cost realism analyses are required under cost reimbursable contracts because the offerors' proposed costs are not "dispositive" since the government is bound to pay actual and allowable costs *(MCR Federal).* An agency must perform cost realism analysis to determine whether the proposed cost elements are realistic for the work, reflect a clear understanding of the requirements and are consistent with the unique methods of performance and material described in the proposal *(Glacier Technical Sltns).* The analysis does not require "impeccable rigor" *(Dellew Corp)* but rather needs the exercise of "informed judgment" *(Innovative Test Sltns).*

6. To be deemed responsible, a prospective contractor must be able to comply with required performance schedule, have adequate financial resources and have necessary organization, experience, operational controls and technical skills where the burden is on the contractor to affirm its responsibility and in its absence the CO is to determine it is non-responsible (FAR 9.104). The burden is on the contractor to demonstrate responsibility where the appeals board will not disturb a determination unless there was no reasonable basis *(Sohail Global).*

7. Examples of ruling there was no "impaired objectivity" organizational conflict of interest include the firm provided a mitigation plan with its initial proposal and final plan with its final proposal revision *(Innovative Test Sltns),* protester failed to provide "hard facts" demonstrating impaired objectivity *(Arc Aspicio),* awardee would not be in a position to validate work it performed (Deloitte Consulting) and firewalled subcontractors were approved by the agency *(Social Impact).* Other types of OCI include "biased ground rules" where a firm is in a position to affect a competition *(Systems Made Simple)* or "unequal access to information" where a firm has access to non-public information that gives it a competitive advantage in a later competition *(Arctic Slope).*

- **Past Performance**

Past performance is one evaluation factor that must be considered in all negotiated procurements. FAR 15-306(b)(1)(i) and (d)(3) provides for discussions in negotiated procurements and gives offerors the opportunity to clarify adverse past performance information (PPI) while awards without discussions in FAR 15.306(a)(2) provides that offerors may be given the opportunity to clarify adverse PPI. Significant past performance considerations include:

The agency has broad discretion to determine the relevance and scope of an offeror's PP history *(Windgate Travel).* Where the protester asserted the agency should have made an inquiry into the total areas of awardee's prior snow removal experience rather than contract the person who completed the PP questionnaire the agency said the agency may rely on info from a PP reference unless it has reason to question its validity *(Dean's Paving).* Rejected protester's assertion the three contracts were not relevant because they were not recent enough *(J.E. AcAmis).* Where both offerors have relevant PP, the agency is not required to further differentiate between PP ratings based on a more refined assessment unless the RFQ requires it *(DynCorp).*

The RFP requires that offerors submit PP references of similar size and scope to the RFQ requirements *(Artic Slope Mission).* Though concerned with the low dollar value of a prior project the source selection committee was satisfied that the similarity of tasks provide satisfactory confidence in its ability to perform *(TENICA & Assocs).* To be "similar in scope" an offeror's PP need not be identical to or compared to in every aspect of the solicitation's requirements *(National Sourcing).*

It is the contractor's responsibility to provide sufficient evidence to establish PP history *(Halbert Construction)*. With incorrect email addresses where protester asserted the agency failed to make a reasonable effort to contact a reference, the GAO ruled as a general matter an agency is required to make a reasonable effort but where the effort proves unsuccessful it is acceptable for the agency to proceed with its evaluation without the benefit of the reference's input *(Cape Environmental)*. There was no basis to question the agency's decision not to credit the protester with the performance of key personnel under the PP factor as the review of the proposals shows there was insufficient information to determine what role, if any, each key person had in prior contracts *(Coctaw Staffing)*.

An agency may consider the experience of PP of a parent, affiliated company or subcontractor where the proposal demonstrates the resources of them will affect performance. It was inappropriate to consider a parent company's PP record where there was no evidence the parent would participate meaningfully in contract performance *(Deloitte Consulting)*. There is nothing improper about an agency considering the PP of entities that make up a joint venture *(MILVETS Systems Technology)*. An agency may assign a confidence rating to an offeror based exclusively on the PP of a subcontractor *(GiaCare & MedTrust JV)*. It is proper for an agency not to downgrade awardee's PP on the basis of the affiliate's performance where no evidence of that affiliate was proposed to perform work on the contract *(AAR Defense Systems)*.

- **Discussions**

FAR 15.306 requires the CO discuss with each offeror being considered for award significant weaknesses, deficiencies or other aspects of its proposal that could be altered or explained to enhance the proposal's potential for award where courts are defining this new area *(DRS Network)*. Discussions should not be confused with clarifications which are limited exchanges with offerors to allow correction of minor or clerical errors or to clarify proposal elements *(Cascadian American Enterprise)*. Examples of clarification and not discussions include submission of additional evidence for a responsibility determination *(Lawson Environmental)* and seeking information where omission of a file was an oversight *(L-3 Communications)*. Clarifications cannot be used to cure proposal deficiencies and material omissions *(Abacus Technology)*. Examples of discussions include proposed key person's employment status where letter of intent is omitted *(DataSource)* and invitation to modify proposal price *(Rotech Healthcare)*. An agency may not hold discussions with one offeror and withhold offering a similar opportunity to all other offerors *(Torres Advanced Enterprise)*. There is no requirement for all areas of a proposal having a competitive impact be discussed, only significant weaknesses or deficiencies *(Q Integrated Companies)*. For example, if its prices are not so high as to be unreasonable it may conduct discussions without saying its prices are not competitive *(AAR Airlift)* Discussions must be meaningful, equitable and not misleading and must address deficiencies and significant weaknesses in offeror's proposal than can reasonably be addressed in a manner to enhance the offeror's potential for receiving an award *(Trarndes Corp.)*. The agency unlawfully misled offeror to lower its price where it already had concerns about its offered low price *(Caddell Construction)*. Also, agencies have no requirement to conduct discussions in competitive Federal Supply Schedule or task order procurements but when they are held the GAO will review proper standards were adhered to *(Paragon Technology)*.

Unallowable Costs

Termination Settlement Costs. The Termination for Convenience clause at FAR 52.249-2 requires a contractor to file a termination settlement proposal within one year of a termination. A T for C is often characterized as converting a fixed price contract to a cost reimbursement contract that entitles the contractor to recover allowable costs incurred in the performance of the terminated work, a reasonable profit on work performed and certain additional costs associated with the termination. In a simplified acquisition, the contractor is entitled to recover costs incurred prior to termination plus profit without completing a percentage of the contract under the theory these are costs "resulting from the termination" *(Rex Systems)*. Settlement costs under a constructive termination are not recoverable where the government has ordered its minimum orders under a IDIQ contract *(CAE USA)* but it is entitled to an equitable adjustment to the remaining un-terminated items after a T of C (Missouri Dept of Social Svcs). Contractor was entitled to 10% of contract price where it had completed 10% of the contract work *(DEAS Construction)*. It was entitled to zero where it had not performed any work under its terminated contract *(Boarhog)*.

Interest Recovery. To recover interest the contractor must either show it is provided for under the contract or by an act of Congress. Claim for interest on borrowed funds was denied *(Vistas Construction)* and damages for rental payments and loss of rental income due to a government

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delay is not a cost of performance *(JDL Castle)*. Though contractors are entitled to interest on late payments under the Prompt Payment this is true only when there is no dispute over compliance with the contract and the invoice is acceptable *(Systems Mgt & Research)*.

The Board allowed payments to subcontracts based on mark ups for overhead and profit ruling the contract was not an unallowable cost-plus-percentage-of-cost contract arguing that the markup was based on labor hours, not cost, where the 15% markup was customary in the construction industry *(Kellogg Brown and Root)*.

The Board rejected DCAA's $100 million of questioned subcontractor costs based on their assertion contractor "breached its duty" to "manage" its subcontractors by failing to audit its subcontractors' incurred costs where the Board ruled this duty was "nonexistent" and the questioned costs were based on an invalid legal theory *(Lockheed Martin)*. CACI's task order for overseas services provided that a workweek would be 84 and 72 hours, respectively where no overtime was paid but "danger" paid in accordance with the Dept of State was paid. The Board ruled against the government's contention that the employees received unallowable overtime for hours in excess of 40 hours worked ruling that basic compensation means pay for a normal work week where here it was 84 and 72 hours *(CACI)*.

Contract Administration Costs. The courts have long distinguished between unallowable costs related to prosecuting claims and allowable costs of contract administration where costs related to negotiating a resolution of a problem during contract performance are allowable where if they are incurred to begin the process of litigating a claim they are unallowable. Consultant costs were for the purpose of administrative resolution through meetings, discussions and negotiation not pursuing a claim *(Optimum)*. A claim for consultant costs must be submitted to the CO prior to appealing a CO decision *(Regency Construction)*.

The Board ruled that CAS 404 was not violated because the lease did not require computation of costs related to a capital lease due to the fact the lease was an operating lease which is not covered by CAS 404. CAS applies only to tangible assets with physical substance while the operating lease was an intangible asset *(Exelis)*.

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