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DOD Announces Intentions to Block Mergers

By Michael Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

In the wake of a recent merger involving Lockheed Martin Corporation and Sikorsky, the Secretary of Defense and other high level DOD Officials have stated that DOD will attempt to block further mergers or acquisitions which could limit DOD's ability to achieve cost savings by maximizing competitive awards. At least for now, the constraints or mergers or acquisitions would likely apply to the very large defense contractors; however, it could apply at any level if DOD perceives that a merger or acquisition will have a significant impact in reducing competitive sources. It's been established or more accurately believed, that competition is critical to DOD cost reduction initiatives such as Better Buying Power III. Further, that cost reductions must be achieved else DOD will not be able to sustain its capabilities as budgets decrease as a by-product of Legislative spending caps (.i.e. sequestration which may be dead as a by-product of a Presidential veto of the 2016 National Defense Appropriations Act/NDAA, a veto rationalized by the fact that the Legislative Branch had attempted to by-pass sequestration spending caps for DOD by using overseas contingency contracting funds for other than contingency contracting).

DOD's promise (or threat) to block mergers and acquisitions is nothing new, noting that at some point during the DOD downsizing and merger-mania in the 1990s, DOD made similar promises (or threats). Although DOD understood why contractors were merging (steep decline in DOD spending after the Berlin "wall came down" and the threats coming from the USSR supposedly disappeared into the sunset), the DOD preferred solution was diversification within the traditional defense industry. In theory, if traditional defense contractors could expand into commercial markets, the additional sales/revenues/costs would displace the declines in DOD spending and would potentially avoid steep increases in indirect/G&A rates as cost allocation bases shrank. The preferred solution lead to a softening of regulations (FARA and FASA), in particular those which were intended to motivate defense contractors to develop commercial sales which meant that independent research and development (IR&D) became wide-open with essentially no expectation of military relevancy. It was and remains acceptable to incur IR&D which had no military relevance as long as the objective of expanding into commercial markets had an indirect benefit to DOD.

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Fast-forward approximately 20 years to 2015 where everyone's crystal ball is projecting steady declines in DOD's procurement spending which also means that DOD contractor investments in IR&D or particularly B&P will have less chance to yield a return on investment. Specifically, contractors are incurring substantial costs to prepare bid proposals for highly competitive solicitations/awards where the "turnout" (other competitive bids) indicates that any given bidder has a statistical probability of not being the awardee. Although it is inconsistent with the fundamental regulatory ground-rule that competitive solicitations should involve nothing more than technical volumes along with price-based quotations, in many cases, these competitive solicitations involve cumbersome requirements for cost data at a significant cost to the bidder which will in some cases be the single opportunity for a contractor to go all out in terms of B&P costs in the pursuit of a relatively large contract award. One or two unsuccessful attempts could translate into unaffordability, thus "no bids" on similar future opportunities.

Why mention all of this in the context of DOD's intent to block mergers and acquisitions which limit competitive bidding? Simply because the DOD is missing the elephant in the room to the extent that DOD's bid and proposal requirements (including requirements to support audits or cost/price analysis reviews) will have a far greater negative impact on competition. As multiple contractors go for "all the marbles" in responding to one or two potentially significant contracts, but only one contractor (and its subcontractors) is the ultimate winner, the unaffordable cost of trying to do business with DOD will limit competition. Mergers and acquisitions will be a distant second and in some cases, those will be a by-product of contractors investing too much time in preparing costly bid proposals with no predictable return on investment (i.e. unsuccessful bids). Too many costly and unsuccessful bids will potentially cause a contractor to become less of a going concern as well as a bargain acquisition.

Based upon some sections in the 2016 NDAA, the Legislative Branch and DOD seem to be awakening to the fact that there is a fundamental and overwhelming problem with the complexities of the acquisition process (the sheer volume of regulations and the associated oversight). Unfortunately, neither the Legislative Branch nor DOD can do anything to eliminate the Executive Orders (issued in 2014 and 2015) which are generating new regulations/requirements which are directed solely at government contractors, in most cases at very low dollar thresholds and include commercial contracts with the government. As is said, it takes time to turn an aircraft carrier towards safer waters (simplify the acquisition process and government regulations), particularly when the Captain of the Ship (our Commander-in-Chief) keeps re-directing the ship towards the rocks (additional "contractor unfriendly" regulations).

ASBCA Decision on Unallowable vs. Expressly Unallowable Costs The Obvious and Less-Than-Obvious Impact

By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

In June 2015, the ASBCA published its decisions on three related cases involving the definition and interpretation of expressly unallowable costs (ASBCA Nos 57576, 57679, 58290, published June 26, 2015). In its decisions, the ASBCA considered the precise wording in each respective FAR Part 31 Cost Principle; hence, no ASBCA assumption that the regulations were intended to be read the same as it pertains to expressly unallowable activities by contractor employees, purchased labor, board of directors, attorneys or consultants. In light of the recent ASBCA decisions, many of us have been anxiously waiting for DCAA to rescind two previously issued MRDs (Memorandums for Regional Directors), 14-PAC-021 and 14-PAC-22, dated December 18, 2014 and January 7, 2015, respectively. Of passing note, DCAA can't seem to consistently follow its policy numbering scheme because a policy dated in January 2015 should have been "15-PAC-XXX" and not "14-PAC-XXX"; perhaps an unintentional confirmation that "precision" doesn't seem to matter to DCAA. In this case, the more consequential lack of precision applies to DCAA's interpretations of "expressly unallowable" wherein DCAA consistently re-writes (or embellishes) the FAR to support DCAA's preferred version of FAR. Translated, DCAA maintains an overly expansive view of what constitutes expressly unallowable costs. Given the fact that DCAA's MRDs were issued prior to the June 26, 2015 ASBCA decisions, one would think that DCAA would withdraw its MRDs, review them in light of the very specific

interpretations coming from the ASBCA, and re-issue the MRDs after synchronizing them with the most recent ASBCA decisions. That has not happened and probably won't happen because DCAA seems to believe that it was right, even when it was wrong as determined by an independent tribunal.

The narrow issue within the ASBCA decisions was the connection of bonus and incentive compensation (BAIC) for any given contractor employee to the employee activities (services rendered) for the relevant period for which the employee received the BAIC. As has been stated in DCAA guidance to its field offices, the contractor must identify the basis for the award in order to determine if some portion of the bonus and incentive compensation (BAIC) is expressly unallowable. Using DCAA's logic, if the BAIC is based upon the employee's overall performance during a one year period and the employee worked on unallowable activity during that one year period, a portion of the BAIC would be expressly unallowable. As stated by the ASBCA, only the precise wording, in particular the phrase "all costs" in FAR 31.205-47 (related to legal costs) would equate to expressly unallowable costs for a proportionate amount of BAIC. Hence, an amount of BAIC proportional to the relative amount of time an employee spent on expressly unallowable legal activity would be expressly unallowable as well as a similar percentage of the employee's salary and fringes.

Although some have viewed the ASBCA decision as a victory for contractors, the ASBCA did not resolve the issue of directly associated costs which "might be unallowable". For example, the application of directly associated (unallowable) costs to a proportional amount of BAIC for an employee whose activities included unallowable public relations (31.205-1). However, with respect to employees engaged in unallowable organization costs (31.205-27), the ASBCA did conclude that proportional BAIC are unallowable (just not expressly unallowable).

Perhaps the biggest victory for the government was related to compensation in the form of common stock under a long term performance plan (LTPP). Key employees were awarded a target number of shares which could be increased based upon TSR (Total Shareholder Return) which was measured by comparing changes in the contractor's (corporate) stock prices to the changes in stock prices of ten peer companies. Although one or more DCAA auditor has opined that this type of LTPP and TSR are allowable, the ASBCA concluded that the costs of any increased number of shares awarded based upon the TSR benchmarking is unallowable based upon FAR 31.205-6(i) that any "compensation which is calculated or valued based upon the changes in the price of corporate securities is unallowable". Per the ASBCA, TSR clearly and unmistakably falls into this category. By direct statement of the ASBCA, the auditors (who have accepted TSR as allowable) have been mistaken in their reading of the regulations which are clear and unmistakable. Likely, there have been a number of audits and auditors who have allowed contractors to use TSR as the metric for determining variable stock compensation; however, one should assume that any and all compensation based upon a TSR metric will be questioned in the future. Although the ASBCA did acknowledge the existence of a principle prohibiting "retroactive disallowance", the ASBCA did not state an opinion concerning retroactive disallowance applicable to the case specific facts.

To summarize, there is a lot going on within ASBCA cases 57576, 57679 and 58290 and it goes well beyond the focus on expressly unallowable or merely unallowable (subject to penalties or not subject to penalties, respectively). There is presumably more to come as these decisions were in response to cross-motions for summary judgment and a number of issues represented material differences of fact; hence, the ASBCA declined to award summary judgment to either party. Contractors subject to FAR Part 31 Cost Principles should revisit their policies and procedures regarding allowable vs. unallowable costs and not get overly focused on unallowable vs. expressly unallowable costs. Even if DCAA were to refine its audit policies to synchronize with the ASBCA decisions, that would only change the categorization of costs as expressly unallowable within a DCAA audit of a contractor indirect cost rate proposal. It would not change the fact that the ASBCA largely agreed with DCAA and the government with respect to unallowable activities/costs. For purposes of obtaining and maintaining an adequate cost accounting system, a contractor must identify and segregate unallowable costs (expressly unallowable or not). For purposes of responding to a DCAA audit report with respect to an audit of a contractor indirect cost rate proposal (incurred cost audit), contractors should assume that DCAA will continue to "over-report" in terms or cost questioned categorized as "expressly unallowable" subject to FAR 42.709 penalties.

(Editor's comment, this rather complex ASBCA case and its implication related to allowable, unallowable or expressly unallowable contractor activities will be discussed in detail during our webinar on December 17, 2015).

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Our Company's Mission Statement: RGCI enables contractors doing business with the U.S. government to comply with the complex and challenging procurement regulatory provisions and contract requirements by providing superior cost, pricing, accounting, and contracts administration consulting expertise to clients expeditiously, efficiently, and within customer expectations. Our consulting expertise and experience is unparalleled in understanding unique challenges of government contractors, our operating procedures are crafted and monitored to ensure rock-solid compliance, and our company's charter and implementing policies are designed to continuously meet needs of clients while fostering a long-term partnership with each client through pro-active communication with our clients

In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

Specialized Training

Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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