GCA DIGEST

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Knowing Your Cost Principles and Cost Accounting Standards…

COST ACCOUNTING STANDARD 410

(*Editor's Note. We continue our on-going series of exploring relevant cost principles and cost accounting standards. The CAS 410 requirements are normally considered to be sound rules covering allocation of G&A costs so they apply informally to even non-CAS covered contractors. The requirements offer sufficient flexibility to help contractors achieve their pricing objectives. We have used numerous sources but have relied most heavily on Mathew Bender's Accounting for Government Contracts Cost Accounting Standards.*)

CAS 410 provides criteria for allocating general and administrative (G&A) expenses to final cost objectives (FCOs) and guidelines for the types of costs that should be included in the G&A expense pool.

Requirement for Accumulating G&A Expenses

The basic requirement of CAS 410 is that G&A expenses be grouped into a separate indirect cost pool and allocated only to FCOs. For an expense to qualify as G&A, it must be incurred for managing and administering the whole business unit and the appropriate base for those expenses be a cost input base. Those management and administrative costs that can be more directly measured by an allocation base other than a cost input base should be removed from the G&A expense pool. For example, program management, procurement, subcontract management, G&A type expenses incurred for another business unit, etc. should not be accumulated as G&A expenses of the business unit. The standard provides one illustration. The personnel function is divided into two functions: (a) a vice president who establishes personnel policies and overall guidelines and (b) a personnel department handling hiring, testing, etc. The VP is included in the G&A expense pool while the personnel department would be included in other indirect cost pools based on an appropriate beneficial or causal relationship. The following will address some of the specific issues related to which costs to include in the G&A cost pool:

Home Office Expenses. Where an operating business unit also performs home office functions (e.g. pension administration and marketing for the whole company), those expenses must be isolated and treated as home office expenses and not be included in the business unit A's G&A pool. However, once isolated as home office expenses, appropriate amounts of home office costs may then be allocated to the business unit A in question in accordance with CAS 403, Allocating home office expenses (see the 1Q07 edition of the GCA DIGEST). Examples are direct allocations (e.g. insurance plans benefiting only our business unit), proportionate shares of centralized services (e.g. central payments), residual expenses or immaterial amounts of expenses properly considered home office but remain in the businesses unit A's G&A pool for administrative ease. It should be reminded that certain home office expenses may need to be allocated to other indirect expense pools of business unit A. The standard gives an example where home office staff management of manufacturing and engineering functions would be better allocated to manufacturing and engineering overhead pools rather than business unit A's G&A pool.

G&A Expenses Incurred by One Business Unit for Other Segments. Certain G&A activities benefiting some but not all segments may be performed at business unit A e.g. accounting functions for several segments where they need to be allocated to those benefiting segments. A two step process is required: first, those expenses need to be identified and separated from the G&A pool and then, secondly, allocated to the benefiting segments on the basis of a beneficial and causal relationship.

Non-G&A Expenses in the G&A Pool. Many costs normally included in a business unit's G&A pool are not strictly G&A type activities. For example, many expenses such as sales and marketing, contract administration, independent research and development and bid and proposal activities are commonly included in G&A expense pools but are not really G&A activities. CAS 410 permits a contractor to include in the G&A expense pool any costs not satisfying the definition of G&A expenses if the best allocation base is the same base (i.e. cost input) used to allocate real G&A expenses. The standard includes an example of scientific computer operations used to support IR&D rather than

management or administration of the company as a whole is properly included in the G&A expense pool "unless they can be allocated to a business unit objectives on a beneficial or causal relationship which is best measured by a base other than a cost input base representing total activity of a business unit." Another example the standard provides of a cost acceptably included in the G&A pool is selling expenses. In addition, any insignificant amounts of non-G&A expenses may be included in the G&A expense pool.

When auditors would prefer to see a cost not included in the G&A pool (e.g. when a different allocation would result in a lower price to the government) they will look for a better allocation base for certain costs. For example, selling, personnel, purchasing and data processing costs may be singled out as items having a better allocation base such as cost of sales, headcount, purchase orders and input/output devices, respectively, might be put forth as better allocation bases than total cost.

Combined Pool of G&A and Other Expenses. The standard allows for combining the G&A expense pool with other expenses for allocation if certain conditions are met: (1) the allocation base used for the combined pool is appropriate for each and (2) there is the ability to identify the components and total of the G&A pool separately from the other expenses. Contractors may want to be able to separate the two types of costs even though on a practical level, the pools are merged having no individual identity. The standard provides two illustrations.

Allocating G&A Expenses

The CAS Board determined that since the G&A expense pool are those expenses related to the business as a whole, the allocation base should measure or represent the total activity of the business unit during the cost accounting period. A cost input base meets this objective and thus the standard requires a cost input base be used to allocate the G&A expense pool. It should include all significant elements of the cost input, whether allowable or not that represent the total activity of the business unit. Which cost input base best represents this total activity must be determined by the circumstances of each business unit. The standard allows contractors to select one of three cost input bases – total cost input, value-added cost input or single-element cost input. (*Editor's Note. Whether non-CAS covered contractors have more flexibility is a source of confusion. Based on our consulting experience, contractors can be successful in using another base but they should realize auditors will be inclined to reject a base not conforming to one of the three acceptable ones so the contractor should be prepared to put forth significant justifications to overcome initial challenges.*).

Appeals boards ruled early that total activity and total cost input are not the same saying it is a "fallacy" that each dollar expended for materials and subcontracts necessarily bears the same beneficial relationship to incurrence of G&A expenses as labor and overhead do. The cost of each element comprising total activity may or may not "best represent total activity" depending on circumstances. The crucial question is "not what activity elements comprise 'total activity' but what 'best represents total activity' ". The CAS Board in effect recognized this concept by permitting value added and single element input bases. The standard does not establish criteria for choosing the best base. The Board in *Ford Aerospace* stated there were neither statistics nor reliable objective standards in which to make the choice. The following discussion should, hopefully, add some light on these three choices.

♦ Total Cost Input

The CAS Board stated in its preambles that the total cost input base was generally the best measure of total activity for a cost accounting period and states it is "generally acceptable" as an appropriate measure. When total cost input (TCI) does not appear to measure total activity of a business unit, other bases may be considered but a contractor should carefully consider its situation before changing from a total cost input base. (*Editor's Note. In spite of the verbiage in the standard for the acceptability of the total cost input base, we do find in our experience that DCAA frequently challenges the use of a TCI base with professional services firms. Consequently, firms should not assume that a stated preference for TCI will always result in acceptance by the government and firms should be prepared to defend their choice.*) However, the appeals board made clear in the Ford case that under the plain wording of the standard the fact that TCI is acceptable in no way equates to it being "preferable." The appeals board stated explicitly there is no preference for a total cost input base if inclusion of material and subcontract costs produce significant distortions in allocations.

♦ Value-Added Cost Input

The standard defines a value-added cost input base as total cost input less material and subcontract costs. CAS 410 allows use of a value-added cost base when two conditions exist: (1) a significant distortion in allocations result form inclusion of material and subcontract costs in the TCI base and (2) costs other

than direct labor are significant measures of total activity. These situations generally occur when there is a significant distortion in the relationship between the activity in the production of goods and services and the costs of such activity. For example, when the activity of producing these goods and services is similar (e.g. similar productions processes, inclusion of same types of costs such as material, labor, ODCs and indirect costs) but the costs vary significantly a distortion is usually indicated and the contractor should consider using a value added base.

Unfortunately, neither the standard nor government procurement regulations provide guidelines for determining whether a distortion exists so considerable judgment and negotiations with auditors may be needed. DOD (DOD Working Group, 78-21) and DCAA have provided several examples where significant distortions would likely lead to a decision to use a value-added base:

1. Government furnished components. The government furnishes engines for Navy aircraft while the contractor issues subcontracts for engines on commercial aircraft. Since the same general management and administration of the business exists whether or not the customer furnishes the engines, inclusion of total cost input would distort the results and it would likely be best to exclude material and subcontract costs (the standard does not permit exclusion of engine costs only).

2. Precious metals. Products with similar configurations where the only difference is one is fabricated with gold while others use sheet metal, there would likely be a distortion by applying G&A to the dollar value of the materials. However, if more general management and administration is related to greater materials costs (e.g. more purchasing and accounting effort) then total cost input may be appropriate.

3. Disproportionate material and subcontract content. The existence of a wide range of material and subcontract content may signal the precondition for distortion. For example, if the material and subcontract content ranges from 20-70 percent of contract costs distortion is a strong possibility while a more narrow range of 30-50 percent may not.

4. Drop Shipments. Drop shipments of large subcontracts where no supervision is needed may clearly be different than arrangements where the prime contract must provide close supervision and participation in its subcontracts. In such cases, the drop shipments generally do not bear the same relationship to G&A expenses as other cost elements and a total cost input base may be inappropriate.

A well known case (*Ford*) provided additional insight into factors that may lead to a value added base. Here, the contractor was able to show through detailed analysis (1) the G&A expenses pertain more to the contractor's "in-house" activities than to material and subcontract activity and (2) G&A expenses provided more benefit to labor-intensive development contracts than material intensive production contracts. The contractor showed that 12 percent of the G&A expenses related to material and subcontract activity and that a value added input base would attribute 10 percent of G&A expenses to material and subcontract activity while the total cost input base would attribute 49 percent to material and subcontract activity. In ruling for the appropriateness of the value added base, the board stated that a base other than TCI does not necessarily mean material and subcontract elements of "total activity" are not represented but only means the exclusion of the price paid for the materials and subcontracts result in a better allocation of G&A costs.

So, the following type of instances are when a value added base should be considered: (1) there is a significant mix of products or contracts in the same business unit where some are highly material intensive while others are labor intensive (2) mixtures of products where some use large amounts of material or subcontract costs while others use customer furnished materials and (3) mix of contracts where some have substantial interdivisional transfers while other have none or little material or subcontract costs.

DCAA provides an interesting caution to its auditors to make sure they avoid inappropriately including or excluding elements from the value added base by assuming a broad meaning to terminology or account classifications. For example, some subcontracts labor may be of the "body shop" type where it supplements normal work force and is used interchangeably with regular employees under the same supervision while the costs of other subcontracts may be for items such as interior decorations of aircraft. DCAA states it would be inappropriate to deduct the "body shop" costs from total costs while it would be appropriate to deduct the interior decoration subcontracts even if they were classified as other direct costs rather than subcontracts.

♦ Single-Element Cost Input

A contractor may use a single element cost input base – most commonly direct labor dollars or direct labor hours – when it can demonstrate such a base best

represents the total activity of a business unit. Such a single element may be used when that element is significant and when other measures of activity are less significantly related to total activity. Conversely, a single element may not be used if it is an insignificant part of the total cost. DCAA provides one of two conditions that must be met to use a single element of allocation: (1) there are no other significant cost elements or (2) all the significant cost element vary in the same proportion as the single cost element. Though neither the standard nor procurement regulations provide guidance on what is significant, in *General Dynamics* the board ruled that a single element representing 28%-32% of the total cost of operations was significant to allow its use. If a contractor wants to continue using the single element base, it needs to periodically review the base to ensure it still represents total activity.

A single element base has the advantages it is easy to determine, simple to verify and is an ordinary element of cost. It also is usually stable over a long term and eliminates distortions caused by different amounts of material and subcontracts on final cost objectives. Circumstances when use of a single cost element is appropriate are (1) the cost element represents a significant part of the activity of all FCOs and is representative of the beneficial relationship between cost objectives and G&A activities (2) the activity is intensive with respect to the cost element chosen as the base (3) the contract mix contains significant differences in the nature and types of costs incurred except for the single common cost element or (4) there is a mix of contracts where some provide for a significant amount of long lead time materials.

Interesting Issues

♦ Special Allocations

The standard requires a special allocation of G&A expenses if a particular cost objective would receive a disproportionate allocation of G&A expenses as a result of using the contractor's normal cost input base. Also, the special allocation from the G&A expense pool must be "commensurate with the benefits received." The provisions related to special allocations must be applicable to a *particular* FCO that is an exception to the contractor's normal operation rather than to *classes* of contracts or FCOs. When computing a special allocation, the amounts attributable to the FCO must be removed from the company's G&A pool and allocation base.

The standard provides an illustration. Where the normal production activity of a company is construction of operating facilities for others the company agrees on one new contract to acquire a large group of trucks and other mobile equipment to equip the facility where its other contracts have no such requirements. The cost of the equipment constitutes a significant part of the contract costs so a special allocation may be needed if the parties agree that the contract as a whole receives substantially less benefit from the G&A expense pool than that which would occur if the contract costs were included in the company's total cost input base. DCAA also provides an illustration of a special allocation where a number of contracts have large amounts of subcontract costs and the contractor is seeking a special allocation for these contracts because it does not believe the subcontracts benefit from all of the G&A pool expenses in the same relationship as the other base costs. In this case, a special allocation would not be appropriate because such an arrangement should apply only to a particular contract not a class of contracts.

♦ Interdivisional Transfers

Though the standard dos not specifically address interdivisional transfers, the DCAA Contract Audit Manual provides the only official guidance where it states interdivisional transfers may be excluded from the receiving segment's G&A base only when (1) circumstances warrant the use of a base whose parts do not include material such as either a value added or single element base or (2) the interdivisional transfers are not significant. However, interdivisional transfers are to be included in the G&A base of the segment performing the work that is transferred.

♦ Unallowable Costs in the Base

FAR 31.203(c) states that all items included in an indirect cost base should bear a pro-rata share of indirect costs irrespective of their acceptance as government contract costs. For example, when a cost input base is used to allocate G&A expenses, all items in the base, whether allowable or unallowable, should be included in the base and receive a pro-rata share of G&A costs. CAS 410 follows this requirement.

♦ IR&D and B&P Costs in the Allocation Base

All cost elements not included in the G&A cost pool or a combined pool of G&A and other expenses are part of the G&A input base. This would imply that IR&D and B&P costs that are accumulated in a

separate cost pool must be in included in the G&A allocation base. However, CAS 420 states that IR&D and B&P identified with a specific business unit shall be allocated to all FCOs using the same base as that used to allocate G&A costs. Therefore IR&D/B&P costs need to be allocated on the same basis as G&A expenses (e.g. included in the G&A pool) and not treated as an element of the G&A base.

♦ Disproportionate Ratios of Materials and Subcontracts Among Programs

A DCAA illustration sheds light. The contractor used a single element allocation base (direct labor) because of (1) the existence of disproportionate ratios of materials among various contracts and (2) the unusual aspects of a Navy program where there were drop shipments and directed subcontracts. DCAA cited the contractor for noncompliance with CAS 410 stating it has consistently been the government's position that the existence of disproportionate ratios of material and subcontracts among different contracts does not, in itself, constitute distortion reasoning that production of goods and services requires material, labor, overhead and other direct costs in varying amounts and any occurrence of disproportionate ratios of material and subcontracts merely reflects a variance in activity involved, not a distortion in the relationships between costs and activity. Since the question is whether inclusion of materials and subcontracts in the G&A base will distort allocation of G&A costs, DCAA argues that CAS 410.50(d) makes the appropriate base value added if there was a significant distortion, not single element. The single element would represent total activity only when either (1) there are no other significant costs elements or (2) all significant elements vary in the same proportion as the singe element to the total costs.

Case Study...

CHALLENGING QUESTIONED COSTS RELATED TO AMORITIZATION OF SOFTWARE DEVELOPMENT EXPENSES

(*Editor's Note. The following case study represents a response to a client's request that we provide some "talking points" for them to prepare a response to DCAA questioning amortized costs of developing a software system. We think an edited version of our opinion would provide some interesting insights because it touches on many relevant issues like differing treatments of software costs, ability to submit new incurred cost proposals, challenging DCAA positions, etc.*)

Basic Facts

During the period of 2001-2005, Contractor developed an Enterprise Resource Planning (ERP) system to be used internally with the intention of eventually selling the system to both commercial companies and the government. The system was significantly different than its core professional services work but since it had the capabilities in-house, it devoted resources to develop the system. The Contractor recently sold the system to another commercial company where they retained the rights to use and sell the system to government agencies. The Contractor has been discussing the ERP capabilities with several government agencies where there is apparently definite interest.

The contractor stated that, in conformity with SOP 98, it capitalized the costs and amortized them over several years. During their review of Contractor's 2002-2005 incurred cost proposals, the Defense Contract Audit Agency questioned those costs stating they (1) they were not properly expensed in the periods they were incurred and (2) they were not allocable to government contracts since they benefited only commercial contracts. They are awaiting a response and this paper is intended to provide some ideas for preparing a response.

Comments

In general, when the FAR cost principles are silent on the accounting treatment of specific costs, generally accepted accounting principles (GAAP) will govern how costs will be charged to government contracts. The FAR is silent on software development costs but GAAP certainly is not. Both Statement of Position (SOP) 98 and Financial Accounting Standards Board (FASB) 86 address different types of software development expenses and DCAA has addressed the impact of these on government costing.

♦ Government Benefit

It would seem that DCAA simply does not possess certain facts in asserting there is no benefit to government work. First, as you state, the ERP was from its inception, intended to benefit both commercial and government concerns. Second, subsequent interest by both commercial and government entities demonstrate the system benefits

both commercial firms and the government. If you want to continue challenging the government on their position, I would recommend detailing for the government (1) the nature of the ERP system (2) how it was envisioned to be of benefit to both classes of clients and (3) what current benefits the system now provides. Lastly, as we discuss below, if it is appropriate to consider the expenditures in question as IR&D, the issue of non-benefit disappears because IR&D costs are (1) allocable to all contract work in the same way G&A costs are allocable (see discussion of CAS 410 above) and (2) allowable costs of those contracts in accordance with FAR 31.205-18, IR&D/B&P.

♦ Should the Costs be Amortized or Expensed

DCAA's position that SOP 98 precludes amortizing the costs is incorrect for two reasons. First, SOP requires software costs to be capitalized and then amortized over several accounting periods. The only costs to be expensed are those incurred before the "preliminary project stage" is completed and those incurred after substantial completion of the project (e.g. maintenance, training). Secondly, and most important, SOP does not apply to the costs in question. SOP 98, issued March 4, 1998, provides that certain costs used to develop software for internal use be capitalized and amortized over their economic life. DCAA has addressed the requirements of SOP 98 as they pertain to government contract costs where in its Contract Audit Manual (DCAM) Chapter 7.104-2 it states that SOP 98-1 applies to "Internal-Use Computer Software." The guidance goes on to define the characteristics of "internal use".

- " the software is acquired, internally-developed or modified *solely* to meet the entities internal needs; and
- during the software development or modification, no substantive plan exists or is being developed to market the software externally." (emphasis added).

It appears that neither the condition of "solely" being used for internal needs nor there being no substantive plan to market the software externally applies here. The intention to market the ERP system to various organizations from the beginning undermines the applicability of SOP 98 to the ERP system.

However, FASB 86 is a different story. Financial Accounting Standards Board 86 applies to computer software that is intended to be "sold, leased or marketed to others", which is the case here. The DCAM Chapter 7-106 addresses this and stresses that "before technological feasibility" is established costs of developing the software is expensed as research and development in the period incurred while costs incurred after are capitalized and amortized over the periods revenue is expected to be generated.

♦ Are the Costs Incurred in 2001-2005 IR&D Expenses?

So should the costs of the software be expensed or amortized? Since the cost principles and even the cost accounting standards are silent on this issue, FASB 86 (not SOP 98) should govern. Those costs incurred before "technological feasibility" is established should be expensed while those costs incurred afterward should be amortized. First, expensing those cost would seem to benefit the company. Since a substantial amount of your business in those years were cost type government contracts, a significant amount of the IR&D costs would be allocable to those contracts. Though the direct and indirect costs rates for 2001 are closed, the remaining years are still open. So you are entitled to withdraw the other incurred cost proposals and resubmit revised ones (where IR&D costs would be added) as long as they are not closed out, which is the case here. Though there may continue to be a dispute about whether the amortized costs benefit government contracts, it would be an unreasonable position to deny IR&D costs as not benefiting government contracts since there is a long history of cases substantiating the position that IR&D costs are allocable and allowable to government contracts no matter whether a particular IR&D project is "commercial" or "government."

Second, the costs incurred in developing the ERP system is consistent with the definition of IR&D costs. FAR (see FAR 31.205-18(a)) defines IR&D costs. There are four elements of IR&D, any of which if satisfied would constitute IR&D:

1. Basic Research.
2. Applied Research
3. Development
4. Systems and other concept formulation studies.

Though the definitions of basic research would not apply here, the descriptions of Applied Research and Development would seem to describe the efforts related to the ERP project. In the definition of Applied Research it states "…Applied Research does not include efforts whose principle aim is design, development or test of specific items or services to be considered for sale; these efforts are within the definition of the term 'development' defined below".

The definition of Development is "the systematic use, under whatever name, of scientific and technical knowledge in the design, development, test or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purposes of meeting specific performance requirements or objectives. Development includes the functions of design, engineering, prototyping and engineering testing…" It seems that the effort related to developing the ERP system would fall under the category of Development which would clearly allow for classifying the effort as IR&D.

One word of caution. Recent court cases have raised the issue of whether the research and development costs FASB 86 calls for qualify as IR&D. If not, then the R&D costs would be considered direct expenses of the final cost objective that caused the R&D expenses to be incurred. Several recent cases have established limitations on whether the R&D costs can be considered IR&D. (*Editor's Note. Though we summarized the impact of these cases in our position memo we will spare the reader this section of our report since the cases and issues have been detailed in prior GCA DIGEST issues.*) Suffice is to say the ERP system was never funded by an external source nor was it sold until long after it was developed so there is a good basis to treat the expenses as IR&D.

Conclusion

The fact the ERP system was designed for both commercial and government customers and both types of clients are clearly interested in it, it would seem as if you can demonstrate "benefit" for government contracts. Though SOP 98 is not applicable, FASB 86 does provide for amortized costs and there is no cost principle that makes such costs unallocable. If some of the costs are expensed they would meet the definition of IR&D.

Classic Oldie…

SOME CONSIDERATIONS FOR TEAMING

(Editor's Note. The government's acceptance and even encouragement of offerors to combine resources of several firms in teaming arrangements is greater now than ever. At the time we originally addressed the issue of teaming arrangements they were just becoming popular so we asked one of our colleagues Kathy Szymkovicz, a former contracting officer and source selection official and now a consultant and one of our favorite guest authors, to address this issue. We recently asked her to make any improvements in the article and she said it was fine as is. We asked her at the time to provide some practical insights into how to avoid common problems she is encountering helping contractors form joint ventures as well as some useful pointers on how to help present the team to the government in order to win contracts. This article is not intended to cover all the legal aspects of team arrangements (you will need to work with an experienced attorney) or cost and pricing issues since this was covered in a prior article which we intend to update in a later issue. Kathy is a consultant with The Acquisition Network that provides acquisition assistance and training to federal contractors and can be emailed at TANetwork@hotmail.com or called at 415-861-0556. Kathy is also a member of our "Ask the Experts" panel.)

Common Problems

Whether you are a large business looking for a small business to partner with or a small business looking for a large business to help you grow, teaming can be a tricky business. Knowing some of the pitfalls and making wise decisions up front can avoid many of the catastrophes that happen everyday as a result of teaming gone wrong.

Occasionally teaming disasters are a result of actual intent to mislead the other party. For example, a business might hide an affiliate from its teaming partner, representing itself as small, to have a teaming arrangement for bidding as a small business. When the Small Business Administration investigates and learns the business is large, both members suffer damage to their reputations and pocketbooks. In this situation, the intent to mislead the Government sticks to both firms.

Much more common are simple misunderstandings that occur as the result of differing assumptions by the teaming partners. Too often, short bid periods and unanticipated opportunities that look too good to miss lead firms to jump into teaming arrangements with other firms who are not sufficiently checked out. For example, if your "partner" fails to pay Davis Bacon rates to its employees, the Department of Labor will look at both of you and while only your partner will suffer the monetary consequences imposed by DOL, the damage to your reputation will stick to you both. Or, if your partner has an inadequate accounting system where contract price is based on cost-based build-up the entire proposal may be rejected.

Often the agreements are verbal or if written are quite sketchy. Things such as proposal costs, profit and loss sharing, and management control are often not specifically discussed, with both firms thinking the arrangements are obvious. Unfortunately, what is a logical assumption to one firm may not be to another.

For example:

- Who pays for the preparation of the proposal. This sounds obvious, and often it is the obvious nature of this item that leads to failure to spell out the specific terms. The cost sharing terms for this item should be stated in the written Agreement. More than one small firm has been shocked to receive a substantial five figure bill from a large business that offered to prepare the proposal. The smaller company assumed preparation included covering the costs and never verbalized this assumption for confirmation.
- Profit/Loss sharing and a clear statement of financial responsibility. A small firm may assume limited liability (since the larger firm can more easily incur a greater loss without disastrous consequences) and at the same time expect 50% profit. Obviously the sharing arrangements should be discussed and documented. Many a firm has ended up in court by assuming this type of "obvious" arrangement.
- Responsibility for any space (such as offices or warehouses) or equipment that was leased or purchased prior to submitting the bid. Clarify who will be responsible for lease payments, including if one firm or the other uses the leased location or property.

Presentations to the Government

Once a Teaming Agreement is firmly in place, the presentation of the Team to the Government needs to be considered.

It is vital that the Team is presented as an entity in itself. Presenting two firms who plan to work together may appear to be an attractive arrangement but will not be to the Government. To represent the Team as two firms working together invites Government fears of finger pointing and failure to take responsibility. What the Government wants to see is a single entity comprised of the strengths of the Team members, but with a single management point of contact that can commit the joint venture.

If the firms have worked together in the past, this is an important element to the Government and one that should be emphasized. Once again, the Government is looking for a seamless arrangement with a minimum of impact on contract administration. If you can show that you have accomplished this with your teaming partner on a previous contract, the Government will view the arrangement favorably. Whether you have this past experience or not, it is vital to show your management plan for integrating the Team into a single entity.

Know the Common Rules

Joint ventures are subject to most of the same acquisition rules as individual contractors (e.g. small business classification, past performance criteria, cost allowability, etc.). For example, since a Teaming arrangement is a Joint Venture the gross annual receipts of both firms together must total an amount under the size requirement for the appropriate NAICS in order to qualify as a small business. Or an 8(a) set aside requires that both firms be 8(a) to qualify the Joint Venture as an 8(a).

Knowing the rules gives you the flexibility to create the best arrangement for a particular procurement. An 8(a) firm that wants to work with a small business on an 8(a) set aside would need to show the small business as a subcontractor, meeting the subcontracting rules as they apply to the specific procurement. Or, since past performance information can be considered in various ways under a given award scheme to maximize past performance evaluation the prime team member can choose to portray the past performance of the subordinate member as a full team partner, subcontractor or even employee of another firm.

Most often, it is assumptions and an unfamiliar partner that get the teaming arrangement into trouble. If you want to create a joint venture, do your market planning now, deciding what type of procurements you want to pursue and what type of partner you need. Create the team in advance of a specific opportunity so that your planning is well thought out, thoroughly investigated and not rushed. As in most situations, it is far better to plan than to react.

GOVERNMENT EXPANDS EFFORTS TO ENSURE PRICING IS FAIR AND REASONABLE

(*Editor's Note. In response to media and government reports that prices being paid by the government are excessive there has been a rash of guidelines being produced to ensure prices paid are reasonable. In the midst of this proliferation, it seems that the pendulum is swinging away from basing contract prices on*

methods found in the commercial marketplace and instead returning to the older practices of basing contract prices on cost buildups. We briefly reported on a recent change to the Department of Defense (DOD) pricing guidelines in the last issue of the GCA REPORT and decided it was significant enough to detail here. The guidance we discuss is consistent with several recent actions we discuss below that are attempting to urge contracting officers to obtain "sufficient information" to support determinations that contract prices are "fair and reasonable." The effect is to urge contractors to provide more data, including cost data and even judgmental data, to support these efforts.)

In a June 8 memo to the military services and defense agencies, Director of Defense Procurement and Acquisition Policy Shay Assad transmitted May 31 revisions to the Procedures, Guidance and Instruction (PGI) that DOD uses as guidelines for implementing the FAR and the Defense FAR Supplement. The memo states the PGI changes came in response to several recent reports including a Sept 29, 2006 DOD Inspector General report finding the Air Force negotiating team used "questionable commercial item determinations" that exempted a large government contractor from submitting cost or pricing data on an $860 Million noncompetitive commercial contract for spare parts used on DOD weapons systems. Azad explained the revised PGI coverage:

- Emphasizes the requirement for COs to obtain cost or pricing data when a procurement is above the Truth in Negotiations Act (TINA) threshold – currently $650,000 – and none of the exemptions apply
- Emphasizes COs must obtain "whatever information or data is necessary" to make sure the government's contract prices are "fair and reasonable"
- Includes procedures and guidance pertaining to TINA waivers
- Includes guidance for determining when to perform price, cost and technical analyses.

The revised PGI addresses pricing policy, obtaining cost or pricing data, requiring information other than cost or pricing data and techniques for proposal analysis to ensure price reasonableness.

Pricing Policy (PGI 215.402)

1. When cost or pricing data are not required but the CO does not have sufficient data or information to determine price reasonableness, the memo reminds its readers that FAR 15.402(a)(2) requires offerors to provide whatever information or data COs need in order to determine fair and reasonable prices.

2. Obtaining sufficient data or information from the offeror is particularly critical where an item is determined to be a commercial item as defined in FAR 2.101 and the contract is being awarded on a sole source basis. In this case, the information should include commercial sales information on items sold in similar quantities and if such information is insufficient, cost data to support the proposed price.

3. The memo refers to PGI 215-404-1 for more detailed procedures for obtaining data or information needed to determine fair and reasonable prices.

Obtaining Cost or Pricing Data (PGI 215-403)

1. Even when an exemption to TINA applies, the CO must still determine reasonableness of price. Under this circumstance, the CO may require "information other than cost or pricing data, including information related to prices and cost information that would otherwise be defined as cost or pricing data if certified." This provision definitely leaves the door wide open to base prices on cost buildups even when requirements under TINA are not met.

2. Under commercial item pricing, especially sole source situations, the CO must obtain some form of prior non-government sales data, or the fact the item was sold, leased, licensed or offered for sale.

3. The fact an item is a commercial item does not in itself prohibit the CO from requiring information other than cost or pricing data which may include cost information that would be considered cost or pricing data if certified. This again leaves the door open to seek cost or pricing data even on commercial item acquisitions.

4. An annual report on commercial item exceptions to TINA will be required from all DOD agencies where the contract number (including modification number), contractor name, total dollar amount of exception, brief explanation on the basis for determining the item is commercial and a brief explanation on the specific steps taken to ensure the price was reasonable.

5. Waivers to TINA requirements are discussed. For example:

   a. Under an exceptional case where a contractor refuses to provide cost or pricing data, the CO

may waive the requirement when, for example, a particular company is offering an item that is essential to DOD's mission but is unavailable from other sources. The intent of this waiver is not to relieve companies that normally perform contracts subject to TINA to certify their cost or pricing data but rather those who do not. COs are encouraged to find other sources or alternative products when the waiver is granted. The CO will also provide input into the past performance system noting the offeror's refusal to provide requested information.

b. A partial waiver may be granted when it is possible to clearly identify part of a cost proposal to which a waiver may apply that is distinct from the balance of the proposal.

Requiring Information Other Than Cost or Pricing Data (PGI 215-4033).

The memo reminds readers that when cost or pricing data are not required and there is no other means for the CO to determine that prices are fair and reasonable, FAR 25.403 requires the offeror to submit "information other than cost or pricing data." The PGI clarifies this requirement.

1. The CO must obtain whatever information is necessary when cost or pricing data is not required. COs must obtain appropriate information on the prices at which the same or similar items have been sold previously. Sales data must be comparable to the quantities, capabilities, specification, etc. of the products or services proposed. Sufficient steps must be taken to verify the integrity of the sales data and use of DCMA and DCAA is encouraged.

2. The CO must determine if the prior sales information is sufficient and if not, additional information "shall be obtained, including cost information if necessary."

3. Before relying on prior price paid by the government, the CO must verify and document that sufficient analysis was performed to determine that the prior price itself was fair and reasonable. The memo points out that supplies and services may have been purchased without a price reasonableness analysis where the problem becomes magnified when the CO assumes the prices paid were adequately analyzed. Failure to verify a previous analysis was performed is a recurring problem requiring "extra attention" to verify previous prices were properly analyzed. At a minimum, the CO should discuss the basis for prior prices paid with the contracting organization that previously bought them.

Proposal Analysis (PGI 215.404)

The changes focus on proposal analysis for sole source commercial supplies and services. The memo states FAR 15.402 sets forth the order of preference to be followed if the CO cannot determine price reasonableness without obtaining information or cost data. At a minimum, the CO must obtain information on the price at which the same or similar items were previously sold (often it is previous sales information that formed the basis of determining whether the items were commercial). If previous information is not sufficient then the CO must obtain "information other than cost or pricing data" and then, if necessary, perform a cost analysis.

The memo sets forth the different types of analysis to be conducted on sole source commercial item procurements:

For a *price analysis* in accordance with FAR 15.404-1, the CO must first obtain and document sufficient information to confirm the previous prices paid by the government were based on a thorough price or cost analysis when the CO is relying on other sources than the offeror. For example, it would not be sufficient to use prices from a database paid by another CO without understanding the type of analysis that was performed. This does not necessarily require another analysis but there should be coordination with the other office. When purchasing sole source commercial items the CO must request non-government sales data for quantities comparable to those in the solicitation. In addition, if there have not been any non-government sales, "information other than cost or pricing data" shall be obtained and a price or cost analysis will be performed as required. This might be the case when, for example, the office has determined an item is commercial but the items have only been offered for sale with no prior commercial sales to rely on. Under this circumstance, the memo states the CO must require the offeror to submit whatever cost information is needed to determine price reasonableness.

Cost analysis. When the CO cannot obtain sufficient information to perform a price analysis a cost analysis is required. When the procurement is not subject to TINA and a cost analysis is required, the CO must clearly communicate to the offeror the cost information needed. Under this circumstance the CO should accept the cost data in a format consistent with

the offeror's records. The CO must always consider the need to obtain support from DCMA or DCAA.

Technical analysis. Technical assistance is particularly important when evaluating pricing related to items that are "similar to" items being purchased or commercial items that are "of a type" or require "minor modifications." Technical analysis can assist in pricing these types of items by identifying differences between the items and "similar to" items e.g. evaluating changes that are required to get the "similar to" items to those being solicited.

Other Recent Developments

The government has been particularly busy lately attempting to modify commercial item exemptions and require more circumstances when cost data needs to be submitted by contractors to make determinations of price reasonableness (some of which have been reported in the GCA REPORT).

1. In a March 2 memo to all military services and DOD agencies, contracting officers are instructed to make sure that commercial item procedures for an acquisition exceeding $1 million must document in writing that the goods and services being acquired meet the FAR 2.101 definition of a commercial item. The memo states particular care must be taken to document determinations involving modifications of a type customarily available in the commercial marketplace and items only offered for sale, lease or license to the general public. When there is insufficient market pricing histories additional diligence must be given to ensure prices are fair and reasonable. This memo was considered a significant moderation over a previous DOD Inspector General report calling for more radical changes in the wake of revelations that $3.5 billion in commercial procurements were not supported by documentation justifying a commercial procurement. In that IG report, the IG recommended legislative change that would instruct COs to regard as commercial items only those with "sufficient commercial sales history to the general public" (thereby eliminating the current conditions for commercial item status where there are items "of a type" or items not sold but offered for sale or lease to the general public) and if not meeting this condition, a request for certified cost or pricing data must be made.

2. The DOD March 28 submitted to Congress a legislative proposal to amend the commercial item exemption under the Truth in Negotiations Act to permit the government to obtain certified cost or pricing data when (1) commercial sales data for the procurement of sole source items "is insufficient" to allow a CO to determine the price is fair and reasonable and (2) the contractor business segment has been required to submit certified cost or pricing data in connection with at least one contract award or modification.

3. April 23 the FAR Council proposed changes to the FAR intended to resolve what the rule writers called "confusion" regarding the requirement the CO obtain contractor cost or pricing data to enable the government to determine whether a contract price was fair and reasonable. The intent of the proposed rules are to make clear the CO should be "free to ask for any information necessary." When TINA certification is not required, the proposed rules would allow the CO to obtain more data than required by TINA, which focuses solely on "facts" at the exclusion of "judgmental" data. The proposed rule would amend the definitions at FAR 2.101 to add a new term "data other than certified cost or pricing data" which would mean "any data, including cost or pricing data and judgmental information." The new term would replace the current term "information other than cost or pricing data." The proposal would revise FAR Subpart 15.4 on contract pricing to clarify the need and authority of obtaining a detailed cost estimate, which includes cost or pricing data, when there is no other means to determine fair and reasonableness.

4. May 11, the House website posted the house version of the 2008 defense authorization bill (the Senate and House versions are currently going through the process of being resolved) that includes two significant provisions affecting the ways to determine price reasonableness.

a. Consistent with the DOD IG and others' recommendation, the house bill would require a revision to the FAR that would remove words "of a type" from the definition of commercial services that may be procured under FAR Part 12. Invoking arguments from the IG report, the house bill is based on the notion that only when services are sold in the commercial marketplace does that marketplace ensure fair and reasonable pricing. The bill would provide two options when the services are "similar to commercial services" – (i) allow FAR Part 12 to govern but would allow the CO to request information on prices paid for the same or commercial items under comparable terms and condition and information regarding price or cost that may support the price offered

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such as wages, subcontracts or material costs or (ii) base the procurement on FAR Part 15 procurement rules.

b. Change the TINA commercial item exception to permit the government to obtain certified cost or pricing data when a contract, subcontract or modification for a commercial item is awarded noncompetitively or when the CO determines the commercial sales data is insufficient when a business unit submitted certified cost or pricing data on at least one of its contracts.

RECENT FEDERAL INTEREST RATES

We frequently receive inquiries into both current and past interest rates by contractors preparing forward pricing, incurred costs, claims and termination proposals as well as attempts to recover interest due for various reasons. The interest rate in question is established by the Treasury Department semiannually that is then applied to (1) what a contractor must pay the government under the "Interest" clause at FAR 52.232-17 and (2) what the government must pay a contractor on either a claim decided in its favor under the Contract Disputes Act or payment delays under the Prompt Payment Act. The rate also applies to cost of money calculations under Cost Accounting Standards 414 and 417 as well as FAR 31.205-10 and when a discount factor is used to calculate the present value of future payments such as deferred compensation. When an annual rate is needed, simply average the two semi-annual rates. The source used is prior issues of the GCA REPORT:

	January-June	July-December
2001	6.375 %	5.875 %
2002	5.5	5.25
2003	4.25	3.125
2004	4.00	4.5
2005	4.25	4.5
2006	5.125	5.75
2007	5.25	5.75

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