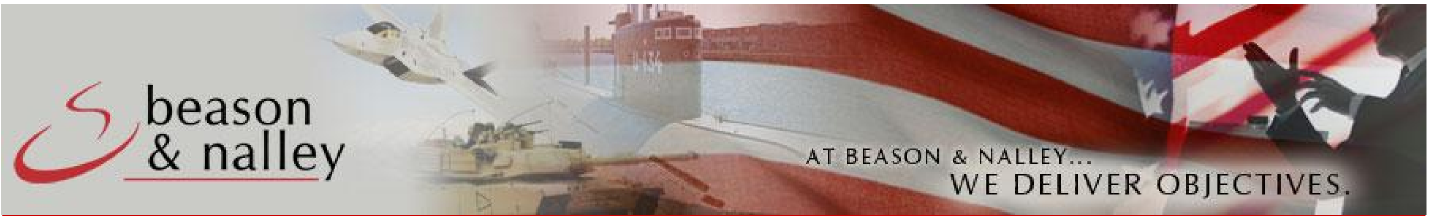


GOVERNMENT CONTRACTS NEWSLETTER AUGUST 2007

IN THIS ISSUE...

Why My Government Contract is Reimbursed Less Than Would Be Allowed by the Typical FAR (Federal Acquisition Regulations)?

More than one government contractor has had the unfortunate experience of rejected billings in spite of the billing having been prepared in strict compliance with the FAR.

There are two possible explanations, hopefully an “accidental rejection” which will require some follow-up inquiries and a resubmission, but more likely, the FAR compliant billing was not in accordance with the specific contractual terms.

Perhaps the most common cause are cost reimbursable line items (CLINs) which state that only direct costs will be reimbursed while stating that overhead, material handling, G&A and fee/profit will not be reimbursed. Assuming a hypothetical reimbursable purchase of a $100 for a widget and otherwise allocable material handling (5%) and G&A (10%), the contractor is left to absorb $15.50 for the allocable, but unbillable indirect costs.

Another contract specific limitation maybe ceiling rates (overhead and/or G&A) which happen to be less than the actual rates used for interim billings. In this case, a system generated billing will need to be adjusted to reduce the billing to match the ceiling rates.

Finally, there are billing reductions which are a matter of a contracting officer’s more conservative interpretation of a FAR clause. Sometimes these become “unwritten rules” within a specific contracting organization; an example being a civilian agency whose unwritten rule was to disallow all food and refreshment costs for any purpose other than overnight travel.

Arguably the relevant contractual clause would permit more liberal cost recovery; nonetheless the contracting officer(s) had made it clear that certain costs need not be billed. These rarely involve large amounts and applying the theory of “pick your battles,” few contractors actually challenge these disallowances.

All of these scenarios involve the contractor’s absorption of costs which could be allocable and allowable, but for the specific terms and conditions of a specific contract. The point to be made is very simple: know your contract, know your contracting officer/organization and never assume your next contract will match your existing or previous contract(s).

ASBCA CAS Decision on Lockheed F-22 Program: When are “Voluntary” Accounting Changes Acceptable?

The ASBCA has decided that the Government is not due a price adjustment on Lockheed’s F-22 contract, which is covered by the Cost Accounting Standards (CAS), because of a change in cost accounting practices that affected the negotiated price.

The court held that the L-22 re-pricing action was not an “affected contract” subject to a cost impact adjustment under CAS provisions. Such cost impact proposals and potential price adjustments to CAS covered contracts may be required when a contractor changes its cost accounting practices. Further, the court disabled the government’s traditional stance that any voluntary change in cost accounting practice, which results in a cost increase to CAS covered contracts, will be unacceptable.

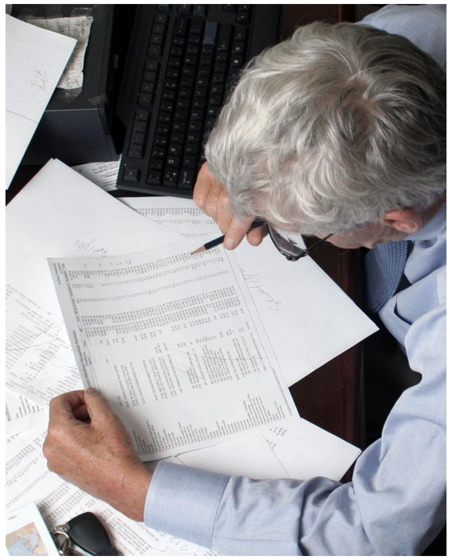
When a company alters its cost accounting practices and those changes are departures from the accounting practices used to estimate and negotiate a price for a CAS covered contract, the contractor must submit a cost impact statement calculation to determine if an increase in cost/price to the Government has occurred. Because the changes in cost accounting practices in this case were considered "voluntary", the Government was permitted to determine if those changes are "desirable…and not detrimental to the interests of the Government". (FAR 30.603-2(b)). Since the changes resulted in cost increases to these contracts, the contracting office had previously determined those changes to be undesirable and detrimental to the Government.

The court ruled that the F-22 contract was not affected by Lockheed's changes in cost accounting practices, because the effects of the cost accounting practice changes were already factored in the estimated and negotiated price. Therefore, there would be no "cost impact" required, and as a result, the decision on whether changes were "desirable" would be a moot point.

The court also noted that the Government procurement command viewed the Lockheed cost accounting changes as desirable during the proposal evaluation process, and actually put pressure on Lockheed to make the changes in question.

Perhaps the most far-reaching part of the court's decision, however, is that the court recognizes that factors other than cost increases should be considered to determine if a voluntary (also referred to as unilateral) change in cost accounting practices is desirable and not detrimental to the Government. Prior to this decision, federal procurement agencies and auditors have usually considered any cost accounting change resulting in an cost increase to CAS covered contracts as detrimental, without looking at other factors.

In determining if such changes are desirable and not detrimental, the court noted that the contracting office must consider "…the extent of active government involvement in, and support for, the decision to institute the changed practices; the degree to which the changed practices increased the accuracy and precision of the cost



measurement, assignment, and/or allocation process; the degree to which the changed practices increased the visibility, manageability, and/or controllability of the costs in question; and any other short or long term benefits to the government."

The court decision provides land-mark verbiage that will, in the future, give contracting offices pause in rejecting unilateral changes in cost accounting practices as not desirable and detrimental, solely on the basis that such changes increase costs to Government CAS covered contracts.

DFARS Interim Rule "Excessive Pass Through Costs"

In our May 2007 Government Contracts Newsletter, we initially reported on this subject. In the meantime, it continues to draw interest, speculation and angst as the public was given the opportunity to provide "public comments" in response to DFARS Case 2006-D057 (published on June 25, 2007 to further implement Section 852 of the National Defense Authorization Act for FY2007).

Just to review, the objective of Section 852 is to ensure that pass-through charges on contracts or subcontracts (or task orders and delivery orders) for DOD are not excessive in relation to the cost of work performed by the relevant contractor. As defined in DFARS 252.215-7004, excessive pass-through costs are (paraphrased) as indirect costs or profit that adds no or negligible value.

Additionally, as stated in the interim rule, the excessive pass-through restrictions will apply to solicitations and contracts, i.e. price proposals and incurred costs/billings (only commercial items and competitive firm-fixed price contracts are excluded from this interim rule). If challenged or if the level of subcontracting exceeds 70% of the total cost of the work to be performed on the contract, the contractor will be required to describe (and by implication to support) the "value added" applicable to the subcontract costs.

In virtually all situations, similar historical costs had been accepted as allocable (FAR 31.201-4) and reasonable (FAR 31.201-3); however, the rule may affect a reasonableness challenge (i.e. "excessive") while not challenging allocability. In other words, allocations remain the same: however, allocable but "excessive" pass through costs will be disallowed.

Equally ominous, is the potential recovery of excessive pass through costs on fixed-price contracts. Operating independently of Defective Pricing ("TINA"), the rule and the associated contract clause provide for a price reduction for the amount of excessive pass-through costs included in the price. Unlike Defective Pricing which has been interpreted and clarified through the assistance of many sources including contract disputes and litigation; excessive pass through costs are definitely, "the new kid on the block". As such, after the fact price reductions will be subject to differing interpretations which could yield inconsistent and cost contract price deductions.

Noting that an interim rule implicates intervening action leading to a final rule, as a defense contractor, one might ask about interim strategies. At best, read and understand the interim rule and as it becomes a reality (e.g. within a solicitation within DFARS Contract Clause 252.215-7003 & -7004), be prepared to measure the pass-through costs and to prepare your description which justifies these costs as "value-added".

Conversely, it is probably not the best strategy to make wholesale changes to your indirect allocation bases as such changes may trigger other life-complicating contractual issues such as a noncompliance with FAR 31.201-4 or Cost Accounting Standards (CAS).

For example, if your G&A base has long since been TCI (total cost input) and accepted as such, changing to value added may do nothing more than trigger a CAS 410 Noncompliance Report. Reconciling the new rule with long standing cost allocations may not be the only conundrum we may encounter in the process of implementing the public law which gave us the limitation on "excessive pass through costs".

Government Contract Training

FAR Part 31 Cost Principles Training Course

The FAR Part 31 cost principles without a doubt have the greatest impact on a government contractor's system for preparing bid proposal estimates and billing costs during contract performance of all procurement regulations. No other regulations governing contract compliance command as much procurement attention and audit oversight as these cost principles. Failure to understand the application of these regulations can cost a government contractor not only lost revenue but also interest and penalties on unallowable billed costs.

Presented by: Beason & Nalley, Inc.

Date: August 28, 2007

Location: Huntsville, AL

Time: 8:30 a.m. – 4:30 p.m.

Instructors: Charlie Broome and Mike Steen

Registration: Go to http://www.beasonnalley.com/default.asp?ID=286 to register or for details, or call Beason & Nalley at 256.533.1720.

Government Contract Accounting Systems Compliance

Brief Synopsis: This course is designed to detail the components of a government contract accounting system and explain how an accounting system helps to ensure your compliance with government contracting rules and regulations.

Presented by: Federal Publications Seminars

Dates: October 30-31, 2007, Washington D.C.

December 11-12, 2007, Las Vegas, NV

Instructors: Darryl Walker, Charlie Broome and Mike Steen
Go to www.fedpubseminars.com and click on the Government Contracts tab or call Beason & Nalley at 256.533.1720.

Specialized Training

Beason & Nalley will develop and provide specialized Government contracts compliance training for client/contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Sandra Baker at sbaker@beasonnalley.com, or at 256.533.1720.

Future Newsletters

Beason & Nalley welcomes any feedback from the readers of this newsletter. We appreciate any suggestions that you may have as to future content, presentation and format, or interesting developments in the procurement community that would be of interest to our readers. Please provide any feedback or suggestions via our email address at dwalker@beasonnalley.com.

Beason & Nalley, Inc. provides accounting, business, financial and consulting services with a focus on serving government contractors. Beason & Nalley goes well beyond the bounds of what one would normally consider to be "typical" services. We provide services such as government contract services, outsourced accounting, audit, tax and Deltek GCS Premier™ and Deltek Costpoint® consulting and more. Our goal is to provide the business owner with options for their financially related administrative needs. Our service list is comprehensive. Contact us:

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