GCA DIGEST

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RECENT DECISIONS ON TRAVEL AND RELOCATION

(Editor's Note. Though only three parts of the Federal Travel Regulation provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidentals and conditions justifying payment of up to 300% of per diem rates – many contractors choose to follow the FTR either because some contracts call for incorporation of it or auditors and contractors consider it to be the basis for determining "reasonableness". This feature is a continuation of our effort to present new changes or decisions likely to affect contractors' travel and relocation expenses.

A Misunderstanding Does Not Justify First Class Travel

Susan was authorized temporary duty travel to attend a team conference on human resources topics. Travel arrangements were made for August 11 but her travel date was delayed where she assumed one of her team members had changed her travel arrangements. When she arrived at the airport she had no reservation and a first-class ticket for $1,037 was the only available option to reach her destination that day. The government reimbursed her $332 for coach and she appealed to receive the additional $705. The Board denied her request stating first class airfare may be used only (1) in order to accommodate a disability or other special need (2) in the event of exceptional security circumstances (3) in the event no coach or business class accommodations are reasonably available or (4) when required by an agency's mission. The Board stated the third condition was not met because coach or business class were reasonably available because it was "neither reasonable nor prudent to wait until the day of travel" to obtain a reservation or to take no action to ensure necessary travel arrangements were made. The Board considered the fourth condition but concluded a human resources-related visit did not qualify as "required by the agency mission" (*Susan Virgil, CBCA 712-TRAV*).

Costs of Security System in Old House Is Not Reimbursable

Byron was transferred from Indianapolis to Milwaukee but before the transfer he had agreed to pay for a home security system at $39/month for three years. The new owners of his house did not want it and it did not work in Milwaukee so he placed it in storage and sought reimbursement for the three years of service. When the government requested an opinion from the appeals board they found two cases where they were able to come up with a general rule – the costs of purchasing and monitoring a security system are unallowable costs but the costs of disconnecting and connecting an older system from the old to new residence is allowable (*CBCA 644-RELO*).

Travel Home, Not to Another Location, During TDY

Bradley was on a three month temporary duty assignment (TDY) in Washington DC during which he was entitled to take two trips home on non-workdays. His supervisor advised him he could substitute a visit to Las Vegas to meet his wife and another trip to Albany, NY to visit his brother, reasoning the airfare would be $932 cheaper than going home to Idaho. The government refused to pay for the airfare, stating the regulations did not permit Bradley to travel alternate locations. The Appeals Board sided with the government stating FTR 301-11.27 specifies that employees on extended TDY may periodically return *home* or to their official duty station. The Board concluded the regulations do not allow airfare to alternative destinations whether or not Bradley's supervisor approved. The Board did provide that though he was not entitled to travel costs, he was entitled to lodging and per diem incurred in Las Vegas and Albany up to the maximum allowed (*Bradley P. Bugger, CBCA 555-TRAV*).

Reimbursement for "Family" Emergency Visits is Limited to Spouse

Andrew fell seriously ill while on temporary duty in Nevada where his wife, son, two daughters and three sisters-in-law each flew to Las Vegas to be with him. The government rejected his request for family flights, hotels and other costs, repaying only his wife's airfare and some of her miscellaneous costs. In support of his position Andrew cited FTR 301-30.1 and 301-30.2 addressing reimbursements due to family emergencies where "family" is defined as "any member of your immediate family" where the agency may, on a case-

by-case basis expand the definition to include other members of your or your spouse's family. The Board stated that FTR 301-30.4 would be a better citation which allows for transportation costs of a medically necessary attendant in circumstances where an illness or injury occurs on TDY. Here the FTR does not address multiple family members but in referring to a "medically necessary attendant" it implies reimbursement is limited to one person (*Andrew R. Gonzales, CBCA 603-TRAV*).

Cleaning Deposit Not Reimbursed If Apartment Not Left in Good Condition

Henderson was transferred to Washington DC where under his apartment rental agreement he paid a security deposit of $695 which was to be returned if he cleaned the apartment, shampooed carpets, scrubbed and waxed floors and cleaned fixtures and appliances. Upon leaving Henderson was billed $935 for the costs of painting, cleaning, carpet cleaning, damages and maintenance where the $695 deposit would be credited with an additional amount of $240. When Henederson claimed the $935 dollars, the agency refused and the Board rejected Henderson's claim asserting he was entitled to the costs of breaking a lease but only if (1) the employee actually incurred the expenses (2) the terms of the lease provide for payment of the settlement expenses and (3) the expenses cannot be avoided. Here the $935 was not an unavoidable cost but he had incurred the expenses because he had failed to leave the apartment in an acceptable condition (*Lorenzo Henderson, CBCA 651-RELO*).

A Limo is Not Reasonable Even if Convenient

Radhika was traveling to Philadelphia to evaluate medical equipment at two different hospitals before returning home that night. She planned no ground transportation and did not want to rent a car because she was unfamiliar with the area. She ran into a manufacture's rep going to the first hospital and they agreed to split the cost of a shuttle. The shuttle turned out to be a limousine and after her first appointment she took the limo to the second hospital by herself. Her agency refused to reimburse her for the $299 limo cost. The Board noted that with the wealth of information available on the internet, it was extremely easy to determine distances she would need to cover and types of transportation available in an unfamiliar place concluding it would have been reasonable to use a taxi. The Board concluded that a prudent person would not have spent $299 for a limo and stated the cost for a taxi would have been the limit she would have been entitled to (*Radhika Patole, CBCA 770-TRAV*).

Tuition Reimbursement Not Allowed as Miscellaneous Expense

Derek claimed as miscellaneous relocation expenses $1,625 for forfeited tuition for his daughters' private school in Washington DC after the school refused to prorate the tuition. The Board reviewed the definition of miscellaneous expense allowance under FTR 302-16.2 as allowances for such expenses as living quarters, furnishings, appliances and other general types of costs related to relocation of a place of residence and FTR 302-16.1 that included a variety of types of costs such as rugs, draperies, utilities, medical and dental, food locker, institutional care contracts and pet transportation. Relying on a 40 year old opinion (*Jeannette B. Wilbanks, B-162828*) that ruled tuition expenses do not fall within any of the categories of the FTR, the Board upheld the government's rejection of the claim concluding if the GSA wanted to change the FTR to allow tuition reimbursement it had ample time to do so (*Derek M. Siegle, CBCA 643-RELO*).

CASE STUDY: CHALLENGING ASSERTIONS OF EXCESS COMPENSATION

(Editor's Note. As part of our continuing efforts to provide "real life" case studies we encounter in our consulting practice and "Ask the Experts" discussions offered to subscribers, we provide a summary of correspondences we had with one of our subscribers who wanted advice on challenging DCAA's assertion that the President of their company received excess compensation. We thought it would be interesting to recount our communications here since executive compensation is the number one area of audit scrutiny, specific surveys used by the government are identified, differences of unallowable stock options but allowable stock compensation are addressed and potential methods of challenging assertions of unreasonableness are discussed. One cautionary word – our responses were not based on authoritative research nor included in position papers we would prepare for a client but were rather quick opinions our subscriber asked us to provide. We have changed the data to disguise the identity of our subscriber who we will refer to as "Contractor.")

Audit Opinion

In their audit of Contractor's incurred cost proposal, DCAA questioned $340,000 of compensation paid to its CEO, consisting of two elements: (1) $250,000 of stock that DCAA asserted was unallowable stock options and (2) $90,000 of excess salary compensation. Since most of its work consisted of cost type work with the government, the impact of the questioned costs would be huge.

The basis for the stock compensation was Contractor's decision to establish an Employee Stock Ownership Plan (ESOP) that would be capitalized with 100,000 shares of additional stock the company would issue. In order to ensure the percentages of ownership remained the same, the company gave the CEO an amount of shares worth $250,000.

The basis for questioning the $90,000 was the CEO's total salary and bonus of $260,000 (the stock compensation was separate since it is not part of "salaries") while a comparison of salary surveys indicated that the appropriate salary and bonus compensation plus a 10% error factor was $170,000. DCAA used three salary surveys – Watson Wyatt Data Services, Economic Research Institute Executive Compensation Assessor and D. Dietrick Associates – that benchmarked engineering and research services firms, conducted a "sales regression analysis" to compare survey results with Contractor's size and computed an average compensation figure at the 50% median level plus 10% error factor that equaled $170,000.

Advice

The Contractor asked my opinion on how to proceed. After hearing the nature of the stock compensation, I was convinced it was not an unallowable stock option but was allowable "corporate securities" that FAR 31.205-g(d)(1)(ii) provides are allowable forms of payment. I suggested Contractor prepare a letter providing the group who conducted the compensation analysis a clear description of the stock compensation and how it met the requirements set forth in the FAR section identified above. One word of caution: though the stock compensation was not compensation from an ESOP, DCAA may assert that it is which limits such compensation to, I believe, 15-25% of salary plus bonus.

As for excess compensation, I suggested inquiring into how the "sales regression analysis" was conducted. Though DCAA's specialized compensation team located in the Mid-Atlantic regional office is quite experienced in conducting compensation analyses (one of our associates was a member of the team) other teams or individuals conducting compensation reviews throughout the agency are significantly less experienced. We have encountered very "creative" approaches taken to applying a survey that is by necessity not precisely oriented to a particular company (e.g. industry, size, location, etc.) so there may be some inappropriate analyses conducted for benchmarking Contractor's business with survey results. Next, since DCAA has conducted its own survey analysis, the burden falls on Contractor to show why the survey results are not appropriate. Two approaches that come to mind include: (1) provide a better bona fide survey that more closely benchmarks compensation of your particular firm (e.g. more industry specific, size, location, skill levels, etc.) and (2) justify use of a higher percentile on the surveys DCAA used (e.g. demonstrate why your firms' sales, profit, returns on assets/equity/capital, etc. are superior, etc.) so that, for example, a 75% percentile would be more appropriate than using a 50% level that is the default level used by DCAA.

Current Status

Contractor did prepare a letter addressed to DCAA's special compensation team describing the nature of the stock compensation and told us that it appeared as if DCAA agreed that the stock was not unallowable stock options. Contractor also apparently hired a consultant who used a Salary.com compensation survey that provided significantly higher compensation levels, resulting in there being no excess salary if DCAA accepted the results. Examining the survey, it benchmarked companies with 100 employees which was more closely related to Contractor's size than the three surveys used by DCAA. However, the survey purports to examine "Manufacturing – all industries" which does not coincide with Contractor's industry of engineering services. So it is doubtful whether DCAA will substitute its findings with the Salary.com survey results. At best, it may use the survey as a fourth source and take an average of the four surveys.

Contractor also provided us with information that indicated its sales and earnings growth were significantly higher than industry norms. This may be the most productive avenue to take - demonstrate the superior financial performance of Contractor over its peers in order to justify use of a higher percentile (75-90%) and hence a higher salary benchmark. We have not yet received any other word.

DCAA ISSUES NEW AUDIT GUIDELINES

The Defense Contract Audit Agency recently issued several memos to its auditors.

Use of DCAA Form 1 to Suspend or Disapprove Costs on Cost Reimbursable Contracts

When DCAA finds questioned or unsupported costs during an incurred cost audit and the contractor does not concur with its conclusions, DCAA often issues a "Form 1" intended to notify ACOs administering its contracts that billing rates need to be adjusted for the disallowed or unsupported costs until the issue is resolved. Following an in-house review of its practices, DCAA has issued guidance intended to clarify and improve use of Form 1's. Auditors are told not to wait until a final report is issued to send out a Form 1. Rather, auditors are told to issue a DCAA Form 1 to disapprove indirect and direct costs when audit action is complete, the costs are considered unallowable and the contractor does not concur. At locations with ACO-negotiated indirect cost rates, auditors are told to first recommend the ACO promptly adjust applicable billing rates to make sure there is a withhold of questioned or unsupported costs to protect the government's interests. Then a Form 1 should be issued when it is decided after discussions with the ACO that issuance is the best course of action (in lieu of adjusting billing rates) (*07-PPD-031(R*).

Potential Credits Due to Insurance Settlement Agreements

Last year the media was full of stories reporting on lawsuits against some of the largest insurance brokerage firms alleging they had engaged in fraudulent activities by steering unsuspecting clients to insurers with whom the brokers had lucrative payoff agreements while also soliciting rigged bids from insurance providers. The lawsuits were related to numerous types of insurance including workers compensation, employee group benefits, property and casualty and liability. In early 2007 several settlement agreements were reached where in addition to significant fines and penalties the agreements specified that the subject brokers and insurers had to make restitution to its policy holders.

The audit guidance was issued to remind auditors that they should ensure that contractors who obtained insurance through one of the brokers or providers listed below and received payment should reflect any credit to the government in accordance with FAR 31.201-5, Credits. The guidance states auditors should ensure the government receives an equitable share of the amounts received by contractors. The guidance identifies those brokers and insurers who have entered into settlement agreements as Marsh & McLennan, AIG, AON Corporation, Willis North America, ACE Ltd., St. Paul Travelers, Prudential and Met Life (*07-PAC-029(R*).

Time-and-Material (T&M) and Labor Hour (LH) Contracts

New audit guidance was issued to alert auditors of significant new rules affecting T&M and LH contracts (see the second quarter issue of the DIGEST that detailed these changes). The guidance is a good summary of the recent changes, should alert contractors to where they can expect to have added audit scrutiny and ensure they have good documentation available (e.g. make sure hours billed or claimed are backed up by subcontractor and affiliate timekeeping records, labor categories are consistent with contract specified labor categories).

♦ Background

The guidance refers to the February 2007 Federal Acquisition Circular (FAC) 2005-15 amending the FAR Subpart 16.6, T&M and LH Contracts, and identifies the specific sections of the FAR that are changed. FAR 16.601 expanded the definition of "hourly rate" to "the rate(s) prescribed in the contract for payment of labor that meets the labor category qualifications of a labor category specified in the contract that are performed by the contractor, performed by the subcontractors or transferred between divisions, subsidiaries, or affiliates of the contractor under common control." (We will refer to the later category as affiliates.)

FAR 16.601(c)(2)(ii) requires noncommercial contracts awarded without adequate price competition to specify separate fixed hourly rates for each category of labor to be performed by the contractor, subcontractor and affiliates. In addition, a new DFARS 252.216-7002, Alternative A requires competitively awarded DOD T&M/LH contracts to also include separate hourly rates by labor category for the prime contractor, each subcontractor and each affiliate. Blended rates are not permissible on DOD noncommercial contracts.

For non-DOD noncommercial contracts that are competitively awarded FAR 52.216-29 now allows pricing and billing prime subcontract and intercompany rates as either separate rates or blended rates. FAC 2005-15 also revised FAR Part 12.207, Special Requirement for the Acquisition of Commercial Items – Contract Type, to permit use of blended rates on commercial contracts. FAR 52.212-4 addresses the new contract terms and conditions covering commercial T&M and LH contracts.

♦ Guidance

Incurred Cost Audits and Contractor Billing Reviews. The guidance reminds its auditors that during incurred cost audits and reviews of contract billing covering T&M and LH contracts, they are to review contract briefs to ascertain the applicable contract clause. FAR 52.232-7, Payment Under T&M and LH Contract, was revised to allow for payment to be made in accordance with the labor categories specified in the contract that are performed by the contractor, subcontractors and affiliates. Payments of materials now include subcontracts for supplies and incidental services for which there are no labor categories specified in the contract. Payments for materials are subject to FAR 52.216-7, Allowable cost and payment.

Audit procedures to follow include verifying claimed/billed labor rates to the contractual rates by labor category and auditing them for allowability, allocability and reasonableness. Audit procedures covering labor hours should include selectively verifying that claimed or billing prime, subcontract and affiliate labor hours are supported by the applicable timekeeping records or invoices identifying the labor hours worked by labor category specified in the contract. For example, billed subcontract labor should be supported by subcontractor invoices/timekeeping records evidencing the hours expended by labor category. Auditors are also to ensure that the claimed/billed direct labor effort meets the labor category qualification specified in the contract. For non-DOD competitively awarded contracts, the contract may use blended rates. (The term "blended" indicates the rate applies to multiple entities and does not necessarily mean the rates must be based on a weighted calculation.) Auditors still need to reconcile claimed hours to supporting contractor labor records which should include evidence of prime, subcontractor and/or intercompany hours worked by labor category.

Forward Pricing Audits. The guidance states that for forward pricing audits of T&M/LH pricing actions, auditors should selectively verify the subcontract and affiliate direct labor is proposed and supported using separate hourly labor rates and are not intended as part of the prime contractor's labor rates. The subcontract labor rates, separately proposed by the prime contractor, should include the prime's subcontract costs and applied indirect cost and profit. In addition, affiliate labor rates should not include profit of the transferring organization – the exception applies to commercial items where price is market established and presumably does include profit - but may include profit for the prime contractor.

The remaining portion of the guidance summarizes the significant revisions made to sections of the FAR and DFARS for related T&M/LH contracts which are useful to review but too detailed to recount here (07-PPD-023(R).

Contractor Responsibility for Maintaining Pension Data Records

DCAA has issued an alert to its auditors reminding them of the contractor's responsibility to maintain certain pension plan information to comply with CAS 413.50(c) requirements. CAS 413.50(c)(7) describes the record keeping responsibilities as maintaining a record of the portion of subsequent contributions, permitted unfunded accruals, income and benefit payment and expenses that should include a portion of investment gains and losses attributable to the assets of the plan. In the event of a segment closing, pension plan termination or curtailment of benefits, the contractor is to determine the difference between the actuarial accrued liability of the segment and the market value of the assets allocated to the segment. When "systematic deficiencies" exist in maintaining these records, DCAA is to issue a CAS 413 noncompliance report (*07-PAC-021(*R).

Support of Contracting Officers' Cost Realism Analysis

DCAA has issued new guidance, including a new audit program for performing examinations to evaluate proposed costs and indirect rates in support of contracting officers' cost realism analysis. The guidance states the cost realism analysis– an opinion on whether a contractor's proposal on a cost type contract is realistic or significantly understated – should include auditor analysis of specific cost elements (e.g. direct labor rates, indirect rates) of a

proposal and to provide a level of assurance the proposed costs/rates are not significantly understated. The guidance states that Agreed Upon Procedures (AUP) – limited audit steps where steps to be taken are specified beforehand – are not appropriate for their audits since AUP engagements cannot provide opinions, assurances (either positive or negative) or findings based on materiality. The guidance adds that an AUP may be appropriate when there is a limited amount of data provided by the contractor due to the competitive nature of the procurement. When there is a request, the auditor is instructed to obtain a clear understanding of the requestor's needs and discuss with the requester the appropriate level of review and audit.

Highlights of the new Audit Program when conducting an audit of parts of a proposal under a Cost Realism analysis include:

Preliminary Steps

- Considering risk factors, prepare a request assist audit for subcontractor proposed costs.
- Document the understanding of the contractor's internal controls related to accounting and estimating.
- If the contractor is classified as non-major and the evidential material is highly dependent on computerized information systems, either document the audit work performed that supports reliance on the computer-generated evidence or qualify the report.
- If the contract is CAS covered (either full or modified), the auditor needs to consider the contractor's compliance with applicable CAS requirements as part of the proposal evaluation.
- Consider audit leads, key prior audit findings or outstanding CAS noncompliances.
- Consider fraud risk indicators found in the DCAA Contract Audit Manual, Figure 4-7-3.
- Conduct an entrance conference only if the requester permits discussions or communications. If a subcontract, obtain the subcontractor's written consent for release of the audit report or reasons for not authorizing release.

Indirect Rates (Overhead, G&A, Fringe and Cost of Money)

- If agreed-to rates or forward pricing rate agreement (FPRA) exists, verify proper application.
- If they do not exist, compare proposed rates to other sources (e.g. year-to-date experience) and analyze major variances. Determine if the proposed rate structure is the same used to accumulate actual costs and is consistent with disclosed practices.
- Determine that the rates proposed consider known and significant volume changes.
- Ensure the period for the proposed rates coincides with the contractor's fiscal years.

Subcontracts

- Evaluate subcontract or interorganizational transfer costs for possible over or understatement. Determine adequacy of competition.
- For sole source subcontracts where assist audits were not requested, evaluate contractor's cost or price analysis of the subcontract/ interorganizational transfers.
- If contractor's cost or price analysis of a sole source subcontract is inadequate or unavailable and the subcontract cannot be evaluated by other techniques (current or historical data) contact the cognizant audit office of the subcontractor for telephone rate verification.

Direct Labor Rates

- If agreed-to or FPRA rates exist, verify proper application. If they do not, select labor categories with significant costs and compare proposed rates to other sources (e.g. actual/historical costs rates or budget data).

Direct Material Costs

- Evaluate a sample of proposed material items (generally limited to high dollar items).

Other Direct Costs (ODCs)

- Evaluate a sample of proposed ODC items (generally limited to high dollar items) for possible over/understatement. Ensure costs are being proposed in accordance with disclosed practices (e.g. direct costs proposed are not indirect costs)(*07-PSP-030(R*).

Know Your Cost Principles and Cost Accounting Standards…

INTERNAL AND EXTERNAL RESTRUCTURING COSTS

(Editor's Note. Many of our clients and subscribers have been, are or will be going through restructuring arrangements – either from external corporate reorganizations stemming from mergers, acquisitions, divestments, reorganizations with other entities or extensive internal reorganizations in order to bring about significant efficiencies related to cost reductions,

reorganizing product or customer lines, etc. Though we addressed issues related to the corporate reorganization about four years ago we thought it would be a good idea to revisit the issue to explore rules related to incurred restructuring costs for both types of reorganizations.

There is often some confusion that centers around "external reorganizations" versus "internal reorganizations" and when is a cost versus benefit analysis needed to make restructuring costs allowable. Even when that hurdle is surmounted there are a variety of specific FAR cost principles related primarily to facilities and compensation costs as well as cost allocation issues that present additional barriers to recovering these costs. We will present some background information on the regulations, consider the impact of certain cost principles on limiting reimbursement and what auditors will likely be looking at in making a determination of whether the resulting costs are allowable. The source of this article is a variety of texts including a revision to two of Mathew Benders' volumes of "Accounting for Government Contracts" by Lane Anderson and several revisions to the DCAA Contract Audit Manual since our last article four years ago.

Background

Regulations

The government was ambivalent over a rash of corporate reorganizations in the mid nineties. They recognized that lower defense spending required consolidation of defense related industries and this was a good thing if it maintained a strong defense industrial base but they worried that the riches being generated from the reorganizations would add costs to government contracts. Such concerns led to the National Defense Authorization Act of 1997 which provided that restructuring costs stemming from business combinations after September 1996 would be allowable only if (1) audited savings for DOD contracts exceeded the costs by a factor of two to one and (2) the business combination had to result in the "preservation of a critical capability." Regulations implementing this legislation are at DFARS 231.205-70.

The DFARS initially addressed restructuring costs stemming only from business combinations and provided dollar thresholds for when the regulations would apply to DOD contracts and established several steps before restructuring costs could be reimbursed. The limitations the regulation puts on cost recovery apply to only those companies where the restructuring costs are $2.5 million or more of costs allocated to DOD contracts. Costs less than $2.5 are considered immaterial and the limitations of recovery do not apply. The $2.5 million amount refers to all restructuring activities associated with a business combination and is not to be applied project by project or business segment by segment. A decision that the threshold is not met cannot be reversed in the future if conditions change (e.g. business mix differs from projected mix).

In accordance with DFARS 231.205-70 the other conditions for allowability include (1) contracts must be properly novated to the appropriate business entity (2) the contractor must submit a proposal for the planned restructuring projects that includes a breakout of costs by year and cost element showing projected costs and savings and an audit conducted to ensure unallowable costs are excluded *(though too detailed to recount here, see the Defense Contract Audit Agency Manual, Chapter 7-1903 for details on what must be included in the proposal and Chapter 7-1906 how DCAA will audit it)* and (3) the ACO must negotiate an advanced agreement that provides a cost ceiling for allowable restructuring costs. Until these steps are completed, the contractor must segregate the restructuring costs and make sure they are suspended from billings, final cost settlements and overhead rate settlements.

Most of the relatively new rules covering external restructuring costs came about as a result of government and contractor personnel's' concern over how to account for and allocate restructuring costs. The identification of these accounting issues came in the form of an Interpretation of CAS 406, Cost Accounting Period, issued by the CAS Board in the late 90's. Along the way the conditions for incurring restructuring costs were expanded from merely those associated with a business combination – commonly referred to as *external* restructuring to one where significant *internal* restructuring activities occurred which were not part of a business combination but one intended to significantly improve operations. The CAS 406 interpretation deals primarily with the assignment of restructuring costs to cost accounting period where in essence it seeks to clarify whether restructuring costs are to be treated as an expense of the current period or as a deferred charge that is subsequently amortized over future periods. FAR 31.205-52 was added that addressed the allowability of the costs which we will also address below.

Definition.

Restructuring costs result from changes to a contractor's organization in an effort to address a declining business base or to enhance business efficiencies or capabilities. Restructuring constitutes

activities that are either driven by *internal* changes such as downsizing or re-engineering efforts or *external* changes such as acquisitions, mergers, divestments, etc. The costs associated with restructuring are those expected to result from non-routine, nonrecurring or extraordinary events. These types of costs are not "organization costs" within the meaning of FAR 31.05-27 nor do they encompass costs that are normally unallowable as a result of business combinations under FAR 31.205-52. The later represents costs related to the combinations themselves (e.g. legal, consultant, financial type expenses) rather than the restructuring of companies that may occur after the combination.

The definition of restructuring costs that was included in the Interpretation of CAS 406 states restructuring costs "are comprised both of direct and indirect costs associated with contractor restructuring activities taken after a business combination is effected or after a decision is made to execute a significant restructuring event not related to a business combination." The later includes "significant nonrecurring change in its business operations or structure in order to reduce overall cost levels in future periods through work force reductions, elimination of selected operations, functions or activities and/or combination of ongoing operations, including plant relocations." The interpretation specifically excludes those activities related to ongoing routine changes an organization makes to its business operations or organizational structure. Note the reference to inclusion of direct and indirect costs sounds like costs that are accumulated by final cost objectives such as contracts, subcontracts, task orders, etc and like those cost accumulation points, restructuring costs should also be similarly treated as a final cost objective where costs are charged and accumulated by relevant restructuring project number(s). Examples of categories of costs that are restructuring costs are severance pay, early retirement incentives, retraining, employee relocation, lease cancellation, asset dispositions and write-offs and relocation and rearrangement of plant and equipment. However, these costs are not restructuring costs when they do not relate to either a business combination or other significant nonrecurring restructuring decisions.

The following discussions will address the requirements of the changes to CAS 406 which will include both external and internal restructuring costs.

Advance Agreement

An advance agreement must be negotiated whenever (1) a contractor expects to receive increased costs on any contracts that have been novated to it and (2) the costs of internal or external restructuring charges are to be amortized. The purpose of the agreement is to establish upfront the allowability, allocability and assignment of restructuring costs. The advance agreement must address at least the following nine items: (1) identification of covered contracts (current fixed price contracts will not be modified though future modifications to such contracts will be covered) (2) restructuring proposal requirements (3) impact on and updating forward-pricing rates (4) types of allowable restructuring costs (5) amortization of such costs (6) cost of money (7) allocation of restructuring costs (8) changes in cost accounting practices and (9) disclosure requirements. Some of these items are discussed below:

Restructuring Proposal

The contractor must provide the government with a restructuring proposal that provides the basis for a contracting officer's determination of whether the project is expected to result in reduced costs on contracts. Each proposal must include a detailed breakdown of costs by element and project, showing the related estimated restructuring costs and cost reductions on contracts. Each project must have a mutually agreed to cost ceiling that may be revised in a subsequent proposal. Examples of potential restructuring projects include outsourcing to low cost facilities or consolidating purchasing for all operations. As a condition of acceptance of a restructuring proposal the contractor must immediately adjust its forward pricing rates to reflect the impact of the restructuring costs and expected cost reductions. When an agency imposes a "net savings" requirement like DOD does the contractor must submit data specifying (1) restructuring costs by period (2) restructuring savings by period and (3) methods by which the costs will be allocated.

Cost Amortization

Typical categories of restructuring costs (e.g. severance pay, early retirement, lease cancellation, etc) are under normal circumstances recognized as current period costs in the period they were incurred. However, under the Interpretation to CAS 406, restructuring costs are deferred charges and amortized over future periods unless the contracting officer permits the contractor to expense these costs currently. The amortization period should not exceed five years and while a straight line method is normal, other amortization methods are permissible.

Cost of Money

Just because a cost item is treated as a deferred charge does not mean it is considered to be a tangible or intangible asset subject to facilities capital cost of money. The 406 Interpretation does not include cost of money calculations. However, costs incurred under a restructuring project that are necessary to prepare a tangible capital asset for use should be capitalized as part of the tangible capital asset which should include a cost of money factor.

Cost Allocation

The Interpretation of CAS 406 set out the required approach for allocating restructuring costs. However the Interpretation did not say whether multiple or single indirect pools must be used nor how G&A will be affected. Nor does the Interpretation address issues related to continuing costs of discontinued operations that often result from closed, merged or abandoned segments following an internal or external restructuring. However, DCAA has addressed the issue and advocates a case-by-case evaluation to determine appropriate allocation. DCAA guidance states (1) costs associated with segments merged into new single or multiple segments should be allocated to the segments where the work effort or contracts are transferred (2) costs directly associated with a sold segment generally are applicable only to the sold segment and not others and (3) costs associated with an abandoned segment may be allocable to government contracts if the work performed at the abandoned segment benefited government contracts and the government will determine on an individual basis how the costs are to be allocated.

Has an Accounting Practice Changed

Whether CAS covered or not (remember CAS 406 is one of the four standards covering CAS modified covered contracts), contractors often must divulge the impact of an accounting change on its government contracts. Because restructuring costs are incurred under nonrecurring and/or extraordinary circumstances, some commentators argue the costs may be new costs in which case the cost accounting treatment of these costs would be considered the initial adoption of a cost accounting practice and not an accounting change requiring a cost impact analysis. However, to the extent the restructuring activities cause changes to an existing cost accounting practice they are subject to cost impact analyses. The Interpretation refers to this change as "desirable" and not a detriment to the government so the cost impact would normally be measured as the difference between an estimate-to-complete before the restructuring and an estimate- to- complete after.

It should be noted that the issue has not been finalized because the continuing controversy centering on whether an organizational change constitutes an accounting change still persists. It is quite common for contractors involved in restructuring activities to, for example, move work among facilities, centralize support functions that were previously performed at multiple locations or combine separate functions into a single, more cost-effective operation. Many of these changes are considered to be "organizational changes" where contractors have argued they do not constitute accounting changes while many government groups (including DCAA) frequently argue they do represent accounting changes. A well know case *Martin Marietta Corp (ASBCA 38920*) concluded that some of its home office allocation costs that were a result of organizational changes did not represent a change to its cost accounting practice (i.e. techniques used to allocate costs to cost objectives, assignment of costs to cost accounting periods or measurement of cost). Though some agencies have chosen to treat similar situations differently, DOD maintains the criteria about organizational changes should be limited to circumstances in the case – home office organizational changes.

Disclosure

For those contractors required to submit disclosure statements, capitalized restructuring costs may require adopting a new accounting practice in which case it must file a revised Disclosure Statement describing the associated assignment and allocation practices. In addition, other changes to accounting practices following a restructuring must also be made. For those not requiring a Disclosure Statement but who still commit their accounting practices to writing, there is less emphasis on mandatory changes but change may still be indicated.

Allowability

The requirements we have been discussing of course apply only to those restructuring costs that are allowable. As we have seen restructuring costs with less than a $2.5 million impact on government contracts or that can demonstrate a two for one cost savings are allowable but several cost principles and rules of cost allocation set up substantial barriers to full cost recovery.

Organizations costs. FAR 31.205-27 restricts the allowability of these costs by stating merger and acquisition costs and the costs for resisting mergers and acquisitions as well as costs for divesting organizations are unallowable. These costs include such fees for professional services like attorneys, accountants, investment bankers and consultants as well as other expenses such as banking and incorporation fees.

Environmental remediation. Environmental cleanup effort frequently arises in connection with restructuring activities but, in general, DCAA has taken the position that the remediation costs (e.g. soil or water contamination cleanup, asbestos removal, etc.) do not meet the DFARS definition of restructuring costs. Hence, these costs should be excluded from any cost versus savings analysis provided to the government and should be negotiated under a separate agreement.

There are several facility related costs subject to various cost limitations that affect otherwise allowable restructuring costs. For instance (1) *idle facilities* and *idle capacity* under FAR 31.205-17 limits reimbursement to one year unless the ACO agrees to a longer period (2) FAR 31.205-52 restricts *asset write-up* costs such as depreciation, cost of money, etc to costs that would have been incurred had the reorganization not occurred (3) FAR 31.205-16 limits estimates on *gain/loss on asset sales* only to contingencies where there is a ready market where sales are reasonably foreseeable (4) FAR 31.205-31 precludes *plant rearrangement* costs for returning a plant to commercial use unless there is an advance agreement and (5) FAR 31.205-21 restricts *extraordinary maintenance and repairs* to a factor calculated for gain and loss on a sale rather than a normal period cost.

There are also several employee related costs that limit full recovery of otherwise allowable restructuring costs. For example (1) employee termination costs such as *early retirement incentives* and *severance pay* have certain restrictions in accordance with FAR 31.205-6 (2*) retention pay*, especially "golden handcuff" or "golden parachute" arrangements are unallowable in accordance with FAR 31.205-6(l) (3) *relocation* costs have several limitations under FAR 31.205-35 and 46 (4) *recruitment* costs under FAR 31.205-34 has certain restrictions (5) *employee training* costs must pass muster with FAR 31.205-44 and (6) *bonuses* must meet several conditions in FAR 31.205-6 before they are allowable, In addition, any increase in costs resulting from changes in *pension plans* and *post-retirement health benefits* are not considered restructuring costs according to DFARS 231.205-70 and hence are subject to separate review by specialized auditors who will evaluate changes in accordance with FAR 31.205-6 and CAS 412 and 413.

Allocation considerations

DCAA's Contract Audit Manual at Chapter 7-1909 provides guidance to auditors in various cost allocation issues:

1. *Deferral versus expense method.* CAS 406.61 requires restructuring costs to be treated as a deferred charge and amortized over a period in which the benefits are expected to be accrued but not longer than five years. However, subsequent guidance issued by the Director of Defense Procurement on May 20, 1997 provided it would be acceptable for ACOs to agree to allow contractors to expense restructuring costs in one period when the government benefits (the impact on government contracts would be favorable if, for example, the mix of government contracts were such that there were more contracts at a later date than in the period the costs were expensed).

2. *Direct costs.* Direct restructuring costs which benefit a single cost objective should be charged to only that objective. For example, if a contractor's restructuring activities result in the need to recalibrate special test equipment used on only one contract then the recalibration costs should be charged to that one contract.

3. *Indirect costs.* For indirect restructuring costs, they should be allocated in accordance with CAS 403, allocating home office costs, if they are incurred at the home office. If incurred at a business segment level where the benefit is for more than one segment, the costs should be assigned to the home office and allocated, again, according to CAS 403. If the costs are incurred at only one segment and benefit only that segment, they should be allocated only to that one segment in accordance with CAS 418.

Repricing After the Restructuring

The government cannot normally reprice fixed price contracts to take advantage of cost savings to create the restructure. However, DOD has encouraged its contracting officers to consider using downward only pricing clauses for restructuring organizations.
To foster such action, the DOD has added a clause and DFARS 231.205-70(f) has addressed use of this downward adjustment clause for noncompetitive fixed price contracts that are negotiated between the period of announcement of restructuring events and the adjustment of forward pricing rates.

NEW DEVELOPMENTS IN SIMPLIFIED ACQUISITION PROCEDURES

(Editor's Note. We recently reported that the threshold for using simplified acquisition procedures (SAP) for commercial contracts had increased from $5.0 million to $5.5 million. That report triggered some inquiries on just what are these procedures. The inquiries we have received came from contractors both pursuing prime contracts as well as those anticipating awarding subcontracts to their suppliers. In researching recent developments of SAP we found an interesting article written by Michael Golden, Asst. General Counsel with the US Government Accountability Office, in the October 2004 issue of Procurement Law Advisor that addresses both the FAR and some interesting court decisions on the issue of SAP applied to commercial items.).

To streamline the federal procurement process, Congress in 1994 authorized use of simplified acquisition procedures (SAP) for purchases not exceeding $100,000 ($200,000 for contracts awarded and performed outside of the US in support of contingency or humanitarian operations). Such procedures, addressed in FAR Part 13, permit agency officials to expedite the evaluation and selection of offerors and to keep documentation to a minimum. In 1996, Congress expanded the use of SAP to allow government buyers to procure commercial items not exceeding $5 million in order to maximize efficiency and economy while minimizing the burden and administrative costs for government and industry. Under SAP, government buyers may issue combined synopsis and solicitation rather than separate ones and may significantly reduce solicitation notice and response time for receipt of quotations. The requirement is that the CO establish "reasonable deadlines" for submission of responses to a solicitation. Also consequences for late quotations are lessened where the GAO has held that requests for a quotation by a certain day cannot be construed as establishing a firm closing date unless the solicitation expressly states that quotes must by received by that date to receive consideration. In addition, the buyer is not required to establish a formal evaluation plan or competitive range, conduct discussions with vendors or score quotations or offers. Rather a "simple comparative evaluation of offers" is considered proper.

The essence of SAP is that the price must be fair and reasonable. Ordinarily competitive quotes are sufficient to satisfy this obligation. If only one response is received, the CO should include a statement supporting the decision that the price is reasonable (e.g. comparison of price on prior buys, current price lists, catalogs, advertisements). Two other aspects of pricing are that (a) COs are to make every effort to obtain trade and prompt payment discounts and (b) evaluation of quotes should be inclusive of transportation charges from shipping point of the supplier to delivery destination. There is a common misconception that a simplified purchase price must always be awarded to the source offering the lowest price. Rather, the requirement is that the award must be made to the most advantageous quote or price where other factors that are stated in the RFQ are considered. The buyer may also minimize the documentation needed to support its selection decisions. When making an award the agency is not subject to the FAR 15 principles of evaluation criteria but instead need only notify potential offerors of the basis on which the award will be made, which may be on price alone or other factors such as past performance and quality.

Competition is required to "the maximum extent practicable" but need not meet the "full and open competition" requirements under normal acquisitions in order to avoid costly full competition for relatively inexpensive items. Generally soliciting three sources is considered to be sufficient competition where documentation can usually be limited to notes in the contract file. A sole source simplified purchase is permissible when the agency reasonably determines at the time of award that only one source is available to meet its needs. Even if it turns out there are other offerors out there it is still not sufficient to terminate the contract unless it is shown the agency made an unreasonable determination.

Notification to unsuccessful bidders is to be given only if the award is required or requested to be synopsized. If a supplier requests information on a procurement that was based on more factors than price then the agency must provide a brief explanation under post-award debriefing rules found in FAR Part 15. When an agency makes a simplified purchases it will ordinarily do so by use of a purchase order or alternatively, use Form 347, Order for Supplies or Services.

Evaluation

Though discussions and opportunities for revised proposals can be used, SAP does not envision FAR 15 rules of discussions to apply nor provide for submission of revised proposals even though discussion and opportunities for revised proposals

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may occasionally occur. If past performance is an evaluation factor a formal data base is not necessary but an evaluation can be made on such things as the CO's personal knowledge and previous experience with the supplies or services being acquired or customer surveys.

Under streamlined evaluation and solicitation procedures for commercial items the CO is required to select the offer most advantageous to the government based on factors contained in the solicitation and to "fully document" the rationale for the decision. However the FAR does not state what is required to "fully document" the source selection rationale. In *Tiger Enters. Inc. (B-293951)* the GAO concluded an agency must maintain "a record adequate to allow for meaningful review." In *e-Lynxx Corp (B-292761)* where oral presentations were the only technical submissions and slides were the only evidence of the presentation, the agency's evaluation failed to demonstrate what the protester offered during the presentation and hence the GAO ruled there was an insufficient record to allow meaningful review. In another decision the GAO upheld the agency's evaluation of a protester's technical response where the agency had reasonably documented that the protester had not met the RFQ requirements. Even though a simplified acquisition does not require detailed quotations it still remains the vendor's responsibility to submit an adequate written quotation leaving it at risk to have its proposal downgraded or rejected if it is not adequate. If the quote is inadequate, it is not the agency's responsibility to solicit missing information (*NABCO, Inc. B-293027*).

The $5 million threshold (now $5.5 million) applies to commercial items and the agency's determination the items is commercial can be protested. However two recent cases indicate it will be difficult to successfully protest this issue. In *NABCO*, the GAO rejected the protester's contention that the agency did not formally evaluate whether the item was commercial, ruling there was no requirement that the agency either formally evaluate or document the commerciality of the item. Similarly, in *Firearms Training Sys. Inc. (B-292819*), the protester complained that there was insufficient determination whether the item was commercial. The GAO ruled that absent a solicitation provision requiring an investigation or some indication the items were not commercial there was no requirement the agency formally evaluate or document whether the item is in fact commercial.

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