GCA DIGEST

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Classic Oldie...

COMPETING FOR PROFESSIONAL SERVICES AND OTHER CONTRACTS

(Editor's Note. In this competitive marketplace, there are a lot of attempts to bid prices that "cheat the system", resulting in "wage busting", overly optimistic overhead projections and plain "buy ins". These practices are particularly prevalent in professional services contracts where the solicitation lists total hours to be provided and offerors are asked to merely propose base salary rates, overhead and profit.

How do you compete in this environment? The following article identifies some practical measures you can take to lessen the impact of unfair competition for professional services. It is based upon an interesting article we found that was written in September 1998 in the Briefing Papers written by Louis Victorino and William Molinski of the law firm of Freid, Frank, Harris, Shriver & Jacobson. The insights are as valid today as when we wrote the article though we have updated some ideas to correspond to subsequent regulation changes (e.g. uncompensated overtime, notification requirements). Though the authors' perspective is to protect contractors from "unfair" low bidders, we will address many of the methods bidders may use to gain an advantage and what other contractors can do to combat such tactics. The original article explicitly addresses professional services but we believe this article is quite relevant for other types of contracts.)

Compensation Plans

The offeror may promise to hire the highest quality professional, including a promise to hire the best of the incumbent's personnel. The source selection official will often analyze the offeror's compensation plan to determine if it is sufficient to attract and retain quality professionals.

♦ FAR Requirements

The FAR 52.222-46, "Evaluation of Compensation for Professional Services" requires the submission of a compensation plan for solicitations of negotiated service contracts exceeding $550,000. The plan must set forth proposed salaries and fringe benefits for professional employees working on the contract as well as supporting data used to establish the compensation plan such as recognized salary surveys. The purpose of this requirement is to make sure that lower salaries do not make it difficult to attract and retain competent professionals so that the quality of service may be maintained. Should the CO fail to include this provision in the solicitation, you should raise this issue prior to the closing date for receipt of initial proposals.

♦ Plan Requirements

The plan must be specific to the solicitation requirements. For example, if a contract specification requires proposed engineers to have 10 years experience with military software testing, it is not sufficient you demonstrate that software engineers can be hired at a given salary but you must demonstrate that professionals having the 10 years experience can be attracted and retained at the pay levels proposed.

If you expect your proposed salary rates will be lower than the incumbent contractor, you need to be prepared to present special facts to explain your ability to offer lower rates and include them in the compensation plan. These facts may include (1) numerous recent hires at entry-level salaries (2) lower salaries in a different geographic area (3) downturn in the economy or lower-paid employees more readily available (4) special concessions offered by existing employees (5) unusual fringe benefit arrangements such as flexible working hours, "work-at-home" plans, daycare benefits, etc. Of particular importance will be historical evidence you have been able to hire quality professionals at the compensation proposed coupled with historical evidence you have not experienced excessive turnover.

♦ Government Evaluation of Plan

Upon receipt of proposals, the source selection officials must review the compensation plans. The level of review will depend on how much the proposed rates deviate from those of the incumbent

and the presence of language elevating the importance of the compensation plan. While proposed rates that are in line with incumbent salaries will most likely not require a detailed review, proposed rates considerably higher or lower will require a thorough review by procurement officials. A General Services Board of Contract Appeals case stated that compensation rates between 13 percent and 38 percent below the government's estimate indicated the presence of "wage busting" and represented an inadequate compensation plan.

Under recent changes to FAR 15, the government is obliged to apprise an offeror of perceived shortcomings with its compensation plan during the process of conducting discussions during its negotiations.

♦ Impact of an Inadequate Plan

An adverse evaluation of the plan can affect a determination of whether the offeror is "responsible". The failure to demonstrate it can attract or retain qualified personnel means the bidder lacks the resources to perform the work and hence is not a responsible offeror. An inadequate compensation plan can also be viewed as evidence of a failure to comprehend the complexity of work required, resulting in a lower technical evaluation. More commonly, if an offeror's compensation plan is considered inadequate the government may adjust its proposed price upward to reflect more reasonable compensation rather than devalue its technical score. The increased use of "cost realism" analyses by the government on both cost and fixed price contracts has led to adjustments of "low ball" offers. If cost realism is a mandatory requirement of the solicitation, a "low ball" offer can be thrown out. *You may want to request that a cost realism analysis be a mandatory requirement.*

Key Employee Resumes

Since the government is largely buying time and expertise of professionals on these types of contracts, it needs information about the people each offeror proposes to use. This information is contained in resumes of key personnel.

♦ "Bait & Switch"

Some competitors may use resumes to gain an advantage by proposing high-quality, high priced professionals for evaluation but using low-quality, low-priced individuals for actual performance. All government appeal boards and courts have strenuously denounced "bait and switch" tactics ruling that when quality of personnel is a key evaluation factor, a proposal may be rejected if the offeror (1) does not intend to use all of the proposed key personnel (2) does not affirmatively determine the availability of the key personnel or (3) fails to notify an agency in the final stage of a selection of the need to substitute key personnel due to changed circumstances.

A prerequisite for using a resume for a key personnel is that the offeror in fact makes an *inquiry* regarding future availability. It is not sufficient to merely review your personnel database to identify professionals with requisite skills. Once resumes have been submitted, you have a limited obligation to keep the CO apprised of changes in the status of proposed key personnel. This does not mean that all substitutions of personnel after award are prohibited as long as the awardee acted "reasonably and in good faith".

The Courts have ruled that hard evidence of bait and switch tactics include (1) failure to inquire about availability (2) affidavits from individuals whose resumes were submitted that the offeror failed to discuss the intended participation prior to proposed submissions (3) clear commitment of the individual to other work (4) use of labor rates wholly inconsistent with personnel proposed or (5) internal memorandum indicating intent not to use the personnel proposed.

♦ Certified Resumes & Letters of Commitment

Contractors are more effectively protected against "bait and switch" substitutions when the solicitation requires a formal commitment with each proposal of the availability and commitment of the persons whose resumes are submitted. Such commitments often take the form of "certified" resumes and "letters of commitment". A "certified" resume is typically defined as a resume signed by both the offeror and person represented certifying the information is true and complete and is available to work on the contract. "Letters of commitment" are letters from key personnel not employed at the time of offer that states they acknowledge their resume will be used in the offer and that they intend to accept a reasonable offer of employment should an award be made.

Though non-incumbents often face a disadvantage in securing a workforce with relevant experience they, nonetheless, cannot expect to meet key employee listing requirements by promising to hire the incumbent's key employees. They must either (a)

contact the incumbent's personnel and obtain permission to use their resumes or (b) offer other qualified personnel with their consent and advise the government you will consider incumbent personnel for any openings that may arise.

Uncompensated Overtime

Uncompensated overtime is defined as the hours worked in excess of 40 hours per week without additional compensation by employees exempt from the Fair Labor Standards Act who are directly charged to the contract. These employees are salaried executives, administrative or professional employees.

A method of proposing low labor rates when salaries cannot be reduced is to require exempt employees to work overtime without additional compensation. Though there have been numerous proposals put forth and new audit guidelines issued from time to time the government still vacillates in its approach to uncompensated overtime. Proponents of using uncompensated overtime stress that it reduces the cost of services to the government through lowered labor rates while critics stress its unbridled use leads to dissatisfied workers, high employee turnover and a general reduction in quality. This difference of opinion is often reflected in some solicitations where it is often clear use of uncompensated overtime is not prohibited while in others offerors are often warned that proposing uncompensated overtime may result in an offer being downgraded technically.

The Defense Department has stressed the potential for abuses citing examples of contractors who do not record overtime hours playing games by working one contract during normal hours (e.g. cost type) while another contract during the unrecorded time (fixed price or commercial). Auditors often provide conflicting guidance but commonly attempt to determine (a) whether contractors are charging all hours and when significant, urge them to do so (b) hours are allocated fairly among various contracts and (c) each hour worked is allocated its fair share of overhead costs. Government auditors have prescribed acceptable and non-acceptable methods that are beyond the scope of this article to cover.

♦ Proposal Evaluation

A proposal that includes uncompensated overtime must be carefully reviewed. First, the proposal must conform to mandatory accounting rules. Second, the government must assure itself the proposed rates will be delivered. On fixed type contracts, there is less concern where the government will be primarily concerned that rates are not so low as to endanger performance. For cost-type contracts, unless uncompensated overtime can be compelled by agreement or rates are "capped", there is considerable risk the government will not realize the benefits. Third, source selection officials must ensure the level of uncompensated overtime will not lower the quality by the offeror "buying-in". Lastly, source selection officials may perform "cost realism" analyses where it is determined that performance may suffer or uncompensated overtime rates cannot be compelled, it may adjust proposed rates. However, adjustment to rates cannot be made under cost realism reviews unless these two conditions are met.

Recommendations

1. Under the FAR "Evaluation of Compensation for Professional Services" provision, you must submit a well-thought-out compensation plan with your proposal. Include copies of compensation studies supporting your rates – preferably salary surveys. If your salary ranges fall near the bottom of the survey submitted, be prepared to anticipate government questions by providing (1) explanations to support your rates (2) historical evidence of success in hiring and retaining quality personnel and (3) special facts that might cause a professional to work for you for less salary.

2. If you suspect your competitors are paying or planning to pay significantly less than you, make sure your compensation plan surveys address geographic area, company size and professional expertise. Provide a narrative describing trends or developments that would make your competitors' low wages unrealistic (e.g. statistics showing a shortage of professionals in relevant disciplines).

3. If the solicitation does not include the FAR "Evaluation of Compensation for Professional Employees" provision, formally request the solicitation be amended to include it. Also request that a cost realism analysis be a mandatory requirement.

4. Review the solicitation to determine if "specified resumes" or "letters of commitment" for key personnel are required. If not, formally request they be included.

5. Prior to submitting employee resumes, make sure the proposed professionals are available to work on the contract. If an employee must relocate, you should contact them to verify their willingness to do so and

document the agreement by an internal memorandum or a signed statement.

6. If proposed key personnel are not current employees be sure to contact them to obtain their consent to use their resume. No formal employment agreement needs to be reached but you need acknowledgment their resume is being submitted and they are willing to accept employment under reasonable terms. Document communications.

7. Do not use resumes of incumbent contractor personnel unless you have contacted them and obtained their consent to use their resumes and agreement to consider employment.

8. If a competitor is selected, request a debriefing and attempt to obtain names of the key professionals. If you are the incumbent, ask employees if they were contacted. If your attorney doesn't object, consider contacting non-employee personnel the competitor relied upon and determine their level of pre-commitment.

9. Monitor the awardee to determine if the assigned professionals match the resumes of personnel submitted. If not, consider filing a protest.

10. If you or your subcontractors plan on using uncompensated overtime, make sure that (a) you estimate overtime in the same way uncompensated overtime is accounted for and reported in your accounting system (2) the resulting workload will not render performance risky due to loss of key personnel or inefficiencies and (3) you and your subcontractor's use of uncompensated overtime is delineated in your proposal.

11. If a competitor is selected for award at a significantly lower price, request a debriefing and ask if uncompensated overtime was proposed. Consider filing a protest alleging (a) an inadequate compensation plan (b) excess uncompensated overtime and (c) inability to recruit and retain professionals at the salary level and uncompensated overtime levels proposed.

Knowing Your Cost Principles and Cost Accounting Standards....

COST ACCOUNTING STANDARD 404

(*Editor's Note. As part of our ongoing series on important cost principles and cost accounting standards, we want to address how assets are capitalized and depreciated since there are numerous ways of doing so that can significantly affect contract costing and pricing. In this issue we will address requirements on capitalizing assets and in a later issue will address amortization and depreciation. As is quite common with CAS, most provisions of the standard would, in practice, apply to non-CAS covered contractors also since provisions of the standards are normally considered to be proper accounting treatment. In our research we have used a variety of texts but relied most heavily on Accounting for Government Contracts – Cost Accounting Standards – edited by Lane Anderson. We have chosen to focus on those issues having the greatest practical significance to our subscribers.)*

Basics

CAS 404 requires a contractor to establish, adhere to and write its own policy for capitalizing tangible assets within the limits set up by the standard. The standard provides that as the basis for its policy the contractor should designate the economic and physical characteristics important to the capitalization decision. The standard allows a contractor to develop a policy that exempts from capitalization any assets whose life does not exceed two years or whose acquisition cost is not higher than $5,000. The concepts of CAS 404 are generally in conformity with those for financial accounting where there are some exceptions such as cost of assets constructed by a contractor, write up values acquired under the purchase method in a business merger and treatment of impaired assets.

Tangible Capital Asset

The standard recognizes three major characteristics of a tangible capital asset as (1) acquired for use in operations and not for resale (2) long term in nature yielding services over a number of years and (3) having physical substance. The tangible capital asset classification is basically reserved for those properties of a relatively permanent character used in the normal conduct of a business which are commonly referred to as property, plant and equipment as well as land and buildings and other fixed assets.

Capitalization Policies

The decisions on what capitalization policies to adopt should be based on careful considerations. Expensing the cost of an asset normally provides positive cashflow under government contracts because a contractor can recover its costs in the year of acquisition and the higher expense reduces income taxes paid. However, if assets are capitalized and depreciated over the period of their useful life the

delayed recovery can be partially offset by a cost of money factor and the timing of the expenses can be more finely tuned with pricing objectives over several years (e.g. higher mix of cost based contracts in later years implies greater recovery in those years, desire to minimize cost recoveries in current year to allow for a low price).

As we mentioned above CAS 404 requires a written policy that is reasonable and consistently applied. The policy must include: (1) minimum service life criterion which must not exceed two years but can be a shorter period (2) a minimum acquisition cost criteria which must not exceed $5,000 but can be a smaller amount (3) identification of other specific characteristics that are pertinent (e.g. class of asset, physical size, are independent units integrated into a higher level class of asset) (4) identification of asset accountability units to the maximum extent possible and (5) minimal dollar amounts for capitalization of original components as well as subsequent costs of betterments and improvements.

The following are clarifications of the above paragraph as well as some of the issues that need to be considered when formulating your capitalization policies:

Minimum costs and useful life must meet "and" condition. Tangible assets must be capitalized when they meet the criteria of (1) and (2) above where they must comply with an "and" condition and not an "or" condition. For example, an asset with a service life of 18 months and a cost of $6,000 or, similarly, an asset costing $3,000 with a service life of five years does not meet the requirements of capitalization.

Meaning of service life. It is not uncommon for a contractor to purchase a piece of equipment to be used on a program it intends to pursue but does not expect to have any contract for, say, 3-5 years. Must he capitalize and amortize the asset immediately? The answer is yes for the capitalization but no for the period of amortization because the period of amortization is usually thought to be the period over which the asset will generate revenue which does not begin until some future period.

Asset accountability. If possible, the unit should be identified and separately capitalized upon acquisition but for those units that have not been separately capitalized they should nonetheless be removed from asset accounts when they are disposed of.

Can a percentage of acquisition cost criteria be used to capitalize betterment costs? The CAS Board does not object to a capitalization policy that includes a percentage of acquisition cost be used but the policy must provide for a monetary limit above which any betterment or improvement will be capitalized even if its cost is a low percentage of some other asset's costs.

Do "other characteristic" considerations supersede the service life and minimum dollar amounts? Some contractors may interpret the standard's listing of other characteristics that may affect capitalization decisions as meaning that if certain items don't meet the criteria of these other characteristics then the asset should not be capitalized even though the serviced life and minimum dollar thresholds are exceeded. This interpretation would be wrong.

How to direct charge a contract. If an asset benefits only one contract, it is customary to capitalize and depreciate the costs over the period of the estimated life of the asset which is usually the period of performance of that contract. However, where an asset is acquired for a specific contract and the contract is to be started and completed within a fiscal year or where a contract line item provides for specific payment for the asset, then the costs may be charged to the contract without first capitalizing them.

Asset accountability unit. The standard encourages recognition of an "asset accountability unit" to the maximum extent possible. This is a term not commonly encountered in the commercial accounting world and refers to the smallest unit separately identified for capitalization purposes. Many contractors have misinterpreted this to mean that capital assets must be accounted for on a unit basis and not groups. Rather the CAS Board intended that a contractor can maintain any type of records it finds convenient so grouping of assets for convenience is acceptable as long as a unit is removed from its asset accounts when it is disposed of.

Original complement of low- cost equipment. This term refers to groups of low-cost equipment acquired for initial outfitting of a new installation e.g. books in a new library, workbenches and racks in a new factory or furniture and fixtures in a new office building. The CAS Board stated the total original complement should be treated as a tangible capital asset and be identified as an entity rather than separately accounting for each individual item. However, the contractor has the flexibility to define which items make up the original complement and it may have more than one

compliment depending on service life or other factors. Two methods of treating these items are common: either as a tangible asset subject to depreciation or as an inventoried asset. If the later, the amount capitalized is maintained at the original amount because it is not depreciated and as replacement occurs, the costs are expensed in the period acquired.

Determining Acquisition Cost

The basic requirement of CAS 404 is that the cost of acquiring any tangible capital asset must include the purchase price (amount given in exchange) e.g. invoiced amount plus the costs necessary to prepare the asset for use e.g. transportation, installation.

♦ Establishing the Purchase Price

According to CAS 404 the purchase price is the consideration given in exchange for the asset, either cash paid or cash equivalent. If a cash equivalent is not available, the purchase price is measured by the current value of the consideration given for the asset. In the prefatory remarks of the standard, the Board put forth the principle that the full cost of acquiring the asset should be capitalized. However, the Board did not apply this principle by requiring inclusion of specific elements of costs in determining acquisition cost. For example, in addressing sales and use tax costs if including them required significant changes to contractors' accounting systems it noted increased uniformity might not result in more benefits than costs so contractors were not required to change from their existing practices. The standard does, however, require the contractor adjust purchase price for premiums and extra charges as well as discounts and credits received, if it is practical to do so.

The standard does provide examples of what costs to include. For land, all expenditures made to acquire the land and to get it ready for use (e.g. purchase price, closing costs, grading, draining and any additional land improvements having an indefinite life as well as assumption of any liens, mortgages, unpaid taxes). For buildings, all expenditures related to acquisition and construction that might include labor, material and overhead as well as professional fees and building permits. For machinery and equipment, expenditures for freight and handling, insurance while in transit, cost of special foundations and trial runs would be included with the purchase price.

♦ Means of Acquiring the Tangible Assets

Contractors may acquire assets in a variety of ways and the methods used have often generated considerable confusion. We will address below some of these.

Purchase on credit. If a credit instrument is used the asset is to be capitalized at the current value of that instrument. The standard states the current value is the amount immediately required to settle the obligation or the amount of money that might have been raised directly through the instrument.

Issuance of securities. If a contractor obtains an asset by issuing its own stock or bonds then the current value of those securities is the value assigned to the asset. If the current value of the security is its market value then that value is to be used; if there is not a market value or the security is thinly traded or there are volatile values for the security then the fair market value of the asset is to be used.

Exchange. CAS 404 does not address acquisition of an asset by exchange but generally accepted accounting principles (GAAP) do. Under GAAP, when one new nonmonetary asset is traded for another, the new asset should be recorded at the fair market value (FMV) of the asset given up. If a used asset is surrendered for a new one, the FMV of the new asset is usually more evident than the old one so the value of the new one should be used. However, for government accounting purposes, the book value of the used asset given up may be more appropriate because the government does not want to reimburse a contractor for something the contractor has not given up which here the contractor would be giving up book value of the used asset not the FMV of the new one. GAAP says the best measure of FMV is cash or cash equivalent associated with an asset that is acquired or sold so contractors should establish cash or cash equivalent prices in an exchange transaction. Lastly, any difference between the FMV assigned to the asset received and the book value of the old asset should be recognized as a gain or loss on the exchange to be recognized in accordance with FAR 31.205-16.

Construction of assets by contractor. Whether it be to save on construction costs, utilize idle facilities or achieve unique quality performance, contractors occasionally construct their own buildings or equipment for their own use. Though determining the cost of such effort can be a problem without a purchase price or contract price proper identification and allocation of costs can lead to an accurate accounting of the costs to be capitalized. Though material, subcontractor and direct labor can be traced directly to the work,

assignment of indirect costs such as G&A and cost of money can create some problems. The standard states the contractor constructed assets that are identical or similar to its normal other products must receive a full share of all direct costs including G&A and cost of money. If the constructed assets are not identical or similar then the constructed assets must be burdened with an allocable share of indirect costs if they are material but if the G&A expenses are not specifically identifiable with the construction the costs may not be subject to an allocation. In an example in the DCAA Contract Audit Manual DCAA states costs of building a facility and installing equipment for the government are not covered by CAS 404 since the assets are not similar to assets constructed for the contractor's own use. However, allocation of G&A and cost of money are addressed in other FAR and cost accounting standards, CAS 410 and FAR 31.205-10, respectively.

Less-than-arms-length transactions. This type of transaction is typically a related-party transaction where it is assumed that normal market forces do not strictly apply. Examples of related parties are a parent and its subsidiaries; subsidiary of a common parent; principle owners, managers or members of immediate family; affiliates; and enterprise and trusts for the employees' benefit. Neither CAS 404 nor other standards address the acquisition of assets by less than arms length transactions but several FAR cost principles state the acquisition cost to the buyer cannot exceed the costs to the seller. If the assets are new, the cost is whatever the seller paid. If the assets are used, the cost is the sellers acquisition cost less the accumulated depreciation of the seller.

Business combination. A business combination occurs if a corporation and one or more incorporated or nonincorporated businesses come together under common control generally to form a single organization and the newly formed organization carries on the activities of the previously separate entities. Significant problems have emerged in contract costing from the practice of "stepping-up" the book value of assets of an acquired company which enable contractors to recapture purchase costs through increased depreciation expenses. The key elements of acquisition costs are (1) purchase price of assets acquired (2) FMV of assets and (3) net book value of assets on records of company acquired. Goodwill – the difference between (1) and (2) and the step-up amount – difference between (2) and (3) – constitutes the amount acquiring companies recognize. The step-up amount is capitalized as part of the fixed assets and the goodwill is separately identified as an intangible item. FAR 31.205-49 states amortization of goodwill is an unallowable cost. For the tangible assets there is sometimes an apparent disconnect between what the CAS requires for capitalization valuations and what FAR allows as an allowable depreciation expense. Under changes to CAS in the mid-90's, when the assets of a seller were depreciated and allocable to government contracts in the previous year, the asset value of the assets acquired was limited to the net book value of the assets at the time of the transaction. However, if those assets were not allocable to government contracts in the previous year, then the asset values were not to exceed the FVM of the assets (which in most cases is higher then net book value). However, FAR 31.205-52 disallows costs associated with a write-up of assets after a business combination so the depreciation costs associated with the capital assets exceeding old net book value would be unallowable.

Lease. Though CAS 404 is silent on treatment of assets acquired by lease, the prefatory comments to the standard state all assets, when appropriate, should be capitalized "even when the purchase transaction is in the form of a lease agreement." Acquisition of assets on the basis of a capital lease should be treated as a purchased asset while assets acquired by an operating lease (both leases addressed in Statement of Financial Accounting No. 13) should be subject to FAR cost principles dealing with lease and rental costs. It should be noted that even if a lease complies with SFAS No. 13 that does not necessarily result in acceptable contract costs. For example, if a capital lease is amortized over a period that does not meet useful life requirements of CAS 409 the resulting depreciation costs may not be allowed.

Special Issues

♦ Costs Incurred During Service Life

Certain costs are incurred to keep the assets in expected operating conditions while other costs are intended to extend the assets' useful life or capacity or to increase its productivity or operational efficiency. The first category of costs are generally referred to as repairs and maintenance while the later are variously referred to as asset alterations, additions to existing assets, replacement or betterments and improvements (we will use the latter term). Theoretically, repairs and maintenance costs are not expected to extend the service life or productivity (in practice they often do) so their costs are expensed in the period incurred. The betterments and

improvement costs are capitalized in accordance with CAS 404.

♦ Assets Purchased for a Contract

In its prefatory comments to CAS 404, the Board acknowledged that sometimes contractors acquire assets for which they do not foresee any significant utility after completion of a particular contract. For these "unusual" assets the contractor can expect a relatively short economic service life as compared with their physical potential. The Board pointed out the standard allows use of an economic service life criterion for these types of assets provided the contractor specifies that criterion in its capitalization policy.

♦ Capitalization of Computer Software Costs

Computer software costs fall under two general categories: software to be sold, leased or marketed and software developed or obtained for internal use. The first category is subject to FASB No. 86 while the second is covered by AICPA Statement of Position 98-1. Both documents require the costs be capitalized and amortized and the government takes the position that contractors must comply with these documents. For internally developed software (i.e. used solely for internal needs where there is no substantive plan to market the software externally) the costs are to be capitalized up to the point where the software project is substantially completed and is ready for its intended use. Costs incurred after substantial testing is complete (e.g. maintenance, training) are to be expensed. (*See 3Q07 issue of the DIGEST for more detailed coverage of this topic.*)

♦ Write Down of Impaired Assets

SFAS No. 121 requires that companies review the carrying value of long lived assets whenever events or changes indicate the carrying value of these assets may not be recoverable. Examples of such events include a significant decrease in market value, a change in the way it is used, a legal or regulatory change affecting its value or significant decrease in revenue generated from the asset. If one of these events makes the carrying value of an asset unrecoverable, the company must assess associated future cash flow to determine if the asset is impaired and SFAS requires the company to recognize a loss due to impairment.

The government has taken the position that SFAS No. 121 is not appropriate for government contract costing purposes and FAR 31.205-16(g) makes the write down required for financial reporting purposes unallowable. Whether it is the government refusal to admit an economic event has occurred or fear that timing and amounts of impairment write-downs can be manipulated to increase recovery on government contracts the government refuses to recognize an impairment has occurred until the contractor has disposed of the asset. (*See the 4Q04 issue of the DIGEST for more information.*)

CONGRESS ISSUES FY 2008 DEFENSE AUTHORIZATION BILL

(*Editor's Note. The recently passed FY 08 Defense Authorization bill contains numerous acquisition related provisions, characterized by one senator as "the most far reaching acquisition reform measure approved by Congress in over a decade." We believe the significance of the changes needs to be identified in a little more detail here than we addressed in the last issue of the GCA REPORT.*

Subtitle A – Acquisition Policy and Management

DOD commercial services procurements (Sec 805). Within 180 days, the defense secretary must modify defense acquisition regulations to ensure services that are not offered and sold competitively in substantial quantities in the commercial marketplace but are nonetheless "of a type" offered and sold may be treated as commercial items for purposes of not being subject to the Truth in Negotiations Act. The commercial item status will apply only if the CO determines in writing that the offeror has submitted sufficient information to evaluate through price analysis the reasonableness of the price for such services. To the extent necessary to make that determination the CO may request the offeror submit prices paid for the same or similar commercial items under comparable terms and conditions by both government and commercial customers and if this information is not sufficient to determine price reasonableness other relevant information including labor costs, material costs and overhead rates may be requested. As for using time-and-material and labor hour contracts for commercial services, DOD may use such contracts only (1) for services procured in support of a commercial item (2) for emergency repair services or (3) when the agency head approves a CO's determination that the services are commercial items and are "of a type" commonly offered and sold competitively in substantial quantities in the

commercial marketplace where they are commonly sold to the general public through use of T&M or LH contracts.

Clarifying requirements to submit cost or pricing data on noncommercial mods of commercial items (Sec 814). The threshold for submission of cost or pricing data for noncommercial modifications of commercial items is to be aligned with TINA thresholds (e.g. $650,000) and the calculation of whether the mods exceeds 5 percent of the total value of the item is to be made at contract award. This reference stems from the FY 2005 DOD Authorization Act mandating that cost or pricing data be submitted in procurements involving a commercial item with noncommercial mods totaling more than $0.5 million or more than 5 percent of the total value of the item.

Rules clarifying procurement of commercial items (Sec 815). Requires the defense secretary to determine and notify Congress that the offeror of a major weapons systems to be awarded as a commercial item has submitted sufficient information to allow DOD to evaluate, through price analysis, the reasonableness of the price for the system. It also requires a similar determination by the CO before a subsystem or component may be purchased as a commercial item. To the extent necessary to make this determination the CO may require an offeror to submit prices paid for the same or similar items under comparable terms and conditions by government and commercial customers. If the CO determines that the information is not sufficient to permit a price reasonableness determination, the CO may require other relevant information on labor costs, material costs and overhead rates.

Subtitle C – General Contracting Authorities

Restricting government clauses on commercial contracts (Sec. 817). The undersecretary must develop and implement a plan to minimize the number of government-unique contract clauses used in commercial contracts to those specifically required by law or regulation or that are relevant and necessary to a specific contract.

Extension of Authority to use simplified acquisition procedures for certain commercial items (Sec. 822). The Clinger-Cohen Act authority to use SAP procedures for the purchase of commercial item property and services valued at no more than $5 million is extended for two years until Jan. 2010.

Enhanced competition for task and delivery orders (Sec 843). Competition requirements for task or delivery orders in excess of $5 million has been expanded to include the need for significant evaluation factors and subfactors be disclosed by the agency that will be evaluating bids and providing post-award debriefings. The provision also authorizes bid protests for task and delivery orders valued at $10 million or more. In response to publicity over sole source awards in Iraq, the award of task or delivery orders exceeding $100 million is now prohibited unless the agency head can provide a compelling reason for it.

Greater justification for noncompetitive contracts (Sec 844). Agency heads are required to make available within 14 days (30 days if need is unusual) after award of a non-competitive contract the justification and approval (J&A) documents for the contract. J&A documents need to be available on agency websites and on a government-wide website.

Subtitle H – Other Matters

Information on commercial information technologies (Sec 881). The assistant secretary of defense for networks and information integration is to establish a clearinghouse for identifying, assessing and disseminating knowledge about readily available information technologies – with an emphasis on commercial off-the-shelf technologies – that can support war fighting missions.

Specialty metal domestic nonavailable determinations. Before making a domestic nonavailability determination (DNAD) that would waive the domestic specialty metal restrictions, DOD must publish a notice on FEdBizOpps.gov at least 30 days prior to making such a determination to solicit information from interested parties (e.g. producers of specialty metal products).

Green procurement policy (Sec 888). Within 90 days, the defense secretary is to report to Congress on a plan to increase the use of environmentally friendly products that minimize potential impacts to human health and the environment at all DOD facilities inside and outside the US including direct purchase of products and the purchase of products by facility maintenance contractors. The report is to address the budget impact of implementing a green policy.

Title III Operation and Maintenance

Outsourcing government work will become tougher.

Modification to public-private competition requirements (Sec 322). DOD is required to exclude costs for retirement

benefits and health care from consideration in cost comparison studies related to public-private competitions conducted under OMB Circular A-76. The change is made so that a contractor may not receive an advantage for a proposal that would reduce costs for DOD by not making available to employees retirement and health benefits costing less than those applicable to DOD civilian employees. The provision also requires DOD personnel responsible for determining whether to convert DOD functions to contractor performance to consult with and elicit views of civilian employees who would be affected by the conversion. Such consultations must take place at least monthly while the management efficiency study and proposal are being developed and they may include consultations with union representatives of the affected employees.

Public-private competition at the end of period not required (Sec 323). The requirement for automatic re-competition of work performed by federal employees following an A-76 competition is eliminated. The provision gives DOD managers discretion to conduct a follow-on competition at the end of the period specified in the performance agreement if they determine it is in the best interests of the department.

Guidelines on in-sourcing new and contracted-out functions (Sec 324). The undersecretary of defense for personnel and readiness will be required to devise and implement guidelines to ensure DOD managers have the flexibility to consider using federal civilian employees to perform new functions as well as functions currently being performed by contractors that can be done by DOD civilian employees. Special consideration for using DOD employees will be required when a new requirement is similar to a function previously performed by DOD civilian employees or closely associated with the performance of "inherently governmental functions." Similar consideration is also required when the function (1) was performed by a DOD civilian employee at any time during the previous 10 years (2) is associated with an inherently governmental function (3) has been performed by a contractor on a contract awarded on a noncompetitive basis or (4) in the view of the CO, was poorly performed by the contractor as evidenced by excessive costs or inferior quality during the previous five years.

Restriction on OMB influence over DOD public-private competitions (Sec 325). OMB will be prohibited from directing or requiring the DOD or military services to meet any OMB imposed quotas for public-private competitions. This provision was taken to eliminate OMB efforts to intervene in DOD staffing decisions following a recent memo from OMB complaining the Army had not subjected enough federal employee positions to public-private competition.

Bid protests by federal employees in actions under OMB Circular A-76 (Sec 326). Federal employees affected by contracting out decisions will be able to challenge such decisions through either the agency tender official or a representative chosen by a majority of employees performing the affected function. Further, a representative of affected employees will be allowed to intervene if a private sector competitor commences a protest of a public-private competition.

Public-private competition required before conversion to contractor performance (Sec 328). Requirements imposed by FY 2006 defense authorization act will be applied government-wide to all executive agency functions performed by 10 or more agency civilian employees. Such functions cannot be converted to contractor performance without a public-private competition that creates an agency most efficient organization (MEO) plan, formally compares the costs of public and private sector performance, includes the issuance of a solicitation and determines that the private sector performance would save the lesser of 10 percent of all personnel-related costs in the agency tender or $10 million.

Title X - General Provisions

Improvements in processing security clearances (Sec 1073). In response to recent severe bottlenecks in granting new and extended security clearances, the secretary of defense is to implement in six months a demonstration project that applies new and innovative approaches to improve the processing of requests for security clearances. It is also required to develop a plan and schedule for replacing the current flawed process within one year.

Reauthorization of SBIR (Sec 1076). The provision calls for the reauthorization of the Small Business Innovation Research Program stating it is the sense of Congress that the program has stimulated technological innovation through investments in small business research activities and has transitioned a number of technologies and systems into operational use.

ECONOMIC PRICE ADJUSTMENTS

(*Editor's Note. During this period of high fluctuations in commodity prices and uncertainties in finding qualified employees*

at anticipated costs, contractors are more than ever concerned about being able to recover price increases that were not factored into their bids. The issue is compounded by concerns of whether to include some sort of contingency factor in their bid price which would either make their bid noncompetitive or would simply be disallowed. Consequently, economic price adjustment tools are being considered more and more as desirable tools to minimize these concerns and we have received requests to discuss EPAs. Our research has included a search of various texts as well as an article in the Fall 2002 issue of the Lyman Report (no longer published) written by David Bodenheimer and J. Chris Haile of the law firm Crowell & Moring LLP.)

The following addresses (1) when the EPA clauses should be used (2) typical defects in the clauses and (3) typical arguments the government might put forward to preclude claims for adjustments.

Purpose of the EPA Clauses

In general EPA clauses serve two purposes – to protect the parties from unexpected economic fluctuations beyond the control of the buyer or seller and to eliminate contingencies in the contract price.

Protection from price fluctuations. EPA clauses serve to protect the contractual parties from fluctuations in price and/or cost normally from inflation or deflation that is not predicted at the time the original bargain was struck. In fact, the FAR prohibits use of EPA provisions unless the government determines such a clause is necessary to protect the contractor and government from significant fluctuations in labor or material costs. It is to "preserve the benefit of the bargain" and protect against unanticipated or unpredictable changes which might "render the bargain unduly harsh."

Eliminate contingency pricing. Another purpose is to allow the buyer to negotiate a lower price by removing from contract prices any contingency costs for escalation. In some cases the government has sought to block recovery under an EPA clause claiming the contractor should have included a contingency for price changes. However courts and appeals boards have readily rejected such arguments stating that without an EPA clause contractors would be forced to submit a higher bid to cover unexpected increases in its costs and so by using an EPA clause, the government was assured of not having to pay the contingency.

Defects in EPA Clauses

The clauses often come with complicated language and mathematical formulas that reference complex indices or benchmarks that generate disputes.

Omission of relevant cost index. The inflation index included in an EPA clause must be a reasonably accurate reflection of the contract costs the seller is likely to bear so if the cost index included in a clause does not track the relevant costs to contract performance it would be considered defective. For example, in one case an EPA clause omitted a cost index for aluminum that was the principle material for the contract and as such the cost index was determined to not have a logical relationship with the type of contract costs being measured.

Use of unauthorized index. The FAR authorizes adjustments under for four types of EPA provisions: (1) for standard supplies that have an established catalog or market price (2) for semi-standard supplies for which prices can be reasonably related to the prices or nearly equivalent standard supplies (3) based on actual cost of labor or material or (4) based on indices of labor or material. If these conditions are not met the rogue clause may be considered illegal. For example, DOD established a clause that used a price index of petroleum that reflected average prices of refiners. The court ruled the price index did not represent an established catalog or market price because it did not reflect a specific vendor's price but rather a simple average and further the index did not constitute a cost index because it consisted of average prices, not costs (*BDM Mgt Svcs.,* ASBCA 28003).

Failure to make adjustments to base period. To preserve the original bargain the EPA clause needs to relate back to the original base price negotiated by the parties. In one case the EPA clause was deemed contrary to regulations because it only permitted an adjustment for the first 6 month period to tie back to the level price after which it was subject to changes every six month. The court ruled the index merely measured market trends in separate six month increments rather than comparing changes to the original price (*Craft Machine Works,* ASBCA Bo. 35167).

Failure of the benchmark price or index. Sometimes a benchmark price or index may no longer be a good benchmark when (1) the methodology for calculating an index changes (2) the benchmark is split into two prices (e.g. one price subject to price controls and the other not) or (3) the benchmark price or index ceases to exist. In some cases, the EPA clause itself may address these contingencies (e.g. require parties to negotiate new terms) while if the EPA clause is silent courts have employed different legal theories to reach a common result e.g. reform the clause to produce a reasonable price consistent with the original bargain.

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Typical Government Defenses and Counterclaims

It is not uncommon for the government to attempt to avoid liability by putting forth a variety of claims.

Waiver and Estoppel. The government may assert a waiver or estoppel argument against contractors' claims for flawed EPA clauses but the courts have repeatedly rejected such defenses. In *Beta Systems*, the contractor sought reformation of the contract based upon the legal theories of mutual mistake and violation of the applicable procurement regulation because the EPA clause's index did not accurately track costs of contract performance. The contractor had initially objected to the EPA index but later capitulated and accepted the clause in its contract where the government defended against the claim by asserting the contractor had waived its rights by knowingly accepting the clause. The court sided with the contractor ruling the selected index was defective and hence violated procurement law whether or not the contractor accepted it.

Late contractor claims. In *Bataco Industries* the contractor alleged and the government conceded the contract's EPA clause incorporated the wrong index but still the government asserted the contractor had failed to comply with a provision in the clause that required adjustments be made within a 180-day period, which was exceeded by the contractor. The court sided with the government stating even if the index was flawed the contractor could obtain no relief due to its tardy claim.

Government offsets. Another common defense is for the government to claim offsets to contractor damages stemming from a defective EPA clause to the extent the government has made overpayments under the contract or related contracts. In such a claim in *Barret Refining Corp.* the court ruled that because the government made these payments under an illegal contract the government has a right to recover unauthorized payments in excess of both the fair market value and base contract price.

Conclusion

Careful selection of the benchmark price or index, attention to regulatory requirements and precise drafting of terms should be used by both parties to make sure they are protected against unanticipated cost or price escalations and that the parties' original bargain is preserved.

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