

# newsletter

## Government Contracts Consulting

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### In this issue...

- **OFPP Issues Proposed Letter: Defining “Inherently Governmental” Functions**
- **Harmonization of Cost or Pricing Data Thresholds for Non-Commercial Mods for Commercial Items**
- **Independent Research and Development (IR&D) Costs Redefined**
- **OMB Announces FY2010 Executive Compensation Cap**
- **DCAA Audit Policy Relative to the Revised Travel Cost Principle FAR 31.205-46**
- **An Editorial on the Plain Writing Act of 2010**
- **Training Opportunities**

### OFPP Issues Proposed Letter: Defining “Inherently Governmental” Functions

The Office of Federal Procurement Policy (OFPP) under the Office of Management and Budget (OMB) has issued a proposed policy letter to tackle the dilemma of identifying circumstances in which work should be strictly reserved for Federal employees, and thus not eligible for “outsourcing” to the private sector. The policy letter is a consequence of the March 2009 memorandum issued by the White House which requires Executive Agencies to clarify “when governmental outsourcing is, or is not, appropriate...”.

One large component of this proposed policy letter seeks to better define (or redefine) “inherently governmental”, the application of which would identify responsibilities that must always be undertaken by the federal sector, and those that may be outsourced to government contractors.

The OFPP has recommended adopting the language contained in the 1998 Federal Activities Inventory Reform (FAIR) Act and to discard 2003 revisions to OMB Circular A-76, in defining “inherently governmental”. The FAIR Act defines an activity as inherently governmental “when it is so intimately related to the public interest as to mandate performance by Federal employees”. Moreover, this legislation states that the inherently governmental activities encompass functions that require the “exercise of discretion” in application of “Federal Government authority”; the former OMB A-76 verbiage defining “inherently governmental” used the term “substantial discretion” in determining government authority over a job function – although a minor difference in verbiage, the OFPP deemed the FAIR Act which omits a “substantial” qualifier, less confusing and thus an acceptable definition.

The policy letter also addressed job duties “closely associated with inherently governmental functions”, which means jobs that “approach the status of inherently governmental” because those functions, if not properly executed, present risk that other Federal officials’ functions may be significantly undermined. The policy letter thus reminds contracting agencies to exercise careful consideration and discretion when deciding to outsource these responsibilities, although the “closely associated” functions are not defined as “inherently governmental”.

The proposed policy letter makes it clear that government agencies must designate at least a portion of “critical functions” to Federal employees, although such functions may not be “inherently governmental” within the guidance of the proposed letter. OFPP defines critical function as one “whose importance to the agency’s mission and operation requires that at least a portion of the function must be reserved for federal employees” to maintain an internal government capability to perform those functions and ensure control of an agency’s mission.

The policy letter imposes several conditions, limitations, and responsibilities upon any agency when outsourcing of functions “closely associated with an inherently governmental function” to a government contractor. Paragraph 5-2a (c), Responsibilities, outlines controls and procedures that agencies must follow in these circumstances. A striking example pertains to avoiding conflicts of interest (between government and contractor employees); to mitigate risk of conflicts, the letter includes proposed procedures such as physically separating government and contractor personnel at the government worksite, having contractor personnel work offsite (away from government offices), or simply “excluding contractors from subsequent competitions if conflicts cannot be avoided”. As to the unilateral exclusion of contractors from future outsourcing opportunities because “conflicts cannot be avoided” (even if a cost benefits analysis supports outsourcing), it remains to be seen what objective criteria the government will have to determine a “cannot avoid” situation, to include a scenario where the government has created the “cannot avoid” contracting environment.

In the proposed policy letter prepared by Daniel Gordon, Administrator of OFPP, the opening verbiage defines the letter’s purpose as providing guidance to assist agencies in identifying circumstances in which work must be held by government bureaucrats, or otherwise may be outsourced to the public sector. The memo states “nothing in this guidance is intended to discourage the appropriate use of contractors”.

Notwithstanding this purpose, the policy memo will obviously have the effect of either creating new federal jobs, or otherwise shift responsibilities currently held by government contractors (particularly those that will be redefined as “critical” or “closely associated with inherently governmental functions”) to the federal sector. And, upon execution of the policy letter, government agency procurement heads will be more reluctant to outsource any jobs where an identification of inherently governmental for such jobs remains obscure.

## Harmonization of Cost or Pricing Data Thresholds for Non-Commercial Mods for Commercial Items

The FAR Councils finalized an interim rule which aligns the cost or pricing threshold levels, under the Truth-in-Negotiations Act (TINA) for negotiated non-commercial modifications to commercial items. This final rule clarifies that the traditional TINA threshold for non-commercial modifications will also be \$650,000 and therefore consistent with the guidelines of FAR 15.403-1 which are applicable to all other pricing actions.

During the period in which comments were being addressed prior to final rule adoption, one commenter questioned the applicability of TINA thresholds to IDIQ contracts, specifically whether the threshold was applicable to the contract as a whole, or to individual task orders placed under the IDIQ contract. The councils responded “it is commonly understood that it is the estimated total value of orders for the specified period at the time of contract award, as well as the individual value of any subsequent discrete orders...”

In commenting on TINA threshold level determination for IDIQ contracts, the councils’ use of the term “commonly understood” is nowhere to be found in regulations, and such open-ended terminology instead obfuscates defining TINA threshold for these contracts. The councils’ failure to elaborate on its basis for “commonly understood” leads the reader to believe that the council members realize there is no clear (or plainly written) regulatory reference or method for assessing or determining TINA thresholds for IDIQ contracts in which case the question as to IDIQ contract TINA determination is still unanswered. And fortunately for all of us, the councils’ were not asked that same question as to CAS (Cost Accounting Standards) applicability to IDIQ contracts.

## Lawmakers Request GAO Review of Contractor Salaries & Benefits

Representatives Robert Andrews and Patrick Murphy have requested GAO to review specific government contractors to determine if those companies pay an adequate wage and health benefits package, and if not, if those companies are placing the workers and families in federal safety net programs.

The request for GAO to examine these companies comes about in conjunction with the Obama administration's unannounced High Road contracting plan, the purpose of which is to reward prospective contractors for paying their employees higher wages and benefits while also making it more difficult for irresponsible businesses (e.g., cheap-skates that pay low wages and few benefits to employees which border on violating labor regulations) to receive contract awards.

Several legislators have noted that many contractors who pay competitive wages and benefits are often discouraged from competing for government contracts because government procurement bid evaluation methods often focus on lowest proposed price, and in which case, those bidders tend to become poor performers after contract award. Thus, these legislators contend that rewarding contractors by giving them some yet to be determined incentive in the bidding process for providing decent wages and benefits will actually make the procurement system more efficient and enhance quality in services and products delivered to the government. Of passing interest, with respect to lower priced contractors predictably yielding poor quality performance, no empirical data or evidence has been provided to justify this assumption; thus one might conclude that this assumption is based entirely upon a presumed cause and affect consistent with pre-determined beliefs.

One hurdle in accomplishing this initiative is that GAO may not have any contractual or legal rights to detailed salary and benefits information (such as for competitively awarded and/or commercial items or services), and many contractors are likely to resist any requests for such information.

More importantly, government contractors are skeptical of the High Road initiative, inasmuch as the underlying outcome of any such review could be seen as a disguised initiative for the government to begin mandating minimum compensation levels for any company to receive future federal awards. Consistent with the current political climate in the government's initiative to

dictate standards of profitability and compensation in several unnamed industries, government contractors should be concerned that any GAO review of their human resources pay practices may have the unintended (or perhaps intended) consequence of limiting a contractor's competitive edge in bidding on contracts, as it relates to controlling of costs and retaining a favorable posture edge in the cost evaluation factor for receiving an award.

## Independent Research and Development (IR&D) Cost Redefined

In its decision dated March 19, 2010, the U.S. Court of Appeals for the Federal Circuit reaffirmed that costs incurred by ATK Thiokol were not required by a commercial contract, hence properly allocable as IR&D (ATK Thiokol Inc v. United States, Fed Cir., No. 2009-5036, 3/19/10). At issue was the definition of what is required by contract because costs required by contract are by definition not "Independent" Research and Development (FAR 31.205-18: The term does not include the costs of effort sponsored by a grant or required in the performance of a contract).

In the ATK Thiokol case which involved a commercial contract, the buyer (Mitsubishi Heavy Industries) essentially paid for the costs to attach the buyer's satellite to the ATK Thiokol launch vehicle, but the buyer would not pay for ATK Thiokol costs to improve the launch vehicle. Of note, at the time of the commercial contract, ATK Thiokol was actively marketing the improved launch vehicle to a broad range of potential customers. Of further note, ATK Thiokol had also introduced the fact that the government had previously contracted with ATK Thiokol to selectively fund research and development tasks within a program which also involved interrelated, but unfunded or independent research and development tasks. Hence, both a commercial buyer and the government had a track record of selectively funding certain tasks otherwise interrelated with the performance of a contract. Therein creating the explicit requirements (funded tasks) and the implicit requirements (unfunded tasks albeit required to some extent to deliver the funded tasks).

As history has shown back into the 1970s, the IR&D debate has always involved the interpretation of "required by contract" in the context of "explicitly" required or "implicitly" required. Prior to the ATK Thiokol case, the interpretation favored the "implicitly" required, premised upon a Newport News case wherein the government had successfully argued that commercial ship construction contracts required the ship design and related costs; otherwise Newport News would have

been unable to satisfy the requirements to design and build and deliver the ships within the contract specifications. The dispute was focused on the engineering design costs which had been treated by Newport News as IR&D, an indirect cost absorbed through the cost allocation to the G&A base which was typically 90+% US Navy flexibly priced contracts. In round numbers, as IR&D, \$60 million of commercial ship engineering costs were absorbed by US Navy contracts. Newport News unsuccessfully argued that “required by contract” was that which was explicitly required; the government countered with the “implicitly required” which was certainly aided by the contracts which expressly stated, “design”.

At the time, the Newport News decision was heralded as finally deciding the “explicit” vs. “implicit” debate; however, it really did not make anything final because that decision was based upon specific facts and circumstances which suggested that if a buyer-seller were allowed to control cost allocations by controlling the explicit requirements of a contract, we could end up with endless maneuverings to shift costs into IR&D. The deliverables would need to be clearly understood (i.e. implied), but the contract would avoid specific statements of work, thus avoiding specific elements of cost. If abused, this could be the proverbial “license to steal” assuming the seller has other contracts which can absorb the redistributed IR&D costs.

In fact, the ATK Thiokol case was substantially different from Newport News in that there was simply a better, more logical cost accounting approach by ATK Thiokol. It did not appear to be a test of the “explicit” vs., “implicit” definition of required by contract, but simply a reasonable business decision wherein a single buyer wasn’t saddled with development costs which could ultimately benefit a broad range of potential buyers based upon very active marketing to a broad range of buyers.

But now we have the ATK Thiokol decision which seems to have redefined “required by contract” to be the more narrow “explicitly required” or paid for “within the contract price”. And with every decision which “finally settles” some government contract costing debate, we will also have the unintended consequences—in this case, those customers, government and commercial, who will be quite ambitious within their attempts to narrowly define contract requirements with the objective of shifting implicitly required tasks and costs into IR&D. As noted by ATK Thiokol, the government has participated in this charade through selective funding of tasks which were all interrelated to producing the same end product. When confronted with a mismatch between the statement of work and the available funds, what better solution than to shift an underfunded program’s costs to someone else (more often

than not shifting costs among government contracts). Let the games begin.

## OMB Announces FY2010 Executive Compensation Cap

As of April 15, 2010, the statutory cap (FAR 31.205-6(p)) is \$693,951 for contractor fiscal year 2010 and beyond. The increase was only \$9,770 above the 2009 cap; perhaps a sign of the economic times (the statutory cap includes salary, bonus, employer contributions to defined benefit pension plans and deferred compensation).

A few reminders with respect to the statutory cap, it does not require the contractor to pay less than the cap, but it simply defines the maximum allowable for government contracts subject to the cap. It is not measured against amounts which are solely allocated to the government; for example a CEO of a company with 50 percent government and 50 percent commercial work could not be paid (and the company claim in G&A) an amount which is double the cap (\$1,387,902) based upon the amount allocated to the government of \$693,951 (50% of the total).

Additionally, the cap only applies to the five highest compensated executives (management positions) and it does not eliminate the FAR 31.205-46(b) test for reasonableness. Because the cap is derived from publicly traded corporations with revenues of \$50 million or more, the cap could not be applied to a CEO of a company with revenues of \$5 million without triggering a reasonableness issue.

Finally, one cannot apply escalation to the cap; forecasts can only include executive salaries up to the cap as applicable to the top five executives. As only the government can create such anomalies, executive number six could actually be paid more than the cap (in 2010) and/or a contractor could find itself bidding a multi-year contract where salaries for executive number six and below surpass those bid for the top five executives.

## DCAA Audit Policy Relative to the Revised Travel Cost Principle FAR 31.205-46

As previously discussed in our December Newsletter, the travel cost principle (FAR 31.205-46) was amended (effective January 11, 2010) to limit the cost of air travel to the “lowest priced airfare available to the contractor,” with limited

exceptions. The stated purpose of this ruling is to limit a contractor's recovery of air travel costs for employees that are utilizing premium class airfare to the lowest airfare available to that particular contractor based on agreements the contractor has negotiated with the airline and/or with travel agencies.

Although the new wording intended to "clarify" the regulation, in our opinion it is more ambiguous than before and those ambiguities have already been misinterpreted by DCAA (Defense Contractor Audit Agency) in the context of its audit policy 10-PAC-010(R), dated March 22, 2010. DCAA's policy requires extensive documentation including that which supports non-premium fares which are greater than the absolute lowest "available" fare to a contractor (or contractors in general). This audit policy has adverse implications for contractors who do not have negotiated agreements with specific airlines suggesting that reasonableness will be an issue. This poses serious concerns and certainly increases risk regarding DCAA auditors making subjective, judgmental decisions to question the allowability of air travel costs. Certainly from the contractor perspective, the revised travel cost principle accomplished nothing other than giving DCAA different avenues to question contractor costs.

In addition to the risk of air travel cost allowability being questioned, there is the imposing and administratively costly task of documenting the "lowest priced airfare available during normal business hours". This will require (per DCAA) travel administrators to have documented airfare quotes for multiple airlines or from multiple travel agencies when booking air travel for employees, a difficult endeavor given the volatility and variability in the price of air travel between different airlines as well as from a single airline. As is self-evident to anyone who travels, airfares are not a standard price, locked in for a period of time but often vary in price over the course of a single business day. The implications, the revised rule coupled with DCAA audit policies will increase time and administration costs to document that airfare was the lowest available to the contractor

The amended rule clearly requires the use of non-refundable airline tickets (which are lower in price than refundable tickets); however, DCAA's audit policy seems to be reasonable in stating that "auditors should not question costs in excess of nonrefundable tickets if contractor's data shows increased costs result in comparison to refundable tickets". Unfortunately a closer reading unveils the risk to the contractor associated with the documentation issue (i.e. *the contractor's data must show*). Translated, a contractor's data must clearly document refundable tickets were ultimately less expensive than

nonrefundable which implicates a documented history showing additional costs from change fees and then DCAA coaxes its auditors to challenge this scenario if it becomes repetitive which DCAA concludes is inadequate planning and unreasonable costs.

There are long-standing exceptions which still apply to the amended travel cost principle (FAR 31.205-46) and its allowable cost limited to the "lowest priced airfare available to the contractor," including when "accommodations require circuitous routing, require travel during unreasonable hours, excessively prolong travel, result in increased cost that would offset transportation savings, are not reasonably adequate for the physical or medical needs of the traveler, or are not reasonably available to meet mission requirements." In order for airfare in excess of the lowest available to be allowable these exceptions or limited circumstances must be adequately documented. However, there is no guarantee the contractor's documentation will be deemed adequate by a DCAA auditor, encouraged to challenge the "grey" areas and question excess cost based upon his/her interpretation.

The bottom line is that the ambiguous language used in the amended travel cost principle will cause additional headaches for government contractors; first the increased administrative time and cost and then the additional opportunities for the DCAA auditors to question the allowability or reasonableness of any air travel costs which exceeds the absolute lowest available. Government contractors will need to provide well documented airfare analysis when booking employee travel to protect themselves against overzealous DCAA auditors.

## An Editorial on the Plain Writing Act of 2010

The Plain Writing Act of 2010 will require federal agencies to prepare documents explaining how to comply with federal guidelines in plain writing. The bill defines "plain writing" as writing which the intended audience can readily understand and use because that writing is clear, concise, well-organized and follows other best practices of plain writing.

We should all feel much better now or actually within the one year that federal agencies have to comply with the law. If it takes one year to comply, it must be more difficult than we might assume. Or is that presume? Will the intended audience please identify itself? Will we ever know if any agency actually achieved this Congressional mandate and more importantly will Congress be subject to the same requirements (obviously not since the requirements include "concise").

## Training Opportunities

### 2010 Beason & Nalley Sponsored Seminar Schedule:

**May 13, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

**May 18, 2010 – Managing the Ever-expanding DCAA Expectations of Prime Contractor Responsibilities for Subcontractors Lunch & Learn**

Location: Huntsville, AL  
Time: 11:00 AM – 1:30 PM  
Cost: \$50 per person

**June 17, 2010 – FAR Part 31 Cost Principles**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

**June 24, 2010 – Fundamental Requirements of Cost Accounting Standards**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

**September 16, 2010 – FAR Part 31 Cost Principles**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

**October 21, 2010 – FAR Part 31 Cost Principles**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

**November 9, 2010 – Understanding Government Audits and How to Resolve Audit Issues**

Location: Huntsville, AL  
Time: 8:15 AM – 4:45 PM  
Cost: \$325 per person

**November 17, 2010 – Cost and Price Analysis in Government Contracting**

Location: Reston, VA  
Time: 8:15 AM – 4:45 PM  
Cost: \$450 per person

If you need additional information, please contact Lori Beth Miller at [lmiller@beasonnalley.com](mailto:lmiller@beasonnalley.com) or 256-533-1720.

### 2010 Federal Publications Sponsored Seminar Schedule

**May 3-4, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

San Diego, CA

**May 4-6, 2010 – The Masters Institute in Government Contract Costs**

San Diego, CA

**June 8-9, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks**

Las Vegas, NV

**June 9-10, 2010 – A Manager's Guide to EVMS**

Las Vegas, NV

**June 22-23, 2010 – Government Contract Accounting Systems Compliance**

Las Vegas, NV

**July 13-15, 2010 – The Masters Institute in Government Contract Costs**

Hilton Head, SC

**August 2-3, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

Arlington, VA

**August 2-3, 2010 – Government Contract Accounting Systems Compliance**

Arlington, VA

**August 4-5, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks**

Arlington, VA

**August 4-6, 2010 – The Masters Institute in Government Contract Costs**

Washington DC

**September 21-22, 2010 – Government Contract Accounting Systems Compliance**

Seattle, WA

**October 13-14, 2010 – A Contractor's Guide to the Incurred Cost Submission (ICS)**

Las Vegas, NV

**October 19-20, 2010 – Government Contract Audits: Dealing with Auditors and Mitigating Audit Risks**

Herndon, VA

**October 25-26, 2010 – Government Contract Accounting Systems Compliance**

Washington DC

**November 30-December 1, 2010 – A Manager’s Guide to EVMS**

Las Vegas, NV

**December 6-7, 2010 – Government Contract Accounting  
Systems Compliance**

Las Vegas, NV

**Instructors**

- Mike Steen
- Darryl Walker
- Scott Butler
- Chad Braley
- Courtney Edmonson
- Cyndi Dunn
- David Miller

Go to [www.fedpubseminars.com](http://www.fedpubseminars.com) and click on the Government Contracts tab or call Beason & Nalley, Inc. at 800-416-1946.

## Specialized Training

Beason & Nalley, 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 Miller at [lmiller@beasonnalley.com](mailto:lmiller@beasonnalley.com), or at 800-416-1946.

## Reader Inputs for Future Newsletters

Beason & Nalley, Inc. develops its topics based upon recent regulations, information, publicly accessible Government policies and our experience in assisting clients with regulatory compliance. However, we are also interested in the ongoing compliance experiences of our readers; hence, we invite your input in terms of suggestions for topics based upon your compliance experiences. Suggested topics along with any background information (i.e., your experience) should be sent to [lmiller@beasonnalley.com](mailto:lmiller@beasonnalley.com).

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