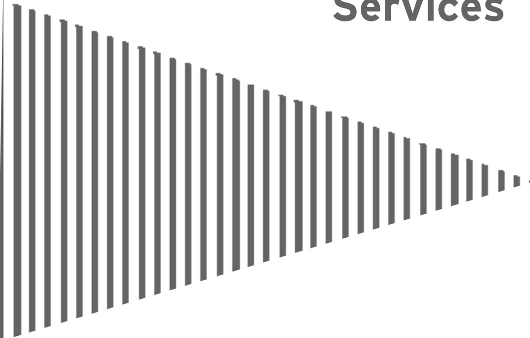
October/November 2010

Government Contract Services



Contents

FAR rule "clarifies" definition of cost or pricing data 1

Increases to acquisition-related thresholds 2

DoD proposed rule on contractor business systems .. 3

Interim FAR rule requires reporting of subcontractors, executive compensation 3

Linking award fees to acquisition outcomes............. 4

FAR rule "clarifies" definition of cost or pricing data

After a long-running period of discussion, the Federal Acquisition Regulation (FAR) was amended August 30, 2010, to address a US Government perception that "the implementation of TINA in FAR subpart 15.4 is not sufficiently clear." While many in industry thought this a topic of sufficient clarity, the FAR Councils have nonetheless proceeded with the helpful effort.

It appears to many in industry that this FAR revision reflects Department of Defense (DoD) concerns regarding commercial item acquisitions; specifically, the Government's ability to request and use contractor cost data when evaluating commercial item price reasonableness. The Council of Defense and Space Industry Associations (CODSIA), in its September 1, 2009, comments, expressed industry concerns about the Government's effort as follows:

> "[We] believe the proposed changes conflict with the Truth In Negotiations Act (TINA) in at least two ways: 1) it will result in the submission of cost or pricing data in acquisitions currently exempt from such requirements, i.e., commercial items, and 2) it would add judgmental information to data required to be submitted whereas TINA currently excludes judgmental data from the definition of cost or pricing data."

As to the submission of cost or pricing not otherwise required, the FAR Councils provided the following:

> "1. Some respondents were concerned that the proposed rule will result in contracting officers by-passing normal market research and pricing techniques and require contractors to submit full cost or pricing data as if the Truth In Negotiations Act (TINA) applied.
>
> "*Response*: The current FAR, as well as the proposed and final rule, protect against this practice. Contracting officers must generally follow the order of preference at FAR 15.408, Table 15-2. However, in most cases the data necessary for a contracting officer to determine cost fairness and reasonableness, or cost realism, will fall short of this level of data. The rule should not result in contracting officers requiring contractors to submit full cost or pricing data as if certification will be required when it is not necessary."

Ernst & Young
Quality In Everything We Do

Some in industry are little comforted by the FAR Councils' response as there is arguably no clear guidance provided to the contracting officer as to when full cost or pricing data is indeed necessary in a commercial item acquisition.

And as to industry concerns about the addition of "judgmental data," the FAR Councils wrote:

> "3. Some respondents were concerned about the broadening of the definition of 'information other than cost or pricing data' by adding the words 'and judgmental information.'
>
> "*Response:* Data used to support an offer will necessarily contain some information that is non-factual, i.e., judgmental information. Due to its nature, judgmental information cannot be certified. Even in situations where 'certified cost or pricing data' are required, judgmental information is not certified, and it is part of 'data other than certified cost or pricing data' that supplements certified cost of pricing data. The final rule deletes the phrase 'information other than certified cost of pricing data' but includes 'judgmental information' and 'judgmental factors' in the definition of other than certified cost or pricing data. The final rule also includes additional language to provide consistency with FAR 15.408, Table 15-2 (i.e., any information reasonably required to explain the estimating process, including the judgmental factors applied and the mathematical or other methods used in the estimate, including those used in projecting from known data; and the nature and amount of any contingencies included in the proposed price). Aligning the definition of 'data other than certified cost or pricing data' and the text of the language in FAR 15.408, Table 15-2, keeps the definition consistent with the current FAR requirement and TINA. The Councils note that the existence of judgment is factual, but the nature and amount of the judgment are not."

The FAR Councils' writings would suggest that although industry comments were considered, judgmental information (albeit "non-factual") must be provided when explaining the estimating process.

Perhaps in an effort to alleviate the forgoing industry concerns, the FAR Councils noted that the final rule amending FAR:

> "... neither expands nor diminishes the existing rights of contracting officers to request cost or pricing data (whether certified or other than certified) or other information, or the existing responsibilities of the offeror to submit such data or other information. Similarly, the rule does not require, encourage, or authorize contracting officers to obtain cost or pricing data or other information unless it is needed to determine that prices offered are fair and reasonable, which may include the request for such data in connection with a cost realism analysis."

Notwithstanding the FAR Councils' attempts to alleviate industry concerns, Ernst & Young LLP believes it would be prudent for companies to anticipate increased Government demands for cost data on commercial item procurements. As government contracting officers and auditors now have a clearer expression of the appropriateness of requests for cost data (albeit not certified) on commercial item procurements, subsequent requests for such data should be expected.

As stated in the final rule, requests for other than certified cost or pricing data may look much like that for certified cost or pricing data — what was welcomed in the published rule was a further "clarification" that FAR 31 does not apply when other than certified cost or pricing data is requested. Companies should be prepared to remind Government auditors that FAR Part 31 is not applicable to data other than certified cost or pricing data. While that may not minimize some Defense Contract Audit Agency (DCAA) auditors' concern that the indirect rates provided as data other than certified cost or pricing data were not adjusted for unallowable costs, it should help companies in the ensuing conversations — or one might hope as much.

Companies' commercial item proposal processes likely already provide for the disclosure of price history. Recognizing there may be increasing instances when cost information might be requested, companies should consider reviewing their policies and procedures to make sure these types of requests are discussed and handled consistently. While such commercial item cost information may not be subject to TINA/defective pricing, some attention to the False Claims Act (FCA) would seem to be appropriate.

Increases to acquisition-related thresholds

The Federal Acquisition Regulation (FAR) was revised, effective October 1, 2010, to reflect inflation-adjusted amounts for certain acquisition-related thresholds. The change reflects the requirements of Section 807 of the Ronald W. Reagan National Defense Authorization Act that requires an inflation adjustment of certain thresholds every five years.

An acquisition-related dollar threshold is defined as a "dollar threshold that is specified in law as a factor in defining the scope of the applicability of a policy, procedure, requirement, or restriction provided in that law to the procurement of property or services by an executive agency ... ." The threshold adjustments include:

- Increasing the simplified acquisition threshold (FAR 2.101) from $100,000 to $150,000
- Raising the cost and pricing data threshold (FAR 15.403-4) from $650,000 to $700,000
- Increasing the prime contractor subcontracting plan (FAR 19.702) floor from $550,000 to $650,000; the construction threshold is raised from $1,000,000 to $1,500,000

The micro-purchase base threshold (FAR 2.101) will not be changed from the current $3,000.

Contractors should revise their policies and procedures (as of the October 1 effective date) to reflect the new acquisition-related thresholds.

DoD proposed rule on contractor business systems

Responding to comments from the Commission on Wartime Contracting (CWC), the Department of Defense (DoD) published in the January 15, 2010, *Federal Register* a proposed rule that provides for government oversight over certain contractor business processes that encompass:

- Estimating
- Purchasing
- Property management
- Earned Value Management System (EVMS)
- Material Management Accounting System (MMAS)
- Accounting

This proposed rule has generated significant industry comment. Of particular concern is the enforcement mechanism contained in the proposed rule that provides for withholdings on contractor invoices when a business system is deemed inadequate. The proposed rule states that when a business system is deemed inadequate but a contractor submits an acceptable corrective action plan within 45 days, the Administrative Contracting Officer (ACO) will reduce the withholding to 5% of each payment. If the ACO determines that the contractor is failing to follow its corrective action plan, the ACO may increase the withholding to 10%. If withholding payments for deficiencies in multiple business systems, the withhold will not exceed 50%; however, if the ACO determines that one or more system deficiencies are "highly likely to lead to improper contract payments being made," then the ACO may withhold 100% of payments. Contract payments, as construed under the proposed rule, include (a) interim payments under cost-reimbursement contracts, incentive type contracts, time and materials contracts and labor hour contracts; (b) progress payments; and (c) performance-based payments.

While industry comments have made it clear that the existence of an internal control deficiency does not necessarily translate into a risk to the Government, it is not yet clear how the DoD will address industry concerns about the proposed rule's lack of linkage between potential harm to the government and the imposition of arbitrary withholds.

The Defense Contract Audit Agency (DCAA) issued a memorandum, "Audit Guidance on Performing Internal Control Follow-Up Audits and Limited Scope Audits," that stated the agency is "performing a comprehensive reassessment of the process for evaluating and reporting on contractor internal controls." The guidance currently limits DCAA internal control reviews to general accounting and billing system audits as well as those internal control audits previously started. Since publication of the proposed rule, DCAA appears to have undertaken efforts to align their internal control audit guidance with the six internal control systems in the proposed rule and we anticipate changes in the DCAA Internal Control Audit Planning Summary (ICAPS) process. DCAA audit teams have typically recorded the results of an internal control system audit on ICAPS and will use the ICAPS data in their audit planning and reporting of audits.

It should be noted that as currently implemented, DCAA contractor internal control reviews are largely limited to "major contractors." The proposed Defense Federal Acquisition Regulation Supplement (DFARS) rule does not include this distinction, which would then arguably extend its coverage to even small businesses.

Indications are that a revised version of the proposed rule will be forthcoming — the final rule may be issued as early as November 2010.

Companies may wish to review their policies and procedures now to make sure they are "current" before issuance of a final rule prompts DCAA requests for copies of policies and procedures.

DCAA may assert a contractor's failure to:

- timely update policies and procedures, or
- reflect current organizational assignments

results in an internal control deficiency…irrespective of the potential harm to the Government.

Interim FAR rule requires reporting of subcontractors executive compensation

An interim rule published July 8, 2010, requires contractors to report all first-tier subcontractor awards of $25,000 or more. In addition, contractors and first-tier subcontractors must disclose compensation of their top five executives if they receive at least 80% of annual gross revenue and $25 million in federal awards and do not already publicly report their compensation.

The interim rule amends the FAR to implement the Federal Funding Accountability and Transparency Act of 2006, which requires the establishment of a public website by the Office of Management and Budget (OMB) with information on all contract awards.

The rule is intended to reduce unnecessary waste and spending by increasing public visibility into money awarded to various organizations as well as to help document the purpose.

FAR reporting requirements include:

- Reporting of only first-tier subcontracts
- Reporting of names and total compensation of the five most highly compensated executives on a monthly basis following the month end of any contract award
- Reporting of names and total compensation of the five most highly compensated executives of all first-tier subcontractors on a monthly basis following the month end of any contract award
- Increased data quality requirements for agencies and contractors

Per the OMB, the intent of many of these changes is to reduce the effort and burden currently placed on contractors, although it remains to be seen how and whether that intent will be achieved.

According to the *Federal Register*, "the reporting requirements of the Transparency Act are sweeping in their breadth, and are intended to empower the American taxpayer with information that may be used to demand greater fiscal discipline from both executive and legislative branches of Government. The Transparency Act reporting requirements apply to all businesses (large, small, disadvantaged small, veteran-owned small, women-owned small, HUBZone small), regardless of business size or ownership."

The rule revises FAR subpart 4.14 and FAR 52.204-10 to implement the Transparency Act reporting requirements, and contracting officers must include the clause in any solicitations and contracts meeting the $25,000 threshold.

The clause is applicable in commercial item contracts, including commercially available off-the-shelf (COTS) item contracts, as well as actions under the simplified acquisition threshold. However, the clause will not apply to classified solicitations and contracts, contracts with individuals, or to contractors (or subcontractors) with annual gross income of less than $300,000 in the preceding year.

The reporting requirements are being phased in to reduce their impact on smaller entities. From July 8, 2010 to September 30, 2010, newly awarded subcontracts should have been awarded if the prime contract was $20 million or more. From October 1, 2010, to February 28, 2011, any newly awarded subcontract must be reported if the prime contract is $550,000 or more. And finally, beginning March 1, 2011, any newly awarded subcontract must be reported if the prime contract is at the $25,000 threshold.

To avoid later catch-up efforts, contractors should update their policies and procedures consistent with the requirements of this rule.

Linking award fees to acquisition outcomes

Converting an interim rule to a final rule (with minor changes), the FAR Councils published a revision to the Federal Acquisition Regulation (FAR) September 29, 2010, implementing certain statutory requirements that provide for linking award and incentive fees to acquisition outcomes.

Preceded by a Government Accountability Office (GAO) report, *DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes*, the FAR rule requires federal agencies to:

"(1) Link award fees to acquisition objectives in the areas of cost, schedule, and technical performance;
"(2) Clarify that a base fee amount greater than zero may be included in a cost-plus-award-fee type contract at the discretion of the contracting officer;
"(3) Prescribe narrative ratings that will be utilized in award-fee evaluations;
"(4) Prohibit the issuance of award fees for a rating period if the contractor's performance is judged to be below satisfactory;
"(5) Conduct a risk and cost-benefit analysis and consider the results of the analysis when determining whether to use an incentive-fee type contract or not;
"(6) Include specific content in the award-fee plans; and
"(7) Prohibit the rolling over of unearned award fees to subsequent rating periods."

Industry concerns expressed upon issuance of the interim rule included the following Aerospace Industries Association (AIA) perspective:

> "We are concerned that the interim rule will have a profoundly negative impact on the industrial base by making it extremely difficult for contractors to earn fair returns on award fee contracts. Programs using award fee are often large, complex system developments — where industry historically earns the least amount of profit — usually low single digit returns. Achieving even single digit returns is a challenge given extraordinarily difficult specifications; supplementation of underfunded programs with contractor money; constant changes in funding, threats and requirements; unallowable costs; and low award fee scores if initial contract targets are missed. The interim rule exacerbates these challenges."

Of perhaps greatest concern is the provision at FAR 16.40(e)(4) that prohibits the rollover of unearned award fees to subsequent rating periods. The FAR Councils rejected industry comments on this matter, stating in the final rule:

> "*Comment:* Three respondents recommended that the language prohibiting the use of rollover be revised to allow rollover under certain circumstances and at the discretion of the head of the contracting activity. Respondents contend that rollover can be an effective incentive tool if used properly.

> "*Response:* The Councils disagree with the respondents. Award fee is structured to incentivize contractors to perform throughout the contract. Therefore, rollover of unearned award fee provides a disincentive for contractors to perform throughout the entire period of performance. If a contractor did not perform adequately during an award-fee rating period and was rated appropriately and then allowed to recover that unearned award fee in a subsequent period, the incentive for the contractor to perform consistently throughout the entire contract would be reduced."

Perhaps the best news in the issuance of the final rule is the retention of the language at FAR 16.405-2 that provides for inclusion of a base fee in cost-plus-award-fee (CPAF) contracts (at contracting officer discretion). Companies' negotiation guidance, if not

already prescribed, should address the handling of base fee implications on CPAF contract discussions.

For more information or questions about the Government Contract Services newsletter, please contact:

Dan Lentz, Partner
Phone: +1 202 327 5630
Email: daniel.lentz@ey.com

Robert Esernio, Partner
Phone: +1 203 674 3305
Email: robert.esernio@ey.com

Todd LaMastres, Partner
Phone: +1 214 969 8484
Email: todd.lamastres@ey.com

Robert Malyska, Partner
Phone: +1 949 437 0302
Email: robert.malyska@ey.com

Deborah Nixon, Partner
Phone: +1 703 747 1478
Email: deborah.nixon@ey.com

Chris Pockney, Principal
Phone: +1 202 327 5865
Email: chris.pockney@ey.com

Darl Rhoades, Executive Director
Phone: +1 720 931 4022
Email: darl.rhoades@ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global and of Ernst & Young Americas operating in the US.

© 2010 Ernst & Young LLP.
All Rights Reserved.

CSG no. 1009-1189472
Score no. WW0218

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither Ernst & Young LLP nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.