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Defense Contract Audit Agency Tightens Audit and Auditor Independence Practices

2010 Emerging Issues 5225

Defense Contract Audit Agency Tightens Audit and Auditor Independence Practices

By Darrell Oyer

July 28, 2010

SUMMARY: The Defense Contract Audit Agency (DCAA) has been the target of Government Accountability Office (GAO) criticism that has resulted in changes in the way they conduct business and interact with contractors. This Emerging Issues Analysis provides tips on how to work with the new DCAA.

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ARTICLE: The New DCAA (2008 and After)

Government Accountability Office (GAO) Reviews. During 2008 and 2009, the Defense Contract Audit Agency (DCAA) was criticized by the Government Accountability Office (GAO) on many points. According to the GAO, DCAA audits and cost-related assignments selected for review failed to comply with Generally Accepted Government Auditing Standards (GAGAS) or were otherwise deficient. Some of the underlying problems included the compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision.

In 2009, Department of Defense (DOD) officials outlined steps the agency is taking to correct the auditing problems. DCAA reported having executed more than 50 improvement actions addressing DCAA's organizational structure, processes, and culture and rescinded 80 audits due to prior criticism. GAO used this fact to conclude that the rescission of the audits was unprecedented for any audit organization; its conclusion of widespread audit quality problems was irrefutable.

DCAA cited several actions taken in response to the findings in both of the GAO reports. They include (1) reassessing the entire process for performing audits of business systems, as well as the types of opinions provided in the audits; (2) centralizing all quality assurance activities and personnel for performance at DCAA headquarters; (3) restricting auditors from receiving feedback from contractors on draft conclusions on adequacy of accounting and business systems; (4) prohibiting documented system deficiencies from being deleted from audits when the deficiencies are identified during performance of the audit, and (5) completing a bottom-up staffing assessment.

DOD observed that during FY 2009 and 2010, DOD has or will fund 500 new auditor positions and will consider further additions beyond fiscal 2010. DOD disagreed with the suggestion that Congress should consider increasing DCAA independence in several ways, including granting DCAA authorities similar to those given to inspectors general

under the Inspector General Act; having DCAA report to the Deputy Director of Defense, or, depending on the success of reforms, separating the agency from DOD entirely.

One Senator expressed particular outrage over a case that GAO documented in which DCAA revised its initial audit findings regarding a large Iraq reconstruction contractor's accounting system. After the contractor objected to the audit findings on several significant system deficiencies, DCAA backed down from two years of audit work, fraudulently prepared new work orders, and even forged the signature of a prior audit supervisor to deliver an adequate opinion on the contractor's accounting system.

DOD Inspector General (IG). According to the DOD IG, DCAA's authority to state their audits are performed in accordance with Generally Accepted Government Audit Standards (GAGAS) expired August 28, 2008, and an IG review is necessary before DCAA can again state that audits were performed in accordance with GAGAS.

Specific Issues. DCAA's official charter has been changed to be responsive to overall taxpayer protection and only secondarily to provide financial service to procurement officials. DCAA no longer provides meaningful exit conferences; a contractor might talk them out of a finding. DCAA will no longer accept forward pricing rate agreements because they are not considered audited. A change in accounting software (with cost accounting changes) will deem the accounting system inadequate for DCAA purposes. Audits will be delayed to stress quality audits versus quantity of audits.

Working with the new DCAA

If you work with the DCAA, you'll want to consider the following pointers:

(1) Continue to escalate an issue, if appropriate. This may not be as effective as before because supervisors will be reluctant to overrule "well-intended but uninformed" staff auditors for fear of being reported to the IG.

(2) Use DCAA's argument about listening to contractor explanations with the equally invalid argument that when they request data that requires some preparation: *"We can't prepare your workpapers for you because it will impair our independence-do it yourself!"*

(3) Write a position paper on DCAA issues for presentation to the Contracting Officer. These people need help in "overruling" an auditor. They don't have the resources (time or talent) to research issues and document their files. Help them out. Prepare a detailed position paper with citations to regulations and decisions for their files.

(4) Insist that the Contracting Officer ask for advice from his/her legal counsel. When the DCAA position is so far off base, the legal opinion can be used by the Contacting Officer to reject the DCAA finding.

(5) Use the 44-cent appeal. It is not practical to hire an attorney for an amount of less than $200,000. Regulatory guidance exists on preparing your own appeal. A small company did this and when the agency attorney found out a case was docketed, the agency immediately begged out of the case as premature, and no final decision was issued. A year later the contractor received his rate letter with no disallowance of the cost.

RELATED LINKS: For more information on audits of contracts and contractors, see
- 1-2 Accounting Govmnt Contracts -- Fed Acquisition Reg § 2.03

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A Lawyer's Primer on "Mark-to-Market" Accounting

2010 Emerging Issues 4861

Closing the Books on Fiscal Year 2009: A Lawyer's Primer on "Mark-to-Market" Accounting

By Shari Helaine Littan

February 18, 2010

SUMMARY: Many lawyers find the term "mark-to-market" somewhat confusing. "Mark-to-market" refers generically to some accounting other than historical cost accounting. Given the importance of applying fair value accounting, (i.e., "market"), appropriately in today's business climate, and the potential for the recognition of losses -- as well as recoveries -- on investments, a primer in the application in accounting rules is beneficial.

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ARTICLE: In his January 13, 2010 remarks to the Financial Crisis Inquiry Commission (FCIC), CEO Lloyd Blankfein described Goldman Sachs as a "mark-to-market" company. Many lawyers find this term somewhat confusing. Given the importance of applying fair value accounting, (i.e., "market"), appropriately in today's business climate and the potential for the recognition of losses -- as well as recoveries - on investments, a primer in the application in accounting rules proves beneficial. For lawyers, it is important to gain an understanding and familiarity with the terminology with applicability to "real world" examples to help minimize their clients' disclosure risk and related regulatory and litigation risk.

What is "Mark-to-Market?"

"Mark-to-market" refers generically to some accounting other than historical cost accounting. Traditional accounting standards developed in an industrial environment and called for the use of historical cost for the recognition of assets on a company's balance sheet. Real estate provides the classic example. Whatever the cost of constructing or purchasing a building, even one such as the Empire State Building in 1929, the owner does not change that historical cost of that asset on its balance sheet, regardless of changes in the fair value of the asset in the marketplace, until the owner actually sells it.

However, as the United States economy shifted over time, reflecting the movement from operating fixed assets to financial assets, the Financial Accounting Standards Board (FASB), the governing body who sets generally accepted accounting principles (US GAAP) in the United States, increasingly moved toward the use of "market" for measurement of certain assets on the balance sheet, reflecting unrealized gains and losses, even without a bona fide sale.

Fundamental Understanding of "Fair Value" Accounting

An example highlights the circumstances which call for "mark-to-market" investment accounting, what professional accountants formally refer as "fair value" accounting.

Consider a financial institution, such as a bank, which makes mortgages to consumers and commercial borrowers. Initially, when the bank makes the loan, (hopefully), n1 it expects the borrowers to repay that mortgage principle, plus interest, over the course of 15 or 30 years. It holds a long-term investment asset.

The bank might sell the security (by management choice or due to liquidity needs) to another entity, such as Freddie Mac or Fannie Mae, who will pool the mortgage with other mortgages and sell a mortgage-backed security, that is, an investment in the pool of mortgages. An investor, typically an institutional investor, can purchase the "mortgage-backed security," an instrument which will entitle the investor to receive selected portions, or cash "streams," of principle and / or interest from the pool. Those securities - the right to receive that stream of cash flow -- can then further be sold or traded to another investor, who makes different assessments of value based on the expected cash flow and various risks: interest rate changes which affect the value of the investment compared to alternatives (interest-rate risk); risk of slow payment, or non-payment or complete default (credit risk); and, the risk that the market will have no interest in buying the security (liquidity risk) such as in very poor economic times.

Investment Accounting

Statement of Accounting Standards No. 115, (now Codified by FASB as Section 320-10-25-1) sets forth the heart of accounting for investments including mortgages and mortgage-backed securities. In that set of standards, US GAAP requires companies to categorize investments into 3 separate buckets, depending on management's intention and financial wherewithal:

Hold to Maturity: HTM applies to "long-view" investments, debt instruments, which the owner, such as the bank that makes the original, traditional mortgage, holds in its portfolio of investments with no intention or compulsion to sell. Because management plans to hold the investment, temporary changes in the market value of the investment are, logically, considered not relevant. The company applies good old-fashioned historical cost, and will not adjust the balance sheet amount, even as the market value of the instrument changes.

Trading Securities - On the other end of the investment classification continuum, if a company intends to sell the security, and turns over its portfolio on a regular basis, it will classify the investment as a trading security. It is this category that Mr. Blankfein likely referred in his comments to the FCIC describing Goldman Sachs as a "mark-to-market" company. The accounting standard, when applied, presumes the investments will likely be sold in very short order. Therefore, each time the company issues a financial statement to investors, investment assets classified as trading securities are "marked" to "market." That is, the balance sheet amount is actually adjusted, using an offset account, called an allowance - so that the investment asset is reported at fair value. Critically, those losses, as well as the gains, are recognized currently on the company's income statement.

Available for Sale Securities - This "intermediate" category represents investments that the company intends to sell, at some point, in accordance with operational and financial decision-making. Just like trading securities, securities categorized as "available for sale" (AFS) are measured at fair value ("marked-to-market") for reporting on the balance sheet. However, unlike trading securities, the offset (keeping the books in balance) is not recognized through current income. Instead, in what some professional accountants deem a "compromise," unrealized gains and losses on AFS securities are recognized through a special category of Shareholders' Equity, "Additional Other Comprehensive Income, or "AOCI." The financial statement reader can see this accumulated, unrealized gain or loss on the AFS portfolio on the Statement of Shareholders' Equity.

By requiring "mark to market" accounting for certain categories of securities, investors in the companies who purchase such securities receive more relevant information than under traditional historical cost. Neal McGarity, Director of Communications for the FASB explains, "Fair Value Accounting increases transparency. No one can

seriously argue that having less information, or misleading information, is good for investors. If a company purchases a piece of property for $1 million and the value of it sinks to $500,000, investors should be informed of the current value of the property as opposed to just the original cost of acquiring it." Overall goals of fair value accounting include providing the market, up-to-date information.

Investment Reclassification

Making appropriate, initial classifications of investments can be critical, because under US GAAP, the investor company cannot readily change investments from one category to another without consequence. (ASC 320-10-35-10). First, to be deemed proper, the standards require some evidentiary support of management's intent with respect to the investment before a classification change. Additionally and critically, reclassification takes place at fair value, i.e. "market." Therefore, classification changes can impact financial results significantly. Nevertheless, the financial crisis and its continuing impact may force management, even reluctantly, to change its initial "intent" with respect to holding certain investments and therefore classification. n2

Indeed, the critical question of how to measure fair value of securities, and therefore the reporting of any "mark-to-market" gain or loss in value, has presented itself acutely during the financial crisis, as investors and their stakeholders (directors, officers, counsel, auditors, regulators, and, importantly, counsel) assess the impact of market conditions.

A Bit of History: Financial Crisis and Fair Value Accounting

The FASB set forth the framework for measuring fair value in Statement of Financial Accounting Standards No. 157 issued in October 2006 (Codified at 802-10-35). Just like the shorthand "mark-to-market" which describes it, SFAS 157 emphasizes that fair value is a "market-based measurement ... determined based on the assumptions that market participants would use in pricing the asset or liability." Early on in the financial crisis, some observers pointed to SFAS 157 as the "cause" of the market distress.

Governmental action in response to the crisis, the Emergency Economic Stabilization Act of 2008, directed the SEC to research and report on whether the fair accounting detrimentally impacted the market, whether rationally or irrationally. In the responsive report, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, the SEC rejected "mark-to-market" as the underlying cause of economic distress, but summarized the debate:

Some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities.

After detailed examination of the issue, the SEC confirmed fair value accounting as conceptually sound, but called for more definition and clarification of the rules and their application. Since 2008, the furor of blaming the financial crisis on accounting methodology has largely dissipated.

In the afterwaves of the financial crisis, the FASB stands by the use of fair value accounting. "Mark to market accounting provides an early warning system to investors and regulators for institutions that are taking on too much risk," reports McGarity. "You can make a strong case that the ongoing banking crisis could have been lessened in its intensity or avoided entirely had comprehensive fair value accounting standards been in place earlier." Such statements not only counter mark-to-market as a cause of the financial crisis, but further deem mark-to-market as a reliable barometer of excessive risk-taking, which otherwise may be hidden as "unaccounted for" losses.

Moreover, use of fair value accounting accords with non-US GAAP, International Financial Accounting Standards (IFRS). As per their announcement, use of fair value accounting and its fundamental concepts were reconfirmed during a January 2010 joint meeting of both the FASB and the International Accounting Standards Board. The respective standard-setters have been working not only to clarify but also to harmonize US GAAP and IFRS fair value accounting.

No question, the financial crisis has brought fair value accounting measurement to the forefront. In closing the books on 2009, US GAAP fair value accounting standards impact key issues pertaining to the financial crisis, including (1) how to measure "fair value" ("market"), particularly for non-traditional securities; (2) when unrealized losses on investments must be recognized for "impairment" even without a sale; and (3) (discussed above) reclassification of investments, such as when management changes its intent with respect to holding an investment to maturity or a mortgage goes into foreclosure.

Marking to Market: Measuring Fair Value

SFAS 157 set forth a 3-level hierarchy for measuring "fair value" based on the reliability of the information used to deduce "market." (ASC 820-10-35). As noted above, this methodology directs the holders to look to an "exchange price" to determine "fair value." Conceptually, the accounting standard is simple: measure fair value at what the security would sell for at market.

Historically, investments, as with other commodities, have been bought and sold on an exchange, a place where buyers and sellers meet. The New York Stock Exchange, with its humble beginnings under a Buttonwood tree in downtown New York City, serves as the paradigm. For the holders of such investment securities, establishing what US GAAP calls "Level 1 fair value" is relatively easy. The investor simply opens a newspaper or, in 2010 more likely checks an online ticker, and find outs what some other investor is willing to pay for the investment.

However, today, sophisticated investors hold many instruments for which there is no formal, ongoing, meeting place for exchange. For such instruments, US GAAP establishes a hierarchy which endorses a "market" approach over a "model" approach, distinguishing "between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) [Level 2 fair value] and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs)[Level 3 fair value]." Simplified, US GAAP directs the holder of an instrument without a regularized market to determine fair value on the basis of "market participant assumptions" before resorting to internal models, a less-favorable manner of determining a "hypothetical" exchange. Some view the standards' application, determining a "hypothetical" exchange, as an uncertain, difficult and risky activity.

Outside the offices of corporate legal and accounting, in the trading area, those with portfolio responsibility likely know or have a good idea of what their securities are worth. What are potential counter-parties, other institutional investors, with knowledge of the relevant facts, willing to pay for the security? Are there enthusiastic portfolio managers who are looking to deal? Will they pay near 100% of the value of the security with a small discount for interest-rate risk? Or, will the continued risk that underwater mortgages will bring foreclosures result in credit discounts of 40% -- 60%?

Importantly, further, as the financial crisis continues to impact markets into 2010, the length of time potential counter-parties have been sitting on their hands, refusing to trade, becomes even more critical to questions of accounting and financial disclosure: are investors still refusing to trade because they believe the lack of liquidity in the market is the result of temporary economic conditions? At what point does "temporary" become an unsupportable conclusion?

Other than Temporary Impairment

On closing the books on 2009, one of the thorniest issues will be application of the 'other than temporary impairment rules' to investment securities, particularly thinly traded floating rate instruments. An investing entity

generally puts off the recognition of losses through the income statement on held-to-maturity and available-for-sale investments until they are sold. However, if unrealized losses on those securities are "other-than-temporary," under the general accounting rules, such losses are recognized through current income.

US GAAP provides a 3-step process to determine "other-than-temporary" impairment. (ASC 320-10-35). First, determine whether the investment is impaired; is fair value less than cost? Second, determine if that impairment is other than temporary. Third, if the impairment is other than temporary, recognize an impairment loss equal to the difference.

In markets still affected by the financial crisis, determination of "other-than-temporary" impairment of investments, particularly those that do not have a regularized marketplace, requires the rigorous analysis of fair value - and more. Not only must the accountants, (along with financial professionals and traders), agree on the expected cash flows and various risks, they must also extend that analysis to future market conditions and how they plan to respond.

In addressing equity securities, the SEC has provided some detailed direction, stating, "numerous factors are to be considered in such an evaluation [of other-than-temporary-impairment] and their relative significance will vary from case -to-case." (Topic 5.M. in the Staff Accounting Bulletin Series entitled *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*) ("Topic 5.M."). Topic 5.M. gives factors to consider in an impairment assessment, including, for example, the length of the time and the extent to which the market value has been less than cost; the financial condition and near-term prospects of the issuer; the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. With respect to non-equity investments, however, the SEC has left standard-setting to the FASB.

In April 2009, responding to the market's demand for more detailed guidance, and, perhaps, an easing of the rules on impairment, the FASB issued FASB Staff Position No**.** FAS 115-2 and FAS 124-2**,** Recognition and Presentation of Other-Than-Temporary Impairments (April 9, 2009). The new rules, applicable to debt securities, focus analysis first to management's intention and ability to hold or sell the security until expected recovery from the impairment. Secondly, the new principles permit different accounting treatment for impairment based on credit risk (currently through income) versus other risks (deferred as part of AOCI). ASC 320-10-35-33. In real life terms, if the debt security holder can indeed "hold on" until the market recovers, then shortfalls in fair value due to a bad market, other investors sitting on the sidelines despite value, (i.e., liquidity risk), may indeed, in accounting terms, be deemed as non-permanent with the day of reckoning, or recognition, put off.

As complex as the assessment of fair value and recoverability becomes, the overall theme coincides with FASB's foundational framework for financial reporting, which specifically defines what may be considered an "asset." At the heart of the accounting rules, simply, is that if it is probable that the cost or carry value of an investment will not be recovered, then it fails the very definition of an asset. Write-off from the balance sheet is appropriate, since such investment no longer exists as a resource.

Corporate Governance: Counsel and Stakeholders

Despite the complexity of applying mark-to-market accounting, the goal of financial reporting remains ever-constant - providing stakeholders and our markets, collectively, the requisite information for beneficial investment decision-making. For counsel, a primer in "mark-to-market" provides a big-picture understanding of a very complex set of accounting rules, a working understanding of which is crucial for carrying out counsel's role at the corporate governance table.

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n1 Some professionals have observed that many troubled assets, such as "sub-prime" mortgages, were made by overriding lending safeguards and controls, resulting in the creation of impaired assets at inception.

n2 A stark example is foreclosure of an "underwater" mortgage, which forces the holder not simply to reclassify the investment, but to take another asset altogether, ownership of the underlying real estate with a lower fair value.

RELATED LINKS: For more information, see

- 1-2 Tax Accounting " 2.02

For more information see

- 1-5 Atty's Handbook of Acct, Auditing and Fin Rep " 5.03

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Shari Helaine Littan, Attorney & CPA, is a translator.

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Additional Ethical Requirements and Considerations for Federal Contractors

2009 Emerging Issues 3390

Darrell J. Oyer on Additional Ethical Requirements and Considerations for Federal Contractors

By Darrell Oyer

February 25, 2009

SUMMARY: This Emerging Issues Analysis explores additional ethical requirements and considerations for Federal contractors. The public perception of corruption in Federal contracting continues. New and proposed laws and new and revised regulations are plentiful. Some promulgations border dangerously on violating individuals Constitutional rights, and many are a clear overreaction to publicity.

PDF LINK: Click Here for Enhanced PDF of Commentary

ARTICLE: With the ample help of Congress, regulation writers for Federal contracts have promulgated more rules and are proposing more revisions to the Federal Acquisition Regulation (FAR) regarding Federal contractor ethics. Congress has passed laws and is considering laws that contain their own version of many of these same proposals. A previously issued rule addressed in another Emerging Issues Analysis (see Darrell J. Oyer on New Ethics Rule for Federal Contractors Imposes Specific Requirements (February 2009)) is relatively mild compared to the new and proposed legislation and finalized and proposed rules.

The stronger versions are an outgrowth of a Department of Justice (DoJ) desire to make sweeping changes to contractor disclosure and cooperation requirements. According to the DoJ the [1980s witnessed significant innovations in the federal procurement system. Many of those reforms, including corporate compliance programs and corporate self-governance, were adopted with industry cooperation, and were later incorporated into evolving regulatory schemes in other business sectors and industries. In fact, the United States Sentencing Guidelines treatment of corporations, adopted in 1991, borrowed heavily from reforms that were first instituted for government contractors in 1986. However, since that time, our governments expectations of its contractors have not kept pace with reforms in self-governance in industries such as banking, securities and healthcare.

Some proposals have already been enacted into law -- for example, provisions for mandatory fraud reporting. One aspect of this law is a requirement for Federal contractors to report fraud or overpayments on a timely basis. The law applies to contracts above $5 million and more than 120 days in duration. The second provision pertains to disclosure of compensation for the top five executives of a contractor. This law applies to contractors with more than $25 million in revenue and more than 80% of their business with the government in the preceding year. This compensation information must be made public. If the information is not already available through reporting requirements of the Securities and Exchange Commission (SEC), additional means will be developed to provide this information to the

public.

The writers of the Federal contract rule have proposed a rule that would add three significant integrity-related provisions to the FAR.

1. Causes for Suspension and Debarment. The causes for debarment or suspension would be modified to add the knowing failure by a contractor to timely disclose (1) an overpayment on a government contract or (2) a violation of federal criminal law in connection with the award or performance of any government contract or subcontract.

2. Mandatory Disclosure. A contractor would be required to notify the applicable Office of the Inspector General (IG) when the contractor has reasonable grounds to believe that a principal, employee, agency, or subcontractor of the contractor has committed a violation of federal criminal law in connection with the award or performance of a contract or subcontract. The contractor would also be required to provide a copy of any such notification to the contracting officer. This is similar to the law described in previous paragraphs of this Emerging Issues Analysis.

3. Mandatory Cooperation. Finally, for businesses other than small businesses, the new contract clause for contracts exceeding $5 million would require full cooperation with any government agencies responsible for audit, investigation, or corrective action.

The proposed rule would change the Federal contracting system from an ethics/compliance model based upon voluntary disclosure to a model based only on specific rules.

The False Claims Act provides a means for contractors to reduce potential liability to double damages by voluntarily disclosing any violation that it detects. The proposed ethics rule basically amends these provisions to make all disclosures mandatory. Thus the voluntary disclosure mechanism is effectively removed from the statute because a contractor is required to disclose. In the future, no disclosure from a contractor could be considered voluntary for purposes of the False Claims Act.

There is also an issue with the term overpayment because it is not defined and could include situations where a contract claim is in dispute. Contractors and the government make payment mistakes and have disputes about the proper allocation and accounting for costs. The term reasonable grounds to believe that a principal, employee, agency, or subcontractor of the contractor has committed a violation of federal criminal law is difficult even for well-seasoned prosecutors and judges to interpret. This revision would require businesspersons with no legal background to make such decisions -- decisions later criticized and leading to fatal consequences to a business.

Senate Bill 2916 would require Federal contractors to notify agency Inspectors General and their contracting officers when they have reasonable grounds to believe that violations of federal criminal law or significant overpayments have taken place in connection with one or more of their contracts or subcontracts.

The term full cooperation is undefined. The provision could be interpreted to (1) require the contractor to disclose attorney-client privileged information, (2) allow government auditors and contracting officers to demand extraordinary disclosures of information as part of contract administration and (3) relinquish any normal protections against self-incrimination. Although this author is not an attorney, I have worked with attorneys on ethics issues for over 25 years. I have been told that a contractor has an obligation to discontinue any wrongdoing as soon as a contractor becomes aware of it. However, there is no obligation to turn yourself in to the authorities (although it may be advisable to do so). My understanding is that this belief is based on constitutional rights regarding self-incrimination. According to most attorneys, reporting the incident is a voluntary act in that the Constitution would not require a contractor to admit wrongdoing (i.e., self-incrimination).

Heretofore, contractors have been permitted to perform internal investigations (generally led by outside attorneys and experts) to determine if potential violations of law have occurred. After the investigation, if the contractor concludes that a violation of law did occur, a contractor could decide if the incident should be reported to the

government. Most contractors would report these incidents but reserved the right to conduct a full review before making any conclusions. Rule changes could lead to the erosion of employees constitutional and legal rights if contractors are pressured not to pay their employees legal fees during investigations, to fire them for not waiving their Fifth Amendment right against self-incrimination, or to take other punitive actions against the employees long before any guilt has been established.

Other proposed legislation termed the Oversight of the Performance and Effectiveness of National Contracting Act of 2008 would (1) ban the award of bonuses or incentive fees to contractors with poor performance ratings, (2) expand the types of information about government contracts to be included on the searchable, publicly accessible online database of Federal contracts and grants (www.USASpending.gov), (3) prohibit the award of contracts or grants to companies purposely organized in an offshore secrecy jurisdiction to avoid Federal tax obligations, and (4) bar the award of contracts to companies that fail to certify their financial reports in accordance with Sarbanes-Oxley requirements.

Senate Bill 2866 would require that no prospective contractor could be awarded a contract unless the agency contracting officer determines the contractor has a satisfactory record of integrity and business ethics, including satisfactory compliance with the law (such as tax, labor, employment), and environmental, antitrust, and consumer protection laws. The bill directs contracting officers making such determinations to consider all relevant credible information, but give the greatest weight to violations of the law that have been adjudicated within the last five years.

This bill would require the General Services Administration to establish a database of information for use by contracting officers regarding the integrity and performance of persons awarded contracts or grants over the past five years, including (1) contracts and grants that were terminated in the past five years due to default, (2) suspensions and debarments, (3) administrative agreements with the Federal Government to resolve suspension and debarment proceedings, (4) final findings by Federal officials that the person has been determined not to be a responsible source under the Office of Federal Procurement Policy Act, and (5) evidence of repeated, pervasive, or significant violations of the law that may indicate an unsatisfactory record of integrity and business ethics.

The bill also would require contracting officers to consider, in descending order of importance, whether there have been convictions of and civil judgments rendered against the prospective contractor for (1) fraud or a criminal offense in connection with obtaining, attempting to obtain, or performing a public, federal, state, or local contract or subcontract; (2) violation of federal or state antitrust law relating to the submission of offers, or (3) commission of embezzlement, theft, forgery, bribery, falsification, or destruction of records, making false statement, tax evasion, or receiving stolen property.

Other legislation would require the Office of Management and Budget and the Treasury Department to provide new guidelines for establishing whether a company has been organized in an offshore secrecy jurisdiction for purposes of avoiding federal tax obligations, and would prohibit executive agencies from awarding contracts or grants to such firms. This provision includes exemptions for contracts awarded for disaster relief assistance and contracts designated as necessary for national security. Foreign subsidiaries of U.S. companies will be treated as U.S. employers for purposes of Social Security and Medicare payroll taxes when the parent company owns at least 50% of the overseas entity. Pub. L. No. 110-245 (2008). Proposed legislation would set that threshold at 80%.

Whats Next Now? The rule writers will likely continue to be faced with Congressional and Executive Branch pressures to do more to prevent, detect and rectify the perceived rampant Federal contract frauds.

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New Ethics Rule for Federal Contractors Imposes Specific Requirements

2009 Emerging Issues 3383

Darrell J. Oyer on New Ethics Rule for Federal Contractors that Imposes Specific Requirements

By Darrell Oyer

February 24, 2009

SUMMARY: This Emerging Issue Analysis discusses a new ethics rule for Federal contractors in response to the publics perception of corruption in Federal contracting. Congress is proposing numerous legislative actions to improve contractor ethics and enforcement of laws, and Government contracting agencies are enacting rules to establish more confidence in the system and to avoid overreactive legislation.

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ARTICLE: More Government Oversight! Fraud and other unethical actions by people involved in Federal contracts are reported almost daily in the newspapers. The Federal Government seeks to prevent such actions and to demonstrate that the government is acting to prevent and punish contractor wrongdoing. New rules, such as this, are often used to further these aims.

New Rule. In late 2007, the Federal Government published a rule requiring most large Federal contractors (1) to adopt a written code of business ethics and conduct, and (2) to implement a program to ensure compliance with that written code. The rule encourages all contractors (large or small) to have a written code of business ethics and conduct and to promote compliance with such a code. This objective is to be accomplished by establishing a training program and an internal control system that (1) are suitable to the size of the company and extent of its involvement in government contracting, (2) facilitate timely discovery and disclosure of improper conduct, and (3) ensure that corrective measures are promptly instituted.

Specifically, the Federal Acquisition Regulation (FAR) [*FAR 3.1002(a)*] requires compliance with the rule for those contracts expected to exceed $5 million and with a performance period of 120 days or more. These new requirements apply to GSA Schedule contracts. Contracts for the acquisition of a commercial item awarded under FAR Part 12 or to be performed entirely outside the United States will be exempted from these requirements.

Code of Ethics. The written code of business ethics and conduct must be established within 30 days after a contract award. The rule provides no guidance on the content of the code, except to require that each employee engaged in performance of the contract must be provided a copy and that the contractor must promote compliance with its code of

business ethics and conduct.

The legislation does not provide much detail on what to cover in a code of ethics and what internal controls are necessary. Thus, practical experience is our only guide. Experience is applicable because if one were new to government contracting, one would conclude that this is a drastic new concept -- ethics in government contracting. Not so. In the 1980s a similar atmosphere resulted in a significant increase in ethics programs and emphasis in day-to-day contracting activities. At that time, defense contractors established a self-governance program called the Defense Industry Initiative to foster compliance with the various aspects of ethics in government contracting.

Written Code of Ethics. Most major Federal contractors developed written codes of ethics at that time. So we have an idea of what to include in such a document. If you must develop a written code of ethics, the following topics should be addressed. The list is long and the details are briefly outlined.

1. Contractor Gratuities to Government Personnel. [FAR 3.2] Contractors are prohibited from offering government personnel anything at less than the fair market value of the item. The prohibited items include sports tickets, food and gifts. Contractors must take steps to assure that employees are not providing gratuities to government personnel.

2. Anti-Trust Activities. [FAR 3.3] Numerous laws preclude these illegal activities. Examples of anti-trust or anticompetitive practices include collusive bidding, follow-the-leader pricing, rotated low bids, collusive price estimating systems and sharing of the business. This is a sensitive subject in a time when some large federal programs require Joint Venture arrangements and teaming agreements that can appear to limit competition.

3. Contingent Fees. [FAR 3.4] A contingent fee, which is prohibited by *10 U.S.C. § 2306(b)* and *41 U.S.C. § 254(a)*, is any commission, percentage, brokerage, or other fee that is contingent upon the success that a person or concern has in securing a government contract. However, if a person or company is a bona fide sales agent (and not merely an agent using improper influence, i.e., bribes and gratuities) this is not prohibited.

4. Contracts with Government Employees. [FAR 31.6] A specific Federal contract may not knowingly be awarded to a government employee or to a business concern or other organization owned or substantially owned or controlled by one or more government employees. This is a rare occurrence, but occasionally a government employee might encourage a prime contractor to award a subcontract to an entity in which that employee has a financial interest.

5. Lobbying payments. [FAR 31.8] A recipient of a Federal contract is prohibited by *31 U.S.C. § 1352* from using appropriated funds to pay any person for influencing or attempting to influence an officer or employee of any agency, a Member of Congress, an officer or employee of Congress or an employee of a member of Congress in connection with any covered federal actions. This law and rule were first promulgated in 1995. The rule writers discovered in 2007 that they forgot to finalize the rule after the interim rule was issued in 1995. The 2007 implementation takes most of the bite out of this rule.

6. Whistleblower Protections. [FAR 31.9] Government contractors shall not discharge, demote or otherwise discriminate against an employee as a reprisal for disclosing information to a member of Congress or an authorized official of an agency or of the Department of Justice, relating to a substantial violation of law related to a contract. This protection is in addition to the fact that as a *qui tam* relator, an employee who has evidence that a contractor has violated the False Claims Act can collect a portion of the governments recovery if the allegation is upheld.

7. Drug-Free Workplace. [*FAR 52.223-6*] For most Federal contracts contractor employees are prohibited from engaging in the unlawful manufacture, distribution, dispensing, possession or use of a controlled substance.

8. Drug-Free Workforce. [National Aeronautics and Space Federal Acquisition Supplement (NFS) 1823.570, as an example] Some Federal contracts require mandatory drug and alcohol testing of certain contractor personnel under various laws, including Public Law 102-195, § 21, *105 Stat. 1616* to 1619. Generally positions requiring a security clearance will also require that the contractor maintain a drug-free workforce.

9. Conflict of Interest. Employees should conduct themselves in a manner that avoids even the appearance of conflict between their personal interests and those of the company. In addition, numerous laws and regulations pertaining to former Federal Government employees and former military personnel impose restrictions on the duties they perform for a company, whether as consultants or employees. Still another version of a conflict of interest occurs when a contractor bids on federal work and the procuring agency hires the same contractor to assist in the evaluation of bids.

10. International Boycotts. [Defense Federal Acquisition Regulation Supplement (DFARS) 225.7601, as an example] In accordance with *10 U.S.C. § 2410i* certain contractors may not enter into a contract with a foreign entity unless that entity has certified that it does not comply with the secondary Arab boycott of Israel.

11. Political Contributions. [*FAR 31.205-22*] Costs associated with (1) attempts to influence the outcomes of any federal, state, or local election, referendum, initiative, or similar procedure, through in-kind or cash contributions, endorsements, publicity, or similar activities and (2) establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections are not reimbursable under Federal contracts.

12. Kickbacks. [*FAR 3.502-2*] The Anti-Kickback Act of 1986 *(41 U.S.C. §§ 5158)* prohibits any person from (1) providing, attempting to provide, or offering to provide any kickback; (2) soliciting, accepting, or attempting to accept any kickback, or (3) including, directly or indirectly, the amount of any kickback in the contract price charged by a subcontractor to a prime contractor or a higher tier subcontractor, or in the contract price charged by a prime contractor to the United States.

13. Unreasonable Restrictions on Subcontractor Sales. [*FAR 3.503-1*] In accordance with *10 U.S.C. § 2402* and *41 U.S.C. § 253* a prime contractor may not unreasonably preclude a subcontractor from making direct sales to the government of any supplies or services made or furnished under a prime contract. This law was enacted in the 1980s because prime contractors prohibited their suppliers from selling parts directly to the Federal Government. Because all such parts had to be purchased from the prime contractor, this permitted the prime contractor to add its costs to the price of the spare part.

Internal Controls. For large businesses, the requirement is to establish an internal control system and an ongoing business ethics and business conduct awareness program within 90 days after contract award. The rule requires that a contractor""s internal control system (1) facilitate timely discovery of improper conduct in connection with government contracts, and (2) ensure corrective measures are promptly instituted and carried out. From a practical standpoint, these are very broad requirements and difficult to put into operation.

The contractor""s internal control system should provide for (1) periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the Contractor""s code of business ethics and conduct

and the special requirements of government contracting; (2) an internal reporting mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports; (3) internal and/or external audits, as appropriate, and (4) disciplinary action for improper conduct. This requirement is to be passed on to subcontractors exceeding $5 million with a performance period of 120 days, except when the subcontract is for the acquisition of a commercial item or is performed entirely outside the United States.

The rule requires that during performance a contractor must prominently display in common work areas all agency fraud hotline posters. The agency posters must be displayed on any website maintained for employees. The contracting officer is to identify any agency fraud hotline posters that must be displayed. The agency fraud hotline poster requirement is waived if the contractor has implemented a business ethics and conduct awareness program, including a reporting mechanism, such as a hotline poster. This requirement must also be observed by subcontractors for those subcontracts exceeding $5 million with a performance period of 120 days, except when the subcontract is for the acquisition of a commercial item or is performed entirely outside the United States. Most major contractors have had their own posters for many years.

Again, many Federal contractors have had internal controls in place for decades. The controls consist primarily of having a means for employees to report incidents of fraud, waste and abuse and periodic reviews of critical portions of the contractors accounting and other systems.

1. Fraud Hotline. Many companies have established hotlines for employees to call to report incidents of potential fraud, waste and abuse. This is a critical aspect of compliance with the new rule. Since the new rule was announced, many more contractors have instituted a fraud hotline for employees to call to report suspected incidents of fraud, waste and abuse.

Company hotlines have proven to be a good idea. One-third of typical calls to a hotline are found to be of no consequence, one-third are found to be a potential management issue rather than fraud, and one-third have some basis for a fraud, waste or abuse investigation *by the company*. When a company has a hotline it can sort out these calls and not involve a government agency (such as an Inspector Generals office) that may have headline objectives rather than mere internal control concerns. Over the years, even an investigation of an initial charge that is proven unfounded can spark further investigations that might eventually turn up a potential issue.

The current hotline concept is based on a company responding to reported incidents. If a company does nothing or conducts a less than satisfactory investigation, the internal controls are not working properly. If a company investigates a complaint and finds wrongdoing, the company has an obligation to cease the wrongdoing. Often companies then decide on a case-by-case basis whether or not to report the incident to the authorities. (A prominent government contract attorney told me 25 years ago that it is not required that a company turn itself in, but it must discontinue the wrongdoing.)

In the past, the authorities tended to accept this process, but presently certain government agencies are pushing for rules or legislation that would require companies who find these problems to turn them over to the authorities immediately without company investigation.

2. Internal Reviews. Various aspects of management systems are of vital concern regarding compliance with contracting laws and regulations. The foremost is a dependable labor recording system. Many billings and prices for government contracts are dependent on accurate timekeeping systems. Companies need to periodically perform labor audits to ensure the system is working. A second subsystem that needs attention is employee expense reporting. Some employee travel expenses and no entertainment expense can be included in billings and prices to the government. Thus, detailed expense reporting by employees is critical. Other systems that require periodic internal control reviews are accounts payable, purchasing, compensation, material management and information systems.

3. Compliance and Discipline. Failure to comply with the standards contained in a Code of Ethics should result in disciplinary action that may include termination, referral for criminal prosecution, and reimbursement to the employer for any losses or damages resulting from the violation. Each employee should be required to read and certify annually that the employee has read the Code of Ethics.

Because the rule contains no specific guidance on the required code of business ethics and conduct or a system of internal controls, no contractor will know if its code or system is sufficient for the purpose of the contract until an issue arises. The rule provides no guidance on whether the government can demand changes to the code. Thus, it can be anticipated that disparate treatment by government officials will occur when assessing contractor codes and internal control systems.

Whats Next? The writers of the Federal contract rule are considering more stringent rules to ferret out fraud, waste and abuse. These would feature mandatory reporting of incidents of suspected fraud, waste and abuse.

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Asset Accounting under Federal Contracts

2009 Emerging Issues 3315

Darrell J. Oyer on Asset Accounting under Federal Contracts

By Darrell Oyer

January 28, 2009

SUMMARY: This Emerging Issues Analysis discusses depreciable asset cost accounting for cost based Federal contracts which involves some misfits with Generally Accepted Accounting Practices. Regulation writers for the Federal contract regulations appear to be concerned about excessive costs for depreciable assets. Thus, unique rules address depreciation, asset impairments, business combinations and fair value accounting.

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ARTICLE: Accounting for the cost of assets involves significant dollars and results in Federal contract cost accounting rules that are designed to protect the government and taxpayer from overpayment of such costs. The perception of what this protection entails generally results in lesser costs being allowed under Federal procurement rules than are required to be recorded for Generally Accepted Accounting Practices (GAAP). This is evident in the recording of depreciation, the accounting for gains and losses on the disposition of assets, costs arising from impairment of assets, and costs recorded as a result of business combinations.

Depreciation. n1 Generally, depreciation cost allowability rules do comport with GAAP. In establishing depreciable costs, the applicable regulation (Federal Acquisition Regulation or FAR) permits a contractor to ignore residual values for tangible personal property if the amount is less than the capitalized cost. The FAR does require that depreciation cost may not significantly reduce the book value of a tangible capital asset below its residual value. The FAR relies on Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, to determine if a lease is a capital or operating lease. Costs incurred under capital leases are computed as though the asset were owned.

At one time the FAR or predecessor regulations tied cost allowability of depreciation to Internal Revenue Service (IRS) depreciation guidelines. During this time the FAR provision on depreciation also required that any depreciation be based on a systematic and rational method of amortization. When the IRS initiated the Accelerated Cost Recovery System (and subsequently Modified Accelerated Cost Recovery System) the Federal contract regulation writers were concerned that economic and political conditions were impacting IRS depreciation policies in a manner that did not necessarily reflect systematic and rational allocation of the cost of assets to accounting periods. The IRS investment tax credit was an issue for government contract costs for many years as well. As a consequence and over time, ties to the IRS rules have been removed from the FAR.

Special rules limit Federal contract costs under sale-leaseback arrangements. Lease costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed if the contractor retained title. In the event a contractor reacquires property involved in a sale and leaseback arrangement, allowable depreciation of reacquired property is based on the net book value of the asset as of the date the contractor originally became a lessee of the property in the sale and leaseback arrangement. Adjustments to this amount are allowed for any allowable gain or loss and any amount of depreciation expense that would have been allowed had the contractor retained title.

Impairment of Assets. FASB 144 requires a write down of the value of assets when changed circumstances occur. However, for Federal contract costs, *allowable depreciation of the impaired assets is limited to the amounts that would have been allowed had the assets not been written down n2* Furthermore, no costs *are allowed for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.).* In other words, asset impairment for financial accounting is ignored for Federal contract cost purposes.

Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets. For the early years of procurement cost regulations (circa 1948 to 1960s), gains and losses on disposition of assets were not recognized for contract cost purposes. It can be assumed that the rationale was that the government should not have to pay for losses resulting from imprudent decisions by Federal contractors in overpaying for assets. Eventually, the regulation writers figured out that because of price escalation, there were more gains than losses on the disposition of assets. Therefore, the regulations were revised to allow the cost of disposition losses and require the sharing of disposition gains in determining contract costs.

Gains and losses on disposition of tangible capital assets are now considered as adjustments of depreciation costs previously recognized. Thus, a gain or loss is the difference between the net amount realized and its undepreciated balance. The gain recognized for contract costing purposes is limited to the difference between the acquisition cost of the asset and its undepreciated balance. In other words, any gain arising from the asset being disposed for more than its purchase price need not be credited to Federal contract costs.

Generally, for Federal contract cost purposes any gains or losses from the sale, retirement or other disposition of depreciable property are included costs in the year in which they occur. The accounting for gains or losses arising from mass or extraordinary sales, retirements or other disposition is considered on a case-by-case basis.

Most importantly, gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs. This aspect of the Federal regulations for contract costs leads to a current controversy that arises when a valuable piece of land with an irrelevant building is sold. The calculation of the gain on this sale is vital because any gain assigned to the building must be shared with the government, but any gain assigned to the land is not to be shared with the government.

For example, assume a piece of property with a book value of $2.5 million is sold for $3.5 million. The new owner demolishes the old building(s) and constructs a new hotel or office building. At first glance the gain is $1.0 million. However, the breakdown of this gain between building and land must be calculated. If the book value of the (undepreciable) land were $1.0 million and the book value of the depreciable building(s) were $1.5 million, then the land had a gain of $2.5 million and the building had a loss of $1.5 million.

Some government officials, who are concerned that a $1.0 million gain to the contractor is simultaneously a $1.5 million loss to the government, do not readily concede this end result. Various schemes have been attempted to recoup this gain from contractors. One is to artificially assign values to the land and building based on a previous real estate tax assessment. Others are more creative and less realistic.

Several years ago a newspaper article was headlined Lockheed Scams U.S. Government. The Armed Services

Board of Contract Appeals (ASBCA) has recently ruled on this alleged scam in Lockheed Martin Corporation (ASBCA No. 54169) and concluded that the distribution of the gain must be realistically based on fair market values in the manner described above. The scam has now been debunked and in actuality is compliant with the FAR.

Asset Valuations Resulting from Business Combinations. n3 Prior to 1990 the FAR had no special cost rules for asset valuation resulting from business combinations (a.k.a., mergers and acquisitions). As a result, several litigations resulted in arguments based on IRS rules and GAAP that were nebulously connected to the applicable Federal contract cost regulations. Ultimately, the Cost Accounting Standards (CAS) and the FAR were revised to provide that *when the purchase method of accounting for a business combination is used allowable depreciation is limited to the total of the amounts that would have been allowed had the combination not taken place.* n4 Thus, asset write-ups n5 required under GAAP do not generate allowable cost under Federal contracts.

The same historical background is pertinent to the accounting for goodwill arising from a business combination. Goodwill is defined in the FAR as occurring *when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair valuesAny costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.* Thus, goodwill recognized under GAAP is not allowed as a cost under Federal contracts.

SFAS 157. Historically, the value of property on balance sheets has been listed in terms of its acquisition cost. For financial statements issued on or after November 15, 2008, companies electing fair value accounting will be able to apply new valuation rules for their assets and liabilities. Fair value is defined in SFAS 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

For example, the land values addressed in the example of gains and losses would show $1.0 million cost on the financial statements. Under SFAS 157 the land could be shown on the balance sheet at its fair value. In a second and more complex example, under SFAS 157 the fair value of software might be determined based on revenues or margin generated over the economic life of the software.

SFAS 157 establishes a hierarchy of valuation techniques. Fair value measurement valuations are categorized as Level 1 where a ready market exists (i.e., where quoted prices for identical assets or liabilities exist in active markets). A Level 2 valuation is where such a market does not exist, but where quoted prices for similar assets or liabilities exist in active markets. If neither Level 1 nor Level 2 valuations are possible, valuations are to be based on the best information available (Level 3).

Federal contractors can fully expect that costs based on SFAS 157 will be summarily dismissed as unallowable. The regulation writers were behind the ball on the asset write-ups due to business combinations and goodwill. Several Board and court decisions resulted before the rules could be changed. On the other hand, with the asset impairment rule, the regulation writers were able to issue promulgations to disallow these costs before any Board or court decision rendered the costs allowable. One could expect that a CAS or FAR rule will disallow SFAS 157 costs before litigation can be initiated.

What is the pattern here? One of the overriding concerns of government procurement officials is that contractors will be paid more than their out-of-pocket costs. In the case of business combinations and goodwill, the purchase price is an out-of-pocket cost to the purchaser. However, the government officials are concerned that the initial owner of an asset may have depreciated an asset and now a second owner/contractor is able to depreciate some of that same amount.

What can Federal contractors do to protect themselves in these circumstances? Nothing can be done to change these rules. Federal contactors need to be cautious in consummating business combinations by assessing the impact that these costs and cost limitations might have on future revenues. Specifically, if negotiated cost-based prices are a significant aspect of the acquired business, a purchaser might not be able to recover all costs related to the acquisition.

Return to Text

n1 *FAR 31.205-11*.

n2 *FAR 31.205-11(g)(2)*.

n3 *FAR 31.205-52*.

n4 *FAR 31.205-52(b)*.

n5 For a brief period of time, the applicable regulations for contract costs recognized asset write-downs but disallowed any cost arising from asset write-ups.

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Pension Costs for Federal Contractors

2009 Emerging Issues 3318

Darrell J. Oyer on Pension Costs for Federal Contractors

By Darrell Oyer

January 28, 2009

SUMMARY: The Pension Protection Act (PPA) of 2006 increased costs for most companies with defined benefit pension plans. These companies need to pass on this increased cost of doing business to customers. However, for companies which have negotiated Federal contracts, the customer is balking at paying these costs. This Emerging Issues Analysis explores what a Federal contractor can do to minimize the financial impact of the PPA on his/her business.

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ARTICLE: In August 2006 the President signed the Pension Protection Act (PPA) of 2006. **The PPA was enacted to ensure adequate funding of defined benefit pension plans and to strengthen** the federal pension insurance system. The government sought to protect defined pension benefits for employees by requiring full funding by companies of their pension liabilities on essentially a liquidation basis (i.e., sufficient funds to provide for benefits if no more contributions were made to the fund by the company). This legislation has had unintended and significant adverse financial impact on many Federal contractors.

The Act. The PPA will result in increased funding of defined benefit pension plans due primarily to lower interest rate assumptions and a shorter amortization period than previously required. The PPA requires the use of corporate bond rates of return **in measuring the pension obligation.** Because the PPA-required corporate bond rates are lower than most alternative rates, a greater pension obligation will likely be computed under the PPA. The s**horter amortization period used for the PPA will also cause pension contribution increases.** The PPA requires that the unfunded actuarial liability and actuarial gains and losses be amortized over seven years.

Federal Contract Pricing. Many Federal contracts are priced-based, which means that in the absence of a commercial product or price competition, the government must rely on an analysis of the offerors costs or estimated costs. n1 **The Federal procurement regulations contain restrictions on what costs should be included in these prices. The governments original intent was to not allow costs that were against public policy. For example, contributions and donations are not allowed because contractors would have an incentive to be generous with these donations if they were reimbursed by the Federal Government in contract prices. Another example is entertainment expenses using a similar rationale. However, over the past century many new cost rules**

have strayed from the public policy principle. The PPA offers a good example of this.

Cost Accounting Standards (CAS) 412 and 413 govern the determination, and subsequent issue, of the allowability of pension costs for Federal contracts. These Standards were issued in the 1970s to provide visibility into pension costs for government price negotiators. The rules also tend to limit accrual of these costs to the most conservative actuarial methods. And, if an actuarially determined amount for any year is not funded, the cost is forever unallowable. The government concern that generates this position is often expressed as not wanting to pay contractors unless a cash expenditure is actually made.

The PPA versus CAS. The PPA and CAS are in conflict in that the PPA requires earlier funding than CAS in order to protect pension plans from under-funding or plan default. The PPA will result in larger funding requirements than permitted by CAS due to lower interest rate assumptions and a shorter amortization period than those prescribed by CAS. Cost Accounting Standards require the use of a long-term average rate of return contractors are expected to experience, whereas the PPA requires the use of lower corporate bond rates of return. **Cost Accounting Standards amortization periods are 10 to 30 years for the unfunded actuarial liability and 15 years for actuarial gains and losses, whereas** the PPA requires that the unfunded actuarial liability and actuarial gains and losses be amortized over seven years.

The aggressive funding required by PPA will cause a material cash flow difference between when Federal contractor pension contributions are required by law and when those contributions are recognized as pension costs under the current CAS. The estimated difference between current CAS and PPA pension measurements for Federal contractors is measured in the billions of dollars. Under these circumstances, Federal contractors must record costs and determine reported income based on the PPA; however, revenues from most Federal contracts cannot include the consideration of all actual, recorded costs. This can result in misleading financial statements for government contractors.

Thus, this well-intended protective legislation may have had unintended and adverse consequences. Federal contractors who are pressed for cash as a result of the inconsistency between PPA and CAS may be forced to consider the elimination of defined benefit pension plans to remain solvent. Ironically, a curtailment of benefits with under-funding would result in an immediate CAS sanctioned pension cost. In general, companies are motivated to abandon the defined benefit plans that Congress was attempting to preserve and protect.

Congressional Help. Congress has attempted to address this cash flow disconnect for Federal contractors, which attempt would likely garner limited success. First, Section 106(d) of the PPA requires that the CAS be harmonized with the PPA by the year 2010. Specifically, *The Cost Accounting Standards Board shall review and revise sections 412 and 413 of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413) to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 of eligible government contractor plans and government reimbursable pension plan costs not later than January 1, 2010.* The required harmonization might diminish the cash flow impact to Federal contractors. However, any relief provided is several years away.

Second, Congress also provided that a few very large defense contractors (called eligible government contractors) are exempt from PPA until 2011 or until the CAS is harmonized, whichever occurs first. This deferral of more aggressive funding requirements protects a few large defense contractors from being subject to the cash flow issues during the interim period while the CAS harmonization is being completed and protects the Federal Government from the immediate recognition of CAS pension cost with the funding of significant accumulated cost deficits.

Interim Temporary Fixes Have Been Rejected. Viable options are available to establish an interim solution for the benefit and protection of all parties. For example, a CAS Board waiver to CAS 412 could allow Federal contractors

to negotiate a factor for estimated impacts of the PPA/CAS harmonization in negotiated prices. The amount included in contract prices could be identified and subject to subsequent adjustment after the actual impact of harmonization on the contract price is known. Incorporation of such estimates into pricing would give Federal contractors confidence that the appropriate costs will be recognized in contract prices and ensure that the government does not overpay for these costs.

The prospects for an industry satisfactory harmonization are bleak. In its deliberations, the CAS Board is to establish valid accounting for these costs. However, there are indications that the factors being considered are not limited to good accounting and fair and reasonable prices, but rather on just how much of the additional costs due to the PPA the government is willing to pay in Federal contract prices.

The problem is that the government contract cost is not the true cost as established by generally accepted accounting practices applied to all companies whether or not they have Federal contracts. So far, the governments response to this has been to quote the regulations rather than address the problem. They simply deny that the true cost is being ignored. To them, true cost is simply determined by the applicable CAS/FAR requirements. They ignore the real issue, which is that the CAS/FAR determination of what is the true cost is unrealistic and inconsistent with Federal pension laws.

Whats a Federal Contractor to Do? Even before this issue arose, savvy companies, including Federal contractors, have jettisoned defined benefit plans as expensive, inflexible and administratively burdensome. This issue for Federal contractors who still have defined benefit plans will undoubtedly result in more terminations of such plans.

My advice for Federal contractors would be to seek alternatives to any defined benefit pension plan.

Return to Text

n1 For a cost reimbursement type contract, the reliance is on after-the-fact audit and negotiation that determine the cost actually incurred and how much is to be paid. For a fixed price contract, the reliance is on an analysis of the estimated cost that is used to negotiate a fixed price arrangement.

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Stock Option and Stock Purchase Plan Rules for Federal Contractors

2009 Emerging Issues 3319

Darrell J. Oyer on Stock Option and Stock Purchase Plan Rules for Federal Contractors

By Darrell Oyer

January 28, 2009

SUMMARY: This Emerging Issues Analysis discusses the disparity between accounting rules for U.S. corporations and those for Federal contractors. The public's perception is that Federal contracts are priced generously for contractors to the detriment of taxpayers which is seldom the case. With employee stock option awards, Federal cost rules often result in a contractor not recovering, in the contract price, all costs under the contract.

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ARTICLE: Employee Stock Option Plans. Several years ago, the accounting for employee stock options for U.S. corporations was revised to base the value of employee stock options on a fair market value rather than what was termed intrinsic value. n1 However, for Federal contractors with negotiated cost-based prices, the Federal Acquisition Regulation (FAR) maintains the intrinsic value approach, which invariably recognizes no cost when the employee award is granted. Federal procurement authorities recently reiterated this position. As a result, corporations with Federal cost-based contract prices will not recover all cost incurred in contract performance. This is not good because the costs essentially reduce contract profitability.

The intrinsic value method of accounting is prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. Under the intrinsic value method, compensation cost is measured as the excess, if any, of the market price of the stock at grant date (or other measurement date) over the amount an employee must pay to acquire the stock. Most stock option plans have no intrinsic value at grant date. Thus, under APB Opinion No. 25, no compensation cost is recognized. This is the position taken in the Federal procurement process both before and after FASB No. 123. At one time Federal procurement rules incorporated the very wording from APB Opinion No. 25 in determining allowable costs.

The fair market value method valuation is prescribed by FASB No. 123. Under the fair market value method, compensation cost is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. Nonpublic entities are permitted to exclude the volatility factor in estimating the value of their stock options, which results in measurement at minimum value. The fair market value of an option estimated at the grant date is not subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock, or the risk-free interest rate.

For Federal contractors, stock option costs must be measured, assigned, and allocated in accordance with Cost Accounting Standard (CAS) 415 (Accounting for the Cost of Deferred Compensation). n2 Two aspects of CAS 415 combine to essentially render stock option costs unallowable -- the amount of the future payment can be measured with reasonable accuracy, and there must be a reasonable probability that the options ultimately will be exercised. Arguably, these two requirements might be met under the fair market value method. The government procurement officials generally distrust the fair market value method because of its subjectivity and because it will increase the amount of costs that would be paid to contractors.

However, the Department of Defense contract auditors have been issued audit guidance on compensation costs arising from stock options that renders such costs unallowable (non-reimbursable). n3 Auditors are directed to continue to evaluate the stock options awarded to contractor employees in accordance with Cost Accounting Standard 415 and disallow any stock option cost claimed in excess of the amount measured under CAS 415. According to this guidance, CAS 415 provides that compensation costs arising from stock options awarded to employees be measured by the difference between the fair market value of the stock and the options exercise price at the measurement date (i.e., the intrinsic value method).

Under FASB No. 123 the fair value based method is preferable to APB Opinion No. 25 method for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Entities electing to remain with the accounting in APB Opinion No. 25 must make *pro forma* disclosures of net income and, if presented, earnings per share, as if the fair value based method of accounting defined in this Statement had been applied. This means that Federal contractors who apply FASB No. 123 must maintain accounting records to show the alternative treatment (APB Opinion No. 25) for purposes of dealing with the Federal Government. This creates the requirement for (at least) two sets of books. n4

So what can a corporation do to avoid expenditure of money that cannot be recovered in contract prices? One alternative is to not use stock options as compensation but rather increase other allowable elements of compensation such as salaries, bonuses, profit-sharing plans, 401(k) plans, fringe benefits, deferred cash compensation or stock purchase plans. An Employee Stock Ownership Plan might be considered. This latter solution is addressed in the remaining portion of this article.

Employee Stock Purchase Plans. FASB No. 123 also addresses employee stock purchase plans. These plans allow employees to purchase stock at a discount from market price. There is no compensation reported for the employee if the plan satisfies three conditions: (1) the discount is relatively small (5% or less satisfies this condition automatically, though in some cases a greater discount also might be justified as non-compensatory); (2) substantially all full-time employees may participate on an equitable basis, and (3) the plan incorporates no option features such as allowing the employee to purchase the stock at a fixed discount from the lesser of the market price at grant date or date of purchase.

For both FAR and the CAS, there are no specific rules that address these costs. In fact, CAS 415 states that purchase plan costs are not addressed in the standard. Over the past 30 years, however, the allowability of these costs under Federal contracts has been an issue addressed in Board of Contract Appeals (BCAs) and courts. Two decisions are noteworthy in that the final decisions were BCA decisions appealed to the courts -- *Singer Company v. United States* (Singer) n5 and *GTE Government Systems Corporation v. Perry* (GTE). n6

In the Singer decision the government argued that a stock purchase plan was really a stock option plan and thus an unallowable cost. The government also argued that the discount was a financing cost, which is unallowable per the FAR. n7 The government also argued that because the employee did not have to recognize the discount as compensation for tax purposes, the cost in effect did not exist. The government argued that the cost was not recorded in accordance with generally accepted accounting practices. The court rejected all government arguments. Ultimately the court and BCA (with court prodding) concluded that the difference between the market price for a share of stock and the price paid by his employees under a stock purchase plan was allowable cost under the applicable Federal regulations.

In the GTE decision the Armed Services BCA (ASBCA) ruled that a discount afforded under an employee stock purchase plan was not a reimbursable (allowable) compensation cost. The court reversed this decision, ruling that the cost was reimbursable because the then-applicable Defense Acquisition Regulation (DAR) provision making such costs allowable only to the extent that they were allowable by the Internal Revenue Code did not require that the costs be deductible when incurred.

According to the court in GTE, there was no question that the employer had incurred a real cost in the years at issue by providing its employees with a stock purchase discount. That cost would have been deductible if Congress had not afforded employees favorable tax treatment for qualified plans, which postponed tax liability until the stock was sold. The employer had voluntarily foregone its tax deduction in order to provide this special tax treatment for its employees. In furtherance of the then broad DAR policy favoring reimbursement of all remuneration for personal services, allowable was construed to refer to costs of the kind that are generally deductible, that is, not forbidden by the Internal Revenue Code.

So what can Federal contractors do to avoid incurring costs that cannot be included in Federal contractor prices? This solution is simpler and likely more successful than the stock option circumstance. Although not specifically sanctioned by the FAR, a stock purchase plan discount (i.e., the difference between the market price and the price paid by the employee) is an allowable cost as long as it is incurred consistent with IRS guidelines. Thus, a stock purchase plan is a viable alternative to a stock option plan.

Return to Text

n1 Statement on Financial Accounting Standards (FASB) No. 123.

n2 *FAR 31.205-6(k)(1),* Compensation for personal services.

n3 Memorandum for Regional Directors, DCAA: Audit Guidance on Compensation Costs Arising from Stock Options, July 7, 2006.

n4 In 1972 when the first Cost Accounting Standards were issued, Industry representatives noted that the CAS and FASB do not match, and thus two sets of books would be required. The governments response was that, in fact, three sets of books were required -- the third for the Internal Revenue Service. Indeed, these three authorities have significant differences in accounting for certain costs.

n5 *Singer Co. v. United States, 229 Ct. Cl. 589 (Ct. Cl. 1981).*

n6 *GTE Govt Sys. Corp. v. Perry, 61 F.3d 920 (Fed. Cir. 1995).*

n7 At that time the current Federal Acquisition Regulation (FAR) was designated as the Armed Services Procurement Regulation (ASPR).

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Limitation of Pass-Through Costs on Federal Contracts

2009 Emerging Issues 3314

Darrell J. Oyer on Limitation of Pass-Through Costs on Federal Contracts

By Darrell Oyer

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SUMMARY: This Emerging Issues Analysis covers Federal Government contracting rules seeking to prevent excessive costs due to multiple tiers of contracting and subcontracting where negligible value is added by the companies involved. The rule is described and contractors advised on how to comply with the rule, how to ensure that the Government complies with the rule, and how to avoid Government-imposed, unilateral, after-the-fact price reductions.

PDF LINK: Click Here for Enhanced PDF of Commentary

ARTICLE: The Issue. The Federal Government awards contracts (referred to as prime contracts) to companies which for various reasons elect to award subcontracts for a portion of the work required under the prime contract. This may be because the prime contractor may not have the capacity to do the work, the subcontractor might have special skills, a subcontractor might be able to do the work for less money, etc. Often the Federal Government awards prime contracts fully expecting the prime contractor to use subcontractors for most, if not all, of the work (referred to as bundling). Generally, it is more efficient for the Federal Government to award only one prime contract to administer. Plus, under this circumstance, the prime contractor assumes the role of selecting companies to do the actual work and thus relieves the Federal Government from this task.

Perception. Aberrations in this process have led to what appears to be glaring contractor waste and abuse. For example, in the aftermath of Hurricane Katrina, a prime contractor was awarded a contract to repair roof damage for about $700 per square unit. The prime contractor awarded a subcontract to a subcontractor to do the work at a lower price and the latter, in turn, awarded yet another tier of subcontracts -- a process which was repeated until the organization that actually did the work did so for about $7 a square unit. So the Government paid $700 for work that actually cost only $7! Such a conclusion ignores the value of finding that $7 organization and does not address the setting of the price at $700 in the first place. This Emerging Issues Analysis focuses on the Federal Governments cure for this occurrence.

The Cure. Congress has required by law that the Department of Defense (DOD) implement rules to assure that pass-through costs not be excessive. In the implementation of this law, the regulation defines such costs as *a charge to the Government by the Contractor or subcontractor that is for indirect costs or profit on work performed by a subcontractor (other than charges for the costs of managing subcontracts and applicable indirect costs and profit based on such costs)* [when] *a Contractor or subcontractor that adds no or negligible value to a contract or subcontract .*

(Department of Defense Federal Acquisition Supplement (DFARS) 252.215-7004) This in itself is a noble cause that taxpayers should embrace.

To ensure that this law is applied, the regulation states: If the offeror intends to subcontract more than 70 percent of the total cost of work to be performed under the contract, task order, or delivery order, the offeror shall identify in its proposal -- (i) The amount of the offerors indirect costs and profit applicable to the work to be performed by the subcontractor(s); and (ii) A description of the added value provided by the offeror as related to the work to be performed by the subcontractor(s). (DFARS 252.215-7003(c)(2)) The first requirement is almost tongue in cheek -- the detailed costs for a contractors proposal clearly indicate (and have for years) the amount of subcontracting and the pass-through costs included in the contract price.

The law and regulation are enforced by an after-the-fact recovery process rather than simply not including the excessive costs in the price in the first place. *If the Contracting Officer determines that excessive pass-through charges exist -- (1) For fixed-price contracts, the Government shall be entitled to a price reduction for the amount of excessive pass-through charges included in the contract price; and (2) For other than fixed-price contracts, the excessive pass-through charges are unallowable in accordance with the provisions in Subpart 31.2 of the Federal Acquisition Regulation (FAR) and Subpart 231.2 of the Defense FAR Supplement.* (DFARS 252.215-7004(d))

Misdirected Cure. The focus of preventing excessive pass-through costs should be on an ounce of prevention (i.e., not creating contracts that contain excessive pass-through costs) rather than a pound of cure (i.e., allowing creation of contracts with excessive pass-through charges with either the intent to attempt to recover or the hope of recovering excessive pass-through charges after the fact). The contractor industry and the DOD should work together to avoid excessive pricing of pass-through charges at the point of price agreement, and thus the need for contentious after-the-fact audits, unilateral determinations and costly disputes would be minimized to everyones advantage -- the Government, the taxpayer and the contractor.

As taxpayers we can all agree with the objective *The Government will not pay excessive pass-through charges.* A simple approach to avoiding excessive pass-through charges is for the DOD to manage or limit the amount of subcontracting (and thus pass-through charges) under prime contracts. In other words, just say no to prime contracts with excessive subcontracting. Contracting officers could be directed to consider awarding multiple prime contracts rather than a bundled prime contract where the need for a prime contractor is not critical and the prime contractor essentially provides negligible added value. Contracting officer decisions to award any contract should be documented as advantageous to the Government and state that, consistent with legislation, the negotiated price does not include excessive pass-through charges. If this were done properly, there would be no reason to have a recovery audit.

The 70% rule that requires identification and discussion of value added for pass-through charges is not derived from the legislation, and has caused confusion and is unnecessary. No rationale has been presented for limiting price negotiation disclosure and discussion to only those contracts with more than 70% subcontracting. Some people have incorrectly assumed that the limitation on excessive pass-through charges pertained only to prime contracts with 70% or more subcontracting. However, this is not the case.

The identification of pass-through charges is a current requirement for negotiation of cost-based contracts. The 70% rule only adds a requirement for a contractor to explain how the pass-through charge pertains to the value added efforts of the contractor. This explanation should be part of any price negotiation process without any additional regulatory requirement. Failure of the contractor and Government to adequately disclose, discuss and resolve pass-through charge reasonableness in a negotiation will lead to innumerable disputes. The objective should be to resolve the excessive pass-through charges during price negotiations rather than to determine excessive charges after contract performance has begun and after costs are incurred.

Not only should pass-through charges be resolved at the time of price negotiation, the negotiated resolution of such issues should be contemporaneously documented. For cost reimbursement contracts, the contract should incorporate a

ceiling pass-through rate or an advance agreement on a pass-through rate that the contractor agrees not to invoice above that rate and the Government agrees is not excessive. Failure to document such an agreement will lead to many after-the-fact disputes.

For a negotiated fixed price contract, eliminating excessive pass-through charges should be accomplished by the Government and the contractor negotiating a contract price that does not include excessive pass-through costs. The price negotiation should not leave open any issue of potential excessive pass-through costs that must be resolved after the final price agreement. In other words, it does not serve the process well to negotiate a contract price and then provide for subsequent unilateral price adjustments by either party. If a contracting officer believes a pass-through charge in a fixed price contract is excessive, the contracting officer should either negotiate a price that excludes that excessive charge or not award the contract.

To avoid after-the-fact disputes on an acceptable pass-through charge, a contracting officer should not be permitted to agree to a contract price that includes excessive pass-through charges. Often a final price is not based on a mutual agreement on each cost element. Therefore, the Government price negotiation memorandum must state affirmatively that the contracting officer has negotiated a price that does not include excessive pass-through charges. Otherwise, the contracting officer should not be agreeing with the contract price.

The only recovery possible for such a negotiated fixed price contract would occur if the contracting officer agreed to a price that included excessive pass-through costs and then later arbitrarily changed his/her mind about that price agreement. Such a requirement does not protect the taxpayer or allow for mutually agreed-to costs, nor is this requirement equitable because one party (the Government) would be entitled to challenge a price mutually agreed to and the other party would not be allowed to do so.

The rule leaves the impression that a contracting officer may award a negotiated fixed price contract with a knowingly excessive pass-through rate with the possibility of subsequently requesting a price adjustment based on excessive pass-through rates determined in what the rule calls a recovery audit. A policy that would permit or encourage contracting officers to not be diligent in the negotiation of these contracts is not desirable. A policy that will result in an unnecessary administrative oversight burden resulting from after-the-fact audit activities that will be encouraged by this rule should not be permitted. Certainly, the consequence of such a sequence of events would produce significant lawsuits.

The regulatory provision The offerors proposal shall exclude excessive pass- through charges. is commendable, but the real objective should be *The contracting officers negotiated prices shall exclude excess pass-through charges.* It is more important that such excessive charges are excluded from negotiated contract prices. As implemented, the cure treats the symptom rather than the cause of the problem.

Excessive pass-through charges have not been defined in terms of dollars, numbers, rates, etc. No guidance is provided for the contracting officer who is charged with making the decision on excessive charges. This lack of definitive guidance in establishing specific parameters to define excessive results in a lack of uniformity and generates more non-value-added audit effort. Contracting officers should be provided some guidelines. For example, the contracting officer might be required to determine if the proposed pass-through cost is less than the Governments cost of administering a separate prime contract.

Avoiding Problems. Contractors should proactively explain and discuss pass-through costs during price negotiations. A contractor should not agree to a price unless the Governments contracting officer specifically agrees that the pass-through costs are not excessive. A revision to the implementing rule has created a potential means to assist in this regard. The regulation permits inclusion of the following provision in the contract: *The Contracting Officer has determined that there will be no excessive pass-through charges, provided the Contractor performs the disclosed value-added functions.* (DFARS 252.215-7004, Alternative I) This agreement and statement ensure that the contracting officer has protected the taxpayer when negotiating a price and ensure that the contractor will not suffer arbitrary and

unilateral after-the-fact price reductions.

Interestingly, the problem was highlighted in a non-defense contract; however, the solution is applied only to defense contracts.

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