United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS

SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT

WASHINGTON, DC 20510-6250

April 2, 1987

Mr. Charles Lloyd, Executive Secretary
Defense Acquisition Regulatory Council
DASD (P)/DARS, c/o OASD (A&L)
Pentagon Room 3C841
Washington, D.C. 20301-3062

Re: DAR Case 84-18

Dear Mr. Lloyd:

I am writing to express my concern about the treatment of "golden parachutes" -- lucrative compensation packages for top executives in the event of a corporate takeover -- under Defense Department cost allowability regulations.

In the past month, several Defense Department officials have taken the position that golden parachute costs are not allowable because they are not "reasonable" and do not bear a proper relationship to government work. Golden parachute costs are not expressly disallowed by DOD's procurement regulations, however, so contractors are not precluded from including such costs in overhead and arguing for their allowability.

I understand that the DAR Council is currently considering a regulation in DAR case 84-18 that would make golden parachute costs expressly unallowable. I have grave doubts about the propriety of reimbursing defense contractors for these costs and urge you to consider the matter as soon as possible.

Sincerely,

Carl Levin

Carl Levin
Chairman

CL:pkl

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-8000

84-18

ACQUISITION AND LOGISTICS
P/CPF

17 MAR 1987

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (RD&A)
ASSISTANT SECRETARY OF THE NAVY (S&L)
ASSISTANT SECRETARY OF THE AIR FORCE (RD&L)
DIRECTORS OF THE DEFENSE AGENCIES

SUBJECT: Golden Parachutes

An article in the Washington Post on March 14, 1987, stated that under Pentagon rules the costs of "golden parachutes" could be billed to the Department of Defense (DoD). Golden parachutes are usually defined as lucrative compensation packages for executives that are triggered in the event of a corporate takeover.

Although the DoD regulation governing the allowability of contract costs does not specifically mention "golden parachutes," it does require that all costs charged to Government contracts be "reasonable." A "reasonable cost" does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Additionally, costs charged to Government contracts must bear a causal or beneficial relationship to the work performed on such contracts. The DoD position holds that the costs of "golden parachutes" are not reasonable nor do they benefit government work. Accordingly, they are unallowable and should be questioned on Government contracts.

The Defense Logistics Agency issued policy guidance on "golden parachutes" in early 1983 as did the Air Force. The Defense Contract Audit Agency (DCAA) incorporated guidance on abnormal executive severance pay in the Contract Audit Manual in mid 1984. However, you are requested to ensure that the policy guidance in this memorandum is made available to all appropriate personnel to make certain that unreasonable costs are not reimbursed on DoD contracts.

This memorandum does not apply to severance pay that meets the requirements of Paragraph 31.205-6(g) of the Federal Acquisition Regulation.

Eleanor Spector

Eleanor R. Spector
Deputy Assistant Secretary of
Defense for Procurement

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ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-8000

ACQUISITION AND LOGISTICS
P/DARS

MAR 17 1987

Honorable Jack Brooks
Chairman, Committee on
Government Operations
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This is in reply to your letter to Secretary Weinberger regarding the Defense Acquisition Regulatory (DAR) Council's handling of the General Accounting Office (GAO) recommendation to improve the consistency with which the Federal Acquisition Regulation (FAR) cost principles are applied.

As you point out in your letter, the Department of Defense (DoD) concurred with this GAO recommendation and a proposed FAR amendment was published in the Federal Register (50 FR 51776) stating that costs made specifically unallowable under any subsection of the FAR cannot be made allowable under other subsections. However, the public comments received in response to our proposed rule indicated that the language, as written, would aggravate rather than improve the consistency issue. Many of the commenters expressed the concern that the proposed rule would distort the process of determining the allowability of a debatable contractor expenditure. For instance, one commenter stated, "... with a few exceptions, costs are not allowable or unallowable per se. Their allowability depends in significant part on the context in which they are incurred." Illustrations of this point are situations in which one cost principle says that a type of cost is unallowable, but another cost principle says that, in particular situations, the same type of cost is allowable. For example, interest on borrowings is unallowable under FAR 31.205-20, but certain types of "interest" on borrowings for certain specified purposes are explicitly made allowable under the cost principles, e.g., FAR Section 31.205-35(a)4, and (7)--for interest paid on mortgages assumed as a result of employee relocation.

The public comments convinced the DoD that the proposed rule, as written, needed revision to achieve the consistency and equity required for effective contract costing. Consequently, the DAR Council is working with the Civilian Agency Acquisition Council (CAAC) to develop revised language that will enhance the fair and consistent treatment of contract costs. Once developed, this revision will be published again as a proposed rule with a request for public comments.

In addition to the above mentioned effort to improve the effectiveness of the FAR cost principles, the Department responded to the 1986 DoD Authorization Act (Pub. L. 99-145) and suggestions from the Office of the Secretary of Defense Task Force on Cost Principles by amending or clarifying many of the specific FAR cost principles. In fact, a recent GAO report dated October 10, 1986, concluded that the improved cost principles should reduce inconsistent treatment of contract costs. Further, the GAO noted that the allowability criteria for all cost elements cannot be written in such a way as to remove all ambiguity.

The Department shares your desire for cost principles written in a way which reduces the possibility of multiple interpretations and inconsistent treatment. We also agree with the GAO recognition that all ambiguity cannot be removed. The DoD will continue to work toward development of cost principles which allow for consistent interpretations and which provide a fair and practical basis for handling contract costs. If you have further questions or concerns regarding this matter, please have your staff contact Colonel Otto J. Guenther, Director, DAR Council at 697-9125.

Sincerely,

Robert B. Costello
Assistant Secretary of Defense
(Acquisition and Logistics)

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ONE HUNDREDTH CONGRESS

Congress of the United States

House of Representatives

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-373
WASHINGTON, DC 20515

1987 MAR -2 AM 5:10
OFFICE OF THE SECRETARY OF DEFENSE

February 24, 1987

Honorable Caspar W. Weinberger
Secretary of Defense
Department of Defense
Washington, D.C. 20301

Dear Mr. Secretary:

As you know, this Subcommittee has a strong interest in the subject of unallowable costs being charged to Government contracts. We held hearings on the subject of public relations and advertising costs in 1984. Following those hearings, the Federal Acquisition Regulation (FAR) was amended to provide that public relations or advertising costs once made unallowable under FAR subpart 31.205-1 could not be allowable under any other FAR subpart. Subsequent to this amendment, the General Accounting Office (GAO), in a report (GAO/NSIAD-85-81), recommended to the Department of Defense (DOD) that this rule be applied to all cost principles.

DOD concurred with the 1985 recommendation and a proposed FAR amendment was issued stating that costs made specifically unallowable under any subsection of FAR cannot be made allowable under other subsections. It is my understanding that recently the Defense Acquisition Regulatory Council has rejected this GAO recommendation and is planning instead to place language in the FAR that could possibly lead to inconsistent treatment of contract costs.

I would appreciate an explanation, at the earliest possible date, of the reasons your Council has chosen not to implement this recommendation.

Sincerely,

Jack Brooks

JACK BROOKS
Chairman

Leo McGary

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Allowable Costs

'GOLDEN PARACHUTES' ARE UNALLOWABLE; DAR COUNCIL WEIGHING RELATED FAR CHANGES

Defense contractors may not charge the costs of "golden parachutes"—arrangements that guarantee lucrative compensation for top corporate executives in the event of a takeover—to the government because such costs neither meet the test of reasonableness nor benefit the government, the Pentagon asserted last week.

A March 18 statement prepared by the office of Assistant Secretary of Defense for Acquisition and Logistics Robert Costello and distributed to the press says that, although the DOD procurement regulation governing allowability of contract costs does not specifically mention golden parachutes, it does require that all costs charged to government contracts must 1) be reasonable and 2) bear a causal or beneficial relationship to the work performed on such contracts.

"The DOD position holds that the costs of 'golden parachutes' are not reasonable nor do they benefit government work," the statement says. "Accordingly, they are unallowable and have always been questioned on government contracts."

According to one DOD source, the Defense Contract Audit Agency has not been able to identify a single instance in which DOD has allowed such costs to be included in a contractor's overhead charges; in every instance where contractors claimed such costs, those costs were disallowed.

DAR Case Pending

Meanwhile, the Defense Acquisition Regulatory Council is considering several changes to the Federal Acquisition Regulation that would specifically make golden parachutes and other costs associated with mergers and acquisitions unallowable.

DAR Case 84-18, "Accounting for Mergers and Business Combinations," has been forwarded to the Council by the cost principles committee. The DAR Council is expected to make its decision on the case in a few weeks.

One DOD source told FCR that the proposed FAR changes may entail revisions to two Cost Accounting Standards—CAS 404, Capitalization of tangible assets, and CAS 409, Depreciation of tangible capital assets.

Dingell To Hold Hearing

The Pentagon statement on golden parachutes was issued in response to recent criticism by Reps. John Dingell (D-Mich) and Ron Wyden (D-Ore) of the methods DOD uses to reimburse contractors for the salary and bonuses they pay their top executives.

Under current cost principles, contractors may include in their overhead charges the proportion of executive compensation that corresponds to the amount of government business the contractor has.

In a March 11 letter to Defense Secretary Caspar Weinberger, Dingell and Wyden cited "bloated salaries and lavish bonuses" paid to top executives of major defense firms such as TRW and General Dynamics. They maintained that it is not fair that taxpayers should help foot the bill for such costs.

In particular, the letter criticized TRW's golden parachute arrangement, which like all such arrangements, is designed to discourage a takeover attempt by requiring that the acquiring entity continue to pay top executives of the acquired entity for a certain period of time, often at higher salaries, even after they have left the firm.

Under the TRW golden parachute arrangement, the top 14 executives would be guaranteed three years cash compensation plus bonuses.

The letter points out that, under TRW's golden parachute arrangement, those executives would be paid over $16 million in a takeover. Roughly half that amount could be billed to the government as part of the overhead charge. TRW's chairman of the board, Ruben Mettler, would receive one-fourth of that amount—$4.2 million—under the arrangement.

"The taxpayers would pay more for Dr. Mettler not to work than they pay for the combined annual salaries of President Reagan, Vice President Bush, and the entire Cabinet," the letter pointed out.

However, a DOD official told FCR that TRW has made an agreement with DOD that its golden parachute costs will not be charged to the government if there is a take over. The source said Dingell had been informed of the agreement. Other firms reportedly have made similar agreements with DOD.

However, Dingell and Wyden maintain that nothing in DOD procurement regulations prevents suchcosts from being charged to defense contracts. Their letter contends that proposed changes to the FAR that would specifically disallow such costs "have been consigned to limbo within the Pentagon's bureaucracy and have never been enacted."

DOD officials maintain that the DAR case in question, Case 84-18, has been held up because of the heavy burden the DAR Council has been under to implement statutory requirements. Costello's statement is intended to set the record straight that such costs, while not specifically unallowable at the present time, could nevertheless not be charged to a government contract.

Separately, Deputy Assistant Secretary of Defense for Procurement Eleanor Spector issued a memo March 17 to the services reminding them that the costs of golden parachutes are unallowable.

Spector also told the House Government Operations Subcommittee on Legislation and National Security March 18 that DOD has a longstanding practice of disallowing golden parachutes.

The House Energy and Commerce subcommittee on Oversight and Investigations—which Dingell chairs—plans to hold a hearing in late spring on the subject of executive compensation, bonuses, and golden parachutes.

DAR Case Pending

Meanwhile, the DAR Council is considering a proposal (DAR Case 84-18, "Accounting for Mergers and Business Combinations," that would specifically make unallowable the costs of golden parachutes.

The pending DAR case would amend FAR 31.205-6, Compensation for Personal Services, to make unallowable the costs of golden parachutes and golden handcuffs (lucrative compensation packages by the acquiring entity to induce executives of the acquired entity to remain). In addition, the case would amend FAR 31.205-27, Organization costs, to make unallowable the costs entailed in fighting a takeover.

Also, the DAR case would amend several FAR sections, including 31.205-10, Cost of money, 31.205-11, Depreciation, and 31.205-16, Gains and losses on disposition of depreciable property or other capital assets, and 31.205-49, goodwill, to make unallowable the added cost of money and the depreciation involved write-up of asset values to current market value that typically occurs in a takeover.

In addition, the case would amend FAR 42.1200 and 42.1204 to extend the requirement for a novation agreement to include situations whereby one company gains control of another through acquisition of a majority of its stock.

The case is currently under consideration by the DAR Council. Once the Council has approved it, it will be sent to the Civilian Agency Acquisition Council for approval, and then issued as a proposed rule in the *Federal Register.*

Text of Spector's March 17 memo on golden parachutes follows:

MEMORANDUM FOR
ASSISTANT SECRETARY OF THE ARMY (RD&A)
ASSISTANT SECRETARY OF THE NAVY (S&L)
ASSISTANT SECRETARY OF THE AIR FORCE (RD&L)
DIRECTORS OF THE DEFENSE AGENCIES

SUBJECT: Golden Parachutes

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Although the DoD regulation governing the allowability of contract costs does not specifically mention "golden parachutes," it does require that all costs charged to Government contracts be "reasonable." A "reasonable cost" does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Additionally, costs charged to Government contracts must bear a causal or beneficial relationship to the work performed on such contracts. The DoD position holds that the costs of "golden parachutes" are not reasonable nor do they benefit government work. Accordingly, they are unallowable and should be questioned on Government contracts.

The Defense Logistics Agency issued policy guidance on "golden parachutes" in early 1983 as did the Air Force. The Defense Contract Audit Agency (DCAA) incorporated guidance on abnormal executive severance pay in the Contract Audit Manual in mid 1984. However, you are requested to ensure that the policy guidance in this memorandum is made available to all appropriate personnel to make certain that unreasonable costs are not reimbursed on DoD contracts.

This memorandum does not apply to severance pay that meets the requirements of Paragraph 31.205-6(g) of the Federal Acquisition Regulation.

/s/ Eleanor R. Spector
Deputy Assistant Secretary of
Defense for Procurement

Contract Policy

DOD LAUNCHES TEST PROGRAM TO SIMPLIFY, SPEED UP ACQUISITION PROCESS

Under Secretary of Defense for Acquisition Richard Godwin has launched a "procurement regulatory reform test" designed to simplify and speed up the acquisition process. To this end, he has delegated his authority to issue class deviations to the FAR and DFARS, and waivers of any DOD procurement regulation not required by statute or executive order, to the service acquisition executives, with authority to redelegate to the assistant secretary level.

"The DOD acquisition process is controlled by too many detailed, complex laws and regulations," Godwin stated in a March 11 memo to the service secretaries and the head of the Defense Logistics Agency.

"To this end, I am establishing a pilot contracting activity program.... The goal is to make it easier and quicker for contracting personnel to get line managers and commanders the quality products and services they need, when they need them," the memo says.

"The pilot activities should place a strong emphasis on quality and timeliness as well as price to get the best value for the nation," the memo continues. "I would also like them to test procurement methods more in line with commercial practices for both commercial and non-commercial products and services."

All class deviations or waivers and the justification for such must be reported to Assistant Secretary of Defense for Acquisition and Logistics Robert Costello. The focal point for the initiative is the office of Deputy Assistant Secretary of Defense for Installations Robert Stone.

Costello Assigns Five-point Agenda to Deputies

Separately, Assistant Secretary of Defense for Acquisition and Logistics Robert Costello has assigned his five-point agenda to five of his deputies. Costello had outlined an agenda last fall before he was confirmed by the Senate (46 FCR 1001).

Little information is available on the implmentation of the five initiatives, since the assignments were made only recently.

The Costello assignments are as follows:

• **Improving relations with industry**—Deputy Assistant Secretary of Defense for Procurement Eleanor Spector. To this end, Spector plans to hold meetings with industry representatives on a regular basis. Also, the DAR Council will conduct meetings with industry

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that the ALJ be independent of the investigating official, the prosecutor, and the office where the matter arose. An adverse hearing examiner's decision can be appealed to the agency head, and then to the U.S. Court of Appeals. The suit can be brought in the D.C. Circuit, the circuit with jurisdiction over the defendant's residence, or the circuit where the claim was made.

The administrative proceedings contemplated by the "Civil Fraud Penalties Act" will pass constitutional muster, according to the Administration's analysis of the bill. In Atlas Roofing Co. v. Occupational Safety and Health Administration, 430 U.S. 442 (1977), the Supreme Court ruled that Congress, in creating new statutory "public rights," could assign the adjudication function to administrative agencies without violating the Seventh Amendment's trial by jury guarantee, the agency notes. "We believe that the statute may, like the False Claims Act, be characterized as a 'remedial' statute."

Another key provision would permit the government to collect penalties assessed through offset against other amounts owed by the government. The Deficit Reduction Act already allows the government to offset debts against the debtor's tax refunds. The draft bill would expand this power to other sources, including sums owed under government contracts.

Contract Disputes Act Amendments

Preaward protest suits are currently filed in the Claims Court, while postaward suits must be brought in federal district court. "There is no principled reason for this multiplicity of forums, and there is still confusion over the division," according to the analysis. The Administration would amend the Federal Courts Improvement Act (923 FCR A-8, F-1) to state that all protest suits must be filed at the Claims Court.

The same draft bill would also amend the Contract Disputes Act, so as to require that all claims be submitted to a contracting officer within 18 months after they accrue. Currently, there is no deadline for submission of claims, the Administration points out in its analysis, adding that this makes resolving disputes more difficult.

In addition, the measure would require contractors to pay within 30 days any monies which the contracting officer determines is owed the government. "By expressly providing that failure to take an appeal requires immediate payment, we should have more success in enforcing such judgments," the Administration analysis states. Moreover, the bill would permit the government to sue in district court to collect these amounts, and to seek injunctive relief to protect the assets of a contractor pending payment.

Another key feature of the bill would legislatively overturn the ASBCA's decision in DMJM/Norman Engineering Co. (41 FCR 631, 658). In that case, the board ruled that the government must follow Debt Collection Act procedures before exercising its common-law offset right. Thus, the government would have to give notice of the claim and its intent to offset, plus an opportunity to inspect the records relating to the claim and review the agency's decision before the amount could be offset.

Under common law, the government would have the right to offset before paying a debt due a contractor, according to the Administration's analysis. "Prior to the *DMJM/Norman Engineering* decision, this right had been routinely used and never challenged; it is an effective and vital method of recouping sums owed to the U.S." The Debt Collection Act procedures were not intended to apply to traditional contract disputes, where the government has a right to offset penalties for inadequate performance against payments due a contractor, DOJ adds. "This amendment would ensure that the Debt Collection Act does not hinder. . . efforts to collect money due for inadequate contract performance."

Bribes and Gratuities

The Administration's package would also strengthen the government's remedies in dealing with contracts, grants and other payments that are tainted by bribery. Under current law, the government may rescind tainted contracts and assess penalties up to ten times the amount of the bribe. The "Bribes and Gratuities Act" would enable the government to rescind the tainted contract and assess damages. However, it also would permit the government to rescind the contract, retain all benefits received, and then recover all amounts paid. These remedies cannot be utilized, though, unless notice is given in the applicable contract or grant.

Debt Collection Act Amendment

the draft bill to amend the Debt Collection Act would permit the Attorney General to "retain private counsel" in the litigation of certain Debt Collection Act cases. The legislation would enable the Attorney General to award contracts to law firms for purposes of litigating small debt collection cases. In addition, it states that the selection will not be subject to judicial review under laws governing contract awards, including the Contract Disputes Act. "This will facilitate the prompt implementation of this new authority, ensuring that the choice of counsel is not delayed by litigation brought by disappointed bidders," the Administration says.

Other draft bills in DOJ's antifraud/procurement reform package would:

- Increase the dollar threshold for publicizing procurement notices in the *Commerce Business Daily*.
- Authorize civilian agencies to award more multiyear contracts.
- Amend the Office of Federal Procurement Policy Act to provide authority to test innovative procurement methods and procedures.

Text of the Administration's draft bills appear on page 367.

Accounting

NO ASSET REVALUATION PERMITTED WHEN FIRM IS ACQUIRED IN PURELY STOCK TRANSACTION

A company acquired in a purely stock transaction cannot increase the value of its assets for government contract costing purposes under the purchase method of accounting, the Armed Services Board of Contract Appeals decides (Marquardt Co., ASBCA No. 29888, 7/18/85).

Marquardt manufactures advanced propulsion systems for the Defense Department. The company was a subsidiary of CCI Corp. until August 1983, at which time it was acquired by ISC Electronics, Inc. There was no exchange of assets; CCI merely sold its stock.

Accounting Principles Board Opinion No. 16, which establishes the generally accepted accounting principles applicable to business combinations, recognizes two different accounting methods. The "purchase method" approach is premised on the acquisition of one company by another; the "pooling of interests" approach is based on "the uniting of the ownership interests of two or more companies by the exchange of securities." Under the purchase method, the cost of an acquired corporation should be allocated to its identifiable assets, according to their fair values. The opinion goes on to state that the values should be determined as of the date of acquisition.

ISC Electronics recorded the Marquardt acquisition on ISC's books, using the purchase method of accounting. The total cost was apportioned among Marquardt's assets based on their value as of the acquisition date. This resulted in an increase in the asset values.

Marquardt subsequently made a written proposal to the government to increase the net book value of its assets from $8 million to $48.4 million, retroactive to the date of the acquisition. Marquardt then incorporated the stepped-up asset base into its overhead rates for purposes of billing on government contracts.

The contracting officer on one of Marquardt's contracts issued a final decision stating that the company should not be allowed to increase its fixed asset base for government contract costing purposes. The contracting officer pointed out that Marquardt had been sold through a transfer of stock; there were no changes to its management team or asset base. The government had agreed that a novation would not be needed to protect existing contracts from additional costs due to the acquisition, the contracting officer noted. Marquardt appealed to the ASBCA.

Asset Revaluation Not Permitted

Marquardt argued that its purchase by ISC Electronics was a business combination subject to the accounting board principles, and that the purchase method of accounting was applicable to the transaction. The purchase method requires that the acquired company's assets be revalued based as of the date of acquisition, the firm maintained.

"Marquardt's arguments lose sight of the fact that [it], and not its new parent... is the contracting party here," Administrative Judge Charles Duvall observes. The Accounting Principles Board opinion states that a business combination occurs when one or more businesses are brought together into a single accounting entity, and that organization carries out the activities of the previously separate enterprises. Since Marquardt remained an independent entity, its reliance on the APB opinion is misplaced, the judge stresses. "It alone remained responsible for performing its government contracts."

Under these circumstances, the APB opinion has nothing to do with how an acquired company is to value its assets, Judge Duvall says. "APB 16 deals solely with how an acquiring corporation is to value the assets it has acquired."

Marquardt also contended that the revaluation was permissible under the ASBCA's decision in Gould Defense Systems, Inc. (40 FCR 200). In that case, the board commented that the government had not contested the general propriety of using the purchase method of accounting for business combinations with respect to government contract pricing.

Marquardt's reliance on *Gould Defense Systems* is again misplaced, Judge Duvall emphasizes. In that case, Gould and Clevite Corp. merged, and Gould—as the acquiring company—was attempting to recover costs attributable to its contracts based on a revaluation of Clevite's assets (40 FCR 200). In contrast, Marquardt acquired no assets here; it was bought by another firm, he notes.

In addition, Marquardt's position also violates the Defense Acquisition Regulation, the board finds. DAR §15-201.4 provides that a cost is allocable to a government contract if it is incurred specifically for the contract and benefits the contract. "There is no benefit to Marquardt's government contract resulting from the purchase by [ISC Electronics]," Judge Duvall declares.

Marquardt was the passive subject of a transaction between its former and present owners, the board concludes. "If [ISC] is to recover the purchase cost of acquiring Marquardt, it can only do so under its own government and commercial contracts." Marquardt is a separate legal entity, and its contracts cannot be burdened ewith costs incurred by a third party.

Accordingly, Marquardt improperly used the purchase method of accounting for valuation of its assets; its claim that it may legally increase the value of its assets for contract costing purposes is denied.

Acting ASBCA Chairman Daniel M. Arons and Acting Vice-Chairman Vasil S. Vasiloff concur in the decision.

Davis-Bacon

WEINBERGER SEEKS DAVIS-BACON REFORMS IN MILITARY CONSTRUCTION BILL

Although a provision that would have exempted most military construction from Davis-Bacon Act prevailing requirements was dropped from the Senate and House conference report on the fiscal 1986 defense appropriations bill (44 FCR 236; 44 FCR 189), Defense Secretary Caspar Weinberger told members of Congress that he supports a waiver from federal prevailing wage requirements on military projects.

"The next opportunity to include the reforms in Department of Defense legislation appears to be through a floor amendment to the 1986 millitary construction bill," Weinberger said in letters sent July 31 to Reps. Charles W. Stenholm (D-Tex) and Arlan Stangeland (R-Minn).

"I would welcome and support such an amendment since the Davis-Bacon reforms proposed by the Senate would save about $150 million annually at a time when we are under severe budget constraints," Weinberger said. "In addition to saving money, the reforms would significantly reduce administrative burdens on the government and contractors, especially small contractors."

A Davis-Bacon exemption was added to the defense appropriations bill in the Senate but not in the House where it was strongly opposed by organized labor. The amendment offered by Sen. Phil Gramm (R-Tex)

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THE WASHINGTON POST
5 March 1985

Navy Policy
85-0-4/84-144/84-217
7 March 1985

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108TH YEAR No. 91 © 1985, The Washington Post Company WEDNESDAY, MARCH 6, 1985

U.S. Withholds Payments To Top Defense Contractor

General Dynamics Freeze Is Part of Wide Crackdown

By Michael Weisskopf and Howard Kurtz
Washington Post Staff Writers

Defense Secretary Caspar W. Weinberger yesterday froze for at least 30 days all payments to General Dynamics Corp. for overhead costs—a figure estimated at $40 million monthly—while the Pentagon reviews whether the nation's largest defense contractor has improperly billed taxpayers for corporate entertainment and personal expenses.

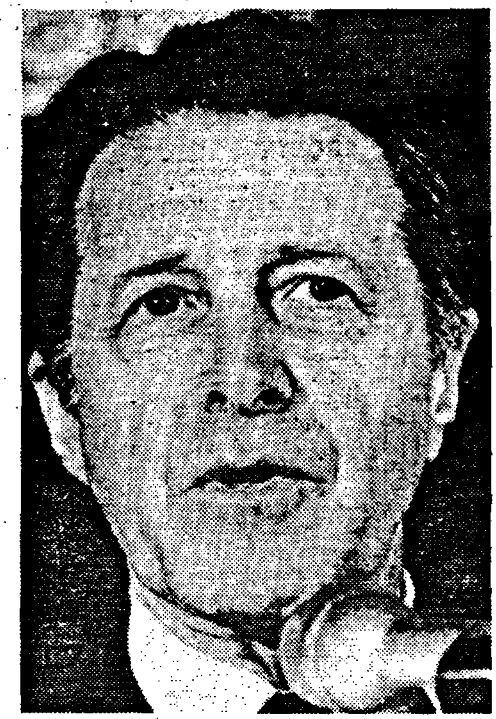
Weinberger, in a speech to the American Legion, unveiled the move as part of a wider crackdown on defense contractors that charge the government for "general and administrative costs" added to the price of weapons systems. The move came as Weinberger battled to justify his defense budget in Congress amid charges that much of the money is wasted.

In the General Dynamics case, he specifically ruled out government payments for "improper expenses" revealed at a congressional hearing last week. Company officials were accused of charging for boarding an executive's dog, country club dues, golfing weekends and a chili cookoff.

Weinberger also said that he has asked the Justice Department to look into possible

See WEINBERGER, A7, Col. 1

■ *Army antiaircraft gun had to be heated up to fire in tests, senator charges. Page A7*



CASPAR W. WEINBERGER
... ordered a review of overhead costs

WEINBERGER, From A1

criminal violations by General Dynamics' officials. A spokesman said later it is illegal to submit false or fraudulent claims to the federal government.

"We found that General Dynamics' testimony was nauseating," said Defense Department spokesman Michael I. Burch. "Some of the claims made were preposterous and completely out of line, did in no way benefit national security," he said.

General Dynamics, in a statement from its St. Louis headquarters, said it believes it will be able to "satisfy the Defense Department's concerns" and promised to immediately withdraw all charges "that are determined not to be bona fide."

The company, which had $7.2 billion in government military sales last year, said about 8 percent of its total monthly billings to the Pentagon cover overhead costs.

In his speech, Weinberger said the Defense Department would suspend payments for General Dynamics' administrative costs until Pentagon auditors complete their review of the rate at which the government reimburses the company. He said the review would take at least 30 days.

Defense contractors are permitted to add a percentage of their overhead costs to the price of a weapons system after negotiations with the Pentagon.

But congressional critics complain that guidelines for determining what is an allowable overhead item are vague, opening the way for contractor abuses and runaway weapons costs.

Burch said the defense secretary agrees that the system of allowing overhead costs "needs to be tightened down. He agrees that the way contracts have been written in the past are wrong."

In what his spokesman described as a "get-tough" policy, Weinberger said he has ordered defense auditors to review the overhead cost rates set for all major contractors to assure that they prevent charges for improper expenses.

Contractors, moreover, will be required to certify under penalty of perjury that their claims for overhead expenses do not include political contributions, entertainment or "other expenses that are not made directly for the benefit of the government and are required for the performance of the contract involved," Weinberger said.

"We found that General Dynamics' testimony was nauseating: Some of the claims made were preposterous and completely out of line . . . ."

—Michael I. Burch,
Defense Department spokesman

"He's only going to pay for things that benefit the country," Burch said. "He's not going to pay for those frivolous overhead expenses."

Burch said auditors will look into reports that the Boeing Co. billed the Defense Department for nearly $127,000 in political contributions in 1982. The aerospace company agreed to withdraw bills for about half of the donations, but justified the rest as legitimate, along with $36,000 in payments to such community events as a Boy Scouts golf tournament and a Hanukkah dinner thrown by the Jewish National Fund.

Many of the problems condemned by Weinberger have been cited for years by the Defense Contract Audit Agency. Critics say the agency's findings often have been ignored by defense contracting officers.

Auditors have questioned $50 million of the $143 million in overhead expenses charged by General Dynamics from 1979 to 1982.

In the latest example of questioned billings, they challenged $330,983 charged in 1982 for the company's promotional "giveaways" of such items as necklaces, tie clips, hats, knives, branding irons and medallions emblazoned with weapons insignia, according to an audit cited by congressional sources.

Burch said it was the batch of bills from 1980 and 1981 now being audited that triggered the General Dynamics crackdown because "we've got enough information now that we felt that we could suspend these payments to a major contractor until we're satisfied that only proper charges are being submitted."

Until now, the Pentagon has attempted to negotiate with General Dynamics to eliminate improper charges, Burch said.

Congressional critics say defense contractors have little incentive to resolve audit disputes quickly because the Defense Department routinely pays up to 95 percent of bills for overhead and other costs on a monthly basis. Usually, these charges are not disputed until years later.

General Dynamics, for instance, has received $120 million of the $143 million in overhead expenses billed from 1979 to 1982, according to congressional officials, despite its recent admission during a hearing that some billings were improper.

In similar fashion, the company has been paid $10 million of the $22 million in corporate aircraft charges, which include more than 100 personal flights by company chairman David S. Lewis, according to Pentagon auditors.

Defense contracting officers often fail to support the auditors who are only empowered to question costs, according to critics.

They said that General Dynamics was paid 75 percent of its aircraft charges for 1976 and 1977 even though Pentagon officials were unable to determine the purpose of the flights because the company had destroyed its passenger lists.

Congressional sources said that the Naval Investigative Service is examining General Dynamics' corporate aircraft claims as well as some of the entertainment expenses it has added to the price of nuclear submarines.

General Dynamics, the nation's largest defense contractor for the past three years with total Pentagon sales of almost $20 billion from 1982 through 1984, makes Trident submarines, SSN688 attack submarines, M1 tanks, F16 jet fighters, Tomahawk cruise missiles, and Stinger defense missiles.

Rep. John D. Dingell (D-Mich.), who held a subcommittee hearing on General Dynamics, said he expects "a significant amount of money to be returned to the treasury . . . . I want to see this fraud rooted out of these overhead accounts and the guilty parties dealt with."

THE SECRETARY OF DEFENSE

WASHINGTON, THE DISTRICT OF COLUMBIA

J. T. Tramp OSD
CWM
X24416

5 MAR 1985

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MEMORANDUM FOR SECRETARY OF THE ARMY
SECRETARY OF THE NAVY
SECRETARY OF THE AIR FORCE
DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Expenses Claimed by General Dynamics

In a recent Congressional hearing, General Dynamics officials stated that various unallowable overhead expenses were claimed against Government contracts. During the next thirty days a review of General Dynamics' overhead claims shall be performed by DCAA to assure that the Government's interests are being protected. Within the thirty days in which this review is conducted, payments to General Dynamics as reimbursements under cost type contracts or as progress payments under fixed price contracts shall not include any amounts for general and administrative expenses.

Caspar W. Weinberger

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SECRETARY OF DEFENSE

WASHINGTON, THE DISTRICT OF COLUMBIA

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5 MAR 1985

MEMORANDUM FOR SECRETARY OF THE ARMY
SECRETARY OF THE NAVY
SECRETARY OF THE AIR FORCE
DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

00
09 H/C
02 H/C

SUBJECT: Overhead Expenses Claimed Against Defense Contracts

During a recent congressional hearing, General Dynamics officials stated that various unallowable overhead expenses were claimed against Government contracts. A separate analysis of General Dynamics' overhead claims is being performed. To provide assurance that all other major Defense contractors are complying with the overhead billing requirements of Department of Defense contracts, you are directed to make an analysis for all major Defense contractors. Your analyses should include each contractor location where final overhead rates for prior fiscal years have not been established as well as billing rates for the current fiscal year.

Contract administration and Defense Contract Audit Agency (DCAA) offices should review payments at each location for each year to assure that no unallowable overhead expenses have been included in interim overhead billings. Existing procedures require that contractors identify expressly unallowable overhead expenses and not claim them against Government contracts. Typically, negotiations for DCAA audit reports result in additional reductions of contractor overhead. Contract administration and audit offices will assure that adequate adjustments are made to amounts billed the Government to cover fully both of these adjustments. These measures shall provide assurance that unallowable expenses are not being paid by the Government even on an interim basis.

The analysis for each major contractor location should be a coordinated effort involving the cognizant contract administration office and the cognizant DCAA office.

MAR 5 12 PM '85

Caspar W. Weinberger

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DEPARTMENT OF THE ARMY
OFFICE OF THE GENERAL COUNSEL
WASHINGTON, D.C. 20310

B

REPLY TO
ATTENTION OF

1984

83-56

84-18

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Novation Requirement When Ownership of a Contractor is Transferred

I. PROBLEM

To obtain authorization for continued use after 1 April 1984 of coverage to clairfy that the Government may require a novation agreement when ownership of a contractor is transferred through a stock purchase transaction or by other means.

07 MAR 1984

II. RECOMMENDATION

That the DAR Council authorize Departmental distribution of the coverage authorized in case 83-56 on 26 October 1983 (as an addition to DAR 26-402(a)) after 1 April 1984 as an addition to FAR 42.1204(a) in the DOD FAR Supplement or in Departmental acquisition regulations.

III. DISCUSSION

On 26 October 1983 the Council authorized Departmental distribution of a modification to DAR 26-402(a) and of a Departmental Intro Item explaining the modification. The Army issued this coverage with further detailed procedures on 8 November 1983 (TAB A).

We consider that this coverage was material in assuring that the Army's rights were fully protected in the recent sale of Hughes Helicopter to McDonnell Douglas. The parties did execute a novation agreement.

In order to assure that the Government's rights will be fully protected in this type of situation after 1 April 1984, it is requested that the Council authorize Departmental distribution of the same coverage previously approved in 83-56 as an addition to FAR 42.1204(a). This could be accomplished through a Departmental to the DOD FAR Supplement or in the Departmental supplement to the FAR.

07 MAR 1984

C.21-23 March

Descriptions of the coverage approved on 26 October 1983 from The Government Contractor and Federal Contracts Report are at TAB B.

Maurice J. O'Brien
Army Legal Member
DAR Council

DEPARTMENT OF THE ARM
OF ;E OF THE ASSISTANT SECRETARY
WASHINGTON, DC 20310

83-56

SARDA

8 NOV 1983

SUBJECT: Acquisition Letter (AL) 83-16

SEE DISTRIBUTION

This Acquisition Letter (AL) 83-16 contains changes to the DAR and Army DAR Supplement, and information on acquisition/contracting issues of interest to Army contracting personnel, as cited in the following items:

I. Change to DAR 1-114 and 1-111, Reporting of Identical Bids.

II. Change to DAR 26-402(a)(iii) and new ADARS 26-402, Agreement to Recognize a Successor in Interest.

III. Bell System Practices - Change to ADARS 4-5704.2(b).

IV. Recission of ADARS 11-351, 7-603.502, and 7-606.51, Washington State Sales and Use Taxes.

V. Waiver of Cost Accounting Standards for acquisitions of ammonium perchlorate from Kerr-McGee Chemical Corp. -- Information/Action Item.

VI. Emphasis on Indian Business -- Information/Action Item.

VII. Review of Subcontract Cost in a Prime Contractor Proposal -- Information/Action Item.

VIII. Guidance on Employee's Rebate and Purchase Discount Plans -- Information/Action Item.

IX. Correction to AL 83-10 -- Information/Action Item.

X. Contract Delivery Schedules and Contractor Performance --Information/Action Item.

TAB A

SARDA
SUBJECT: Acquisition Letter (AL) 83-16

I. To expedite implementation of action taken by it on 26 August 1983, the DAR Council directed Departmental distribution of the material at Enclosure 1 concerning the requirement for reporting of identical bids.

II. To expedite distribution of the revision approved by it on 26 October 1983, the DAR Council authorized Departmental distribution of material at Enclosure 2 concerning protection of the Government's interests under proposed stock purchase transactions. This coverage is effective upon receipt.

At Enclosure 3 is related new coverage at ADARS 26-402.

III. ADARS 4-5704.2(b) (see AL 83-1, Item II) is changed to read as follows:

> "(b) In addition to any other clause pertaining to data prescribed in DAR, the clause in 7-5000, approved by the DAR Council in December 1982 under Case 82-2-36 may be included in contracts involving the purchase of BSP. This authority shall expire 31 December 1983."

IV. DUSD(AM) memorandum of 26 September 1983, subject: Washington State Sales and Use Taxes (Encl 4) advises that the clause entitled "Washington State Sales and Use Taxes (1976 January)," is no longer authorized. As a result, ADARS 11-351, 7-603.502, and 7-606.51 are rescinded.

V. By letter dated 20 September 1983, subject: Kerr-McGee CAS Waiver, (Encl 5), the Director, Contracting and Manufacturing Policy, HQ USAF forwards a Tri-Service CAS waiver, signed by the Secretary of the Air Force. This Determination and Findings applies to acquisitions of ammonium perchlorate from the Kerr-McGee Chemical Corporation, Oklahoma City, Oklahoma.

VI. Deputy Secretary of Defense memorandum of 29 September 1983, subject: Emphasis on Indian Business (Encl 6), requests increased support for Indian 8(a) firms.

VII. DUSD(AM) memorandum of 18 October 1983, subject: Review of Subcontract Costs in a Prime Contractor Proposal (Encl 7), requests coordination between ACO's and PCO's on <u>all</u> audit requests.

VIII. ADUSD(Acquisition) memorandum of 25 October 1983, subject: Distribution of Indirect Cost Monitoring (ICMO) Working Group Guidance Paper No. 83-2, Guidance on Employee Rebate and Purchase

Discount Plans (Encl 8) provides guidance concerning the handling of employee rebates.

IX. SF 83, "Request for OMB Review," and SF 83a, "Instructions for Requesting OMB Approval Under the Paperwork Reduction Act and Executive Order 12291" were furnished with AL 83-11. Unfortunately a couple of pages were missing. Enclosure 9 includes the necessary forms.

X. Enclosure 10, entitled "Contract Delivery Schedules and Contractor Performance" describes "the end-of-the-month delivery syndrome" that has been recently observed on many Army production contracts. It provides guidance in drafting contract clauses to accommodate any particular procurement requirement. It also emphasizes the need for enforcement of such terms and conditions during contract performance and reporting any significant departures from the contractual schedule. Procuring Contracting Officers (PCO's) should bring this matter to the attention of their Program/Project Managers, production specialists, as well as the Administrative Contracting Officers located at DCAS, NAVPRO's, AFPRO's and ARPRO's that administer Army production contracts.

Addressees shall insure immediate distribution of this Acquisition Letter (AL) 83-16 to all subordinate contracting offices and supporting legal offices.

FOR THE DEPUTY ASSISTANT SECRETARY OF THE ARMY (ACQUISITION):

H. J. Dubicki

10 Encl
as

Henry J. Dubicki
Deputy for Acquisition Policy

THE FOLLOWING IS A CHANGE TO THE DAR:

The additional example in 26-402(a) set forth below is added to clarify the application of the policies and procedures in DAR Section XXVI, Part 4, to the situation when the transfer of ownership of a contractor through a stock purchase transaction, or by other means, is determined to significantly affect the Government's rights and interests under existing and future contracts. The revision serves to assure the means for protection of the Government's rights and interests in such a situation.

Title 41, United States Code, Section 15 provides in part that: "no contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States are concerned." A purpose of the statute is to protect the Government's rights and interests by insuring to it performance by the contractor it selects upon the agreed terms. The examples previously set out in DAR 26-402(a) were not all-inclusive nor is it considered that the formality of a legal change in identity of the contractor must have occurred before the policies and procedures of Section XXVI, Part 4, may be required. Past instances have shown that a transfer of ownership of a contractor preparatory to or without a formal change of identity can as adversely affect the Government's rights and interests under its contracts as a transfer accomplished with a formal change of identity. Issues that may arise in such transactions include accounting adjustments, contract costs, quality, quantity and scheduling under the new owner; whether the new owner has adequate financial resources and capability; and whether the transfer of ownership would jeopardize the Government's security interests or its need for adequate competition.

The additional example set forth below requires a determination by the Secretary (as defined in DAR 1-201.15) concerned that the sale may significantly affect the Government's rights and interests under existing and future contracts in order to apply the procedures of Section XXVI, Part 4.

This area is being considered further by the DAR Council to determine whether additional coverage and procedures at the DoD level are necessary or appropriate. In the interim, the Departments may prescribe those detailed procedures they determine necessary in implementation of this action. Deviations to the DAR required by any agreement made pursuant to Section XXVI, Part 4, are governed by DAR 1-109.

Incl 2

DAR 26-402(a)(iii) is renumbered (a)(iv) and a new (a)(iii) is added as follows:

> "(iii) transfer of the ownership of a contractor through a stock purchase transaction, or by any other means, when the Secretary concerned determines that the sale may significantly affect the Government's rights and interests under existing and future contracts;"

THE FOLLOWING ARE CHANGES TO THE ADARS:

1. Add the following to ADARS Section XXVI, Part 4:

"26-402 Agreement to Recognize a Successor in Interest

(a)(i) when a contracting officer learns of a prospective or actual transaction as described at DAR 26-402(a)(iii) from: contractor; a contract administration office; or any other source, the contracting officer shall promptly notify, by telephone or message, the addressee at 1-150(b)(6) for further direction.

(ii) upon request, contracting officers shall forward all information, proposed agreements, and any other pertinent documents available, through contracting channels to the addressee at 1-150(b)(6). Contracting offices shall also provide information to support the required Secretarial determination including an analysis of the potential impact on current and future contract performance and cost."

2. The current ADARS citation "26-401 General." is hereby changed to read "26-404 Processing Novation Agreements and Change of Name Agreements." The text material thereunder remains unchanged.

Encl 3

study group is to be headed by Asst. Deputy Under Secy. of Defense (Production Policy) John Mittino.

★ Note—Industry criticisms of the Council's operations in recent years have centered primarily on (1) the length of time it takes the Council to process proposed reg changes, and (2) the fact that (unlike most other Govt agencies) the Council does not routinely publish proposed reg changes in the Federal Register for public comment but, instead, provides industry with only informal advance notice or no advance notice at all.

¶ 47

Various Procurement Reg Changes Issued

Following are some of the latest changes in agency regulations affecting procurement:

Army—(1) An amendment of Army DAR Supplement (ADARS) 2-201 and 3-501 provides that all foreseeable direct Govt costs that may vary between contract offers must be listed as evaluation factors in the solicitation involved. [NOTE—The change apparently resulted from the discovery of several recent situations in which significant costs (such as transportation in foreign offers) were not included in the proposal evaluation process.] (Army Acquisition Letter 83-14, 18 Oct. 1983)

(2) Army Acquisition Letter 83-16 (8 Nov. 1983) includes changes to regs governing agreements to recognize successors to a Govt contractor. The changes are designed to protect the Govt's interest under proposed stock purchase transactions. See ADARS 26-402.

(3) Army Acquisition Letter 83-18 (6 Dec. 1983) contains new coverage of (a) prenegotiation price objectives (at ADARS 3-802.50), and (b) procurement by offshore purchasing offices (at ADARS 1-302.50).

FPMR—Reg clarification has been provided regarding implementation of the Govt's program of recovering precious metals from surplus property, including the award and administration of contracts for that purpose. (FPMR Amdt. H-147, 49 Fed. Reg. 2246)

FPR—Israel has been added to the list of countries whose products have been exempted from certain Buy American Act requirements. (FPR Amdt. 237, 49 Fed. Reg. 1906)

Interior—With certain exceptions, IPR 14-1.706 has provided that it is the Interior Dept.'s policy to set aside, for award to small business firms, all construction contracts estimated to cost $750,000 or less. In order to reflect the impact of inflation, this figure has been increased to $1 million. (49 Fed. Reg. 3856)

DOD—DAC #76-47 (15 Dec. 1983) includes the following items of interest:

(1) Last year, Congress amended the Small Business Act (in P.L. 98-72) to (a) require that a notice of all proposed over-$10,000 procurements be publicized in the Commerce Business Daily (CBD), and (b) prohibit procuring agencies from issuing a solicitation until at least 15 days after that CBD publication and closing the competition until at least 30 days after the solicitation is issued.

While the amendment specifically exempts orders for perishable subsistence items placed under *requirements-type* contracts, no exemption is provided for the large number of perishable subsistence items which DOD purchases in carlot and less-than-carlot quantities on a daily basis using *individual* solicitations and awards. Such purchases are estimated to cost over $625 million annually, and about 97% of them are placed with small business firms.

However, P.L. 98-72 allows Govt agency heads to approve additional exemptions when advance notification is not appropriate or reasonable, as long as the SBA concurs in such action. Exercising this authority, DOD has now created such an exemption for perishable subsistence item purchases in carlot and less-than-carlot quantities. At the same time, a similar exemption is provided for DOD purchases of brand-name subsistence items for resale in commissary stores.

(2) The DAC includes a 4 Nov. 1983 *Memorandum* from Acting Deputy Under Secy. of Defense (Acquisition Management) Harvey J. Gordon (a) clarifying DOD policy on when ordering officials may seek alternate sources to mandatory Federal Supply Schedules, and (b) providing guidance on the use of "brand name or equal" purchase descriptions (by stating that it is improper to use another contractor's part number

THE GOVERNMENT CONTRACTOR

Published bi-weekly by Federal Publications Inc. ■ One Lafayette Ctr. Wash. D.C. 20036 ■ Annual Subscription $396 ■ Henry B. Keiser, Publisher ■ Marvin I. Friedman, Editor ■ Second class postage paid at Wash. D.C. & additional mailing offices ■ Postmaster: Send address changes to Rm 500 South, 1120 20th Street NW, Wash. D.C. 20036

TAB B

84-18
F1 Discussion
15.205.6
A

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

FEB 17 1983

MEMORANDUM FOR DEPUTY UNDER SECRETARY (ACQUISITION MANAGEMENT)
OFFICE OF THE UNDER SECRETARY OF DEFENSE FOR
RESEARCH AND ENGINEERING

SUBJECT: Employee Termination Payments (Golden Parachutes) - ACTION MEMORANDUM

The Air Force Ad Hoc Task Force assigned to review contracting and pricing policies and procedures has concluded that any reimbursement of the excessive costs associated with terminating employees pursuant to agreements, sometimes referred as the "Golden Parachute", when deemed unreasonable, will not qualify as allowable overhead costs on DOD contracts. Therefore, we have issued the directive, Attachment 1, to our field representatives to insure that these costs will not be allowed on DOD contracts. Though the cost principles of DAR 15-205.6(g) and DAR 15-201.3, 15-205.39 may be interpreted to disallow such termination payments, it is our belief that the DAR should be revised to expressly state that these excessive payments are unallowable. Attachment 2 is a proposed DAR case with the recommended language. We also recommend that DUSD(AM) issue a policy statement on this subject to be subsequently followed by the DAR change.

Edward J. Trusela

EDWARD J. TRUSELA
Deputy for Acquisition

2 Atch
1. ALMAJCOM Ltr
2. Memo to DARC, Excessive Termination Payments

18 MAR 1987

1000.12

READY THEN READY NOW

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.
20330

REPLY TO ATTN OF: RDC

16 FEB 1983

SUBJECT: Employee Termination Plans (Golden Parachutes)

TO: ALMAJCOM-SOA (CONTRACTING)

1. Recent newspaper articles have described the increasing use of extraordinary arrangements with key employees of corporations as one of the techniques used to compensate incumbent management if they are severed or leave as a result of a takeover or merger. Companies with the approval of their Board of Directors, and in some cases their stockholders, are providing key employees with excessive termination benefits as a part of their compensation package. Usually these benefits are only paid in the event of a merger or loss of control and the subsequent dismissal, termination, or leaving of the executive. These arrangements have been referred to as "Golden Parachutes" because they provide extremely lucrative financial arrangements for such employees if they are dismissed, terminated, or leave.

2. Effective immediately, contracting officers are advised to scrutinize the costs associated with "Golden Parachutes" agreements when they are included in contract proposals, invoices, claims or compensation plans. Payments and plans for employees should be carefully examined for the tests of the plans reasonableness under the current DAR provisions of 15-201.3, 15-205.6, and 15-205.39. These costs deemed to be unreasonable shall be determined to be unallowable. The Air Force is now processing a DAR case to make these employee payments expressly unallowable.

FOR THE CHIEF OF STAFF

Bernard L. Weiss

BERNARD L. WEISS
Brig General, USAF
Director, Contracting &
Manufacturing Policy

15-205. Employee Termination Payments (CWAS-NA)

(a) Employee termination plans payments, sometimes identified as "Golden Parachutes" include, but are not limited to, certain cost incurred by a contractor as a result of employment agreements with an employee. Such agreements provide that if there is a change in the control of the management and/or ownership of the contractor and the employee is dismissed, terminated or leaves as a result, the employee shall receive certain compensation upon dismissal or termination of employment. Such employee termination payments are usually:

(i) well in excess of the contractor's severance payments and/or practices for other types of employee termination; and

(ii) offered to a limited number of employees.

(b) Employee termination payments as defined herein, and all costs directly or indirectly associated with such payments, are unallowable.

Atch 2

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D C 20360

DAR Staff
Case 84-18

4 February 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 84-18, Accounting for Mergers and Other Business Combinations

I. PROBLEM:

By DAR Council letter dated 24 February 1984, the Commercial Cost Principles Committee was requested to study issues relating to the appropriate treatment of costs arising from mergers and other business combinations, and to recommend any changes in the cost principles coverage on such costs deemed appropriate. The DAR Council's initial assignment letter noted that certain of these issues had already been considered under Case Numbers 83-100-5, 83-100-47, 83-43, and 83-56. Shortly thereafter, by letter dated 17 April 1984, the DAR Council requested that the Committee consider material sent in by the American Defense Preparedness Association (ADPA) and by the Army concerning the kinds of business combination requiring a novation agreement. Finally, in the approved DAR Council action plan issued in February 1986 in response to publication of the OSD Task Force Report on the cost principles, the Council committed itself to consideration of the report's comments on three cost principles (-10, -11, and -27) under this case. Later, by letters dated 27 May 1986 and 5 June 1986, the Council added the relevant comments on the Task Force report sent in by CODSIA and the DOD IG to the case material.

II. RECOMMENDATIONS:

A. That the DAR Council review FAR 31.109 and 42.12 in light of the Committee's comments in Section III.A.2 below, and decide on the appropriate course of action. *

CAAC case 87-4

B. That FAR 31.205-6(1), and 31.205-27 be revised as shown in Part 2 of TAB A.

C. That FAR 31.205-10, 31.205-11, 31.205-16 and 31.205-49 be revised as shown in Part 3 of TAB A.

D. That FAR 30.404.50(d) and (e), and 30.409.40(a)(4) and .50(j)(1) be revised as shown in Part 4 of TAB A.

III. DISCUSSION:

Anyone who even casually peruses a newspaper is aware that business combinations within American industry in general, and, more specifically, within the defense industry have become far more common in recent years. This development, while it is obviously of broad public concern, is of particular importance to the Government procurement community because business combinations can dramatically alter a company's cost structure on which in turn much of Government contract pricing is ultimately based. Specifically, there are several areas in which the adequacy of current FAR coverage needs to be examined in light of recent developments:

1. New forms of business combination and the requirement for a novation agreement;

2. The treatment of certain organization costs and special compensation arrangements incidental to attempted or successful business combinations;

3. The treatment of increased asset values created by business combinations under generally accepted accounting principles.

This is not to say that these are the only areas of regulatory concern having a connection with the phenomenon of business combinations. For example, business combinations and pension plan terminations can be interrelated since the acquiring company may be tempted to seize excess assets in the acquired company's pension fund to help pay for the acquisition. However, the whole issue of pension plan terminations is being dealt with under another case (namely, 85-180), which would affirm the Government's right to a credit in these circumstances. While the subject of business combinations is highly dynamic, the Committee is unaware of any issues other than those listed that need to be addressed here.

The remainder of this section will provide background information and Committee comments on each of these areas of concern.

1

A. Need for a Novation or Other Agreement

1. Background

While many variations obviously exist, there are only two basic ways for one company or group to obtain control over another company or some part of it. The acquiring entity can either buy the assets of the target company, or, more commonly, some desired piece of that company, directly, or it can acquire a controlling interest in the voting stock of the target entity. In the latter case, the acquisition of stock is often, but not always, followed by a change in the legal form of the acquired entity through merger or consolidation. Since the 1950s, Department of Defense procurement regulations have consistently and explicitly required that certain types of acquisition, namely, those in which the original contractor's assets are transferred to another legal entity, require a novation agreement, that is, a formal agreement between the Government, the acquiring entity, and the selling entity. In such an agreement the Government recognizes the purchaser as the successor in interest to the acquired entity's Government contracts and makes any arrangements deemed necessary to protect the Government's interest.

The basic remaining issue is whether a novation or some other similar agreement should be required in all situations in which control over a company having Government contracts is transferred, and, more specifically, in the case of stock purchase transactions, in which the acquired company remains a separate legal entity (i.e., is not subsequently merged or consolidated out of existence).

Some within the legal community have taken the position that this kind of stock purchase transaction does not create a successor in interest, and hence does not require a novation agreement. The argument is straightforward enough. It is simply that, under such circumstances, the legal entity with which the Government has been doing business has not changed. The Government's relationship is with a company, not with its stockholders. When only the identity of the stockholders changes, there has been no change in the entity with which the Government does business. The opposed position is also quite straightforward. It is that the acquisition of a controlling interest in the stock of a corporation gives the investor the same ability to affect performance under the acquired entity's Government contracts as would a situation in which the legal form of the acquired entity is altered through merger or consolidation.

This whole issue was previously considered in 1983 under DAR Cases 83-100-47 and 83-56. These cases were proposed by the Army, which sought an explicit regulatory statement that a stock purchase transaction in itself could give rise to the requirement for a novation agreement. Under the latter case, the DAR Council approved the Army's proposal, which was then implemented as a revision to DAR 26-402 by Item XVI of DAC 76-48, dated January 25, 1984, which reads as follows:

> (iii) transfer of the ownership of a contractor through a stock purchase transaction, or by any other means, when the Secretary concerned determines that the sale may significantly affect the Government's rights and interests under existing and future contracts.

Through a clerical error, the new DAR coverage was promulgated as a subparagraph within DAR 26-402(b), rather than DAR 26-402(a). Moreover, the new coverage was not incorporated into the corresponding FAR section promulgated on April 1, 1984. As best the Committee can tell, this omission was not the result of a considered decision, but was due to the fact that the new language was overlooked by those responsible for the final stages of drafting the FAR.

This situation soon generated further suggestions for revision. In a letter to the DAR Council dated January 26, 1984, the American Defense Preparedness Association (ADPA) suggested that the new coverage in the DAR be revised in two ways. First, ADPA recommended that the words "complete or partial" be added before "ownership" (see the first line of the above quotation) in order to make clear that a novation agreement may still be required when ownership of less than the entire stock is transferred. Second, ADPA recommended that the decision on which stock purchase transactions require a novation agreement be transferred from the Service Secretary to the administrative contracting officer, who was responsible for obtaining novation agreements under all other circumstances. Moreover, the Army itself, in a letter dated April 13, 1984, pointed out that the new DAR coverage had not been incorporated in the FAR, and requested its inclusion in the DoD FAR

Supplement or at least authorization to include it in Departmental acquisition regulations.

There has also been a recent decision of the ASBCA (in Case 29888 involving an appeal by the Marquardt Company) that is relevant to this issue. The background of this case is that, prior to 1983, all outstanding shares of the Marquardt Company were owned by the CCI Corporation. In late 1983, those shares were sold to ISC Electronics, Inc. Based on the fact that the transaction in question involved simply the transfer of stock from CCI to ISC, without any change in the management or legal structure of the Marquardt Company itself, the cognizant administrative contracting officer and the Marquardt Company agreed that no novation agreement was required. Subsequently, however, Marquardt attempted to have the Government recognize stepped-up asset values based on the price paid for the Marquardt stock by ISC (see C.1.a. below). When the contracting officer refused to do so, Marquardt appealed his decision to the ASBCA. The ASBCA found for the Government on the grounds that Marquardt remained the same legal entity after the transaction between CCI and ISC as before. Therefore, its contracts should not be burdened with costs incurred by an independent party, namely, ISC. The relevance of this case to our discussion here is that in it the ASBCA seemed to accept as a given that a change in ownership effected by stock purchase without subsequent legal reorganization does not require a novation agreement. It should be added that Marquardt is now appealing the ASBCA's decision.

2. Committee Comments

The DAR Council's taskings of 24 February and 17 April 1984 under this case requested the Committee's opinion on whether it would be advisable to adopt the Army's and ADPA's suggestion and expand the current FAR coverage on situations requiring novation agreements to include stock purchase transactions along the broad lines of the change made to the DAR in early 1984. The Committee is sympathetic to the concerns underlying this proposal. For all practical purposes, the investor has, in such circumstances, acquired control over the investee so that in substance, if not in form, the Government is faced with a new entity and should have the opportunity to iron out in advance with the new party any issues of concern to it. Nevertheless, the Committee does perceive some problems with such an approach.

First, it is struck by how awkwardly the subject of stock purchase transactions fits into the existing coverage on novation agreements. The definitions and terminology used in that coverage contemplate situations in which assets required to perform Government contracts are transferred from one legal entity to another, so that the contracts themselves must also be transferred. This is simply not the case for situations in which control of a company is transferred by stock purchase, since assets and contracts remain throughout the property and responsibility of the same legal entity. What is even more important, there is a statutory basis for the requirement to execute a novation agreement in situations in which Government contracts are transferred that is lacking for transfers of control over a company through stock purchase. Even if, therefore, the DAR Council were to adopt coverage modeled on that contained in DAC 76-48, the Committee wonders whether, in the absence of a contract clause, contractors would in fact really be under any greater obligation than they are now to execute "novation" agreements after acquiring businesses through stock purchase.

At this point, the Committee feels obliged to point out that this whole issue lies outside its primary area of expertise. Accordingly, it recommends that the DAR Council seek competent legal advice on it. However, in case the Council remains interested in pursuing the approach proposed by the ADPA and the Army, the Committee has included some detailed comments and suggestions on their proposed coverage at TAB A, Part 1, pgs. 1-2.

options

The Committee would also add here that, should the Council feel that new FAR coverage is necessary to encourage or require advance agreements for these kinds of business acquisition, there are other possibilities besides placing such coverage within the existing language on novation agreements. It would, for example, be possible to locate such coverage in a separate section in Subpart 42.12 parallel to that on novation agreements. It would also be possible to include acquisition of a business through stock purchase in the list of situations for which an advance agreement on the treatment of cost is especially advisable. Since this latter alternative is within the Committee's area of expertise, it has provided language for such an approach at TAB A, Part 1, p. 3 should the DAR Council wish to pursue this possible course of action.

In any case, however--and this is the important point--the Committee believes that the new cost principles coverage it is recommending elsewhere in this report will go a long way towards protecting the Government's interest in situations in which a Government contractor is acquired regardless of the form of the purchase. Thus, while the issue of whether to require or encourage some form of agreement whenever a business acquisition occurs remains of some importance in that each acquisition has unique aspects, its urgency will be diminished if the Committee's recommended cost principles language is enacted. Accordingly, the Committee recommends that, however this issue is handled, deliberations on it not be permitted to impede action on the rest of this case.

B. Costs Generated to Effect or Resist a Business Combination

1. Background

The economic background is the increase in recent years in the number of attempted business combinations, particularly those in which the management and senior personnel of the entity to be acquired is either opposed to the proposed acquisition or at least deeply ambivalent about it. Such events, especially so-called "hostile" takeover attempts, can result in the expenditure of significant sums by companies, including Government contractors. Moreover, in recent years, the frequency of "hostile", or at least "lukewarm", acquisitions has resulted in an explosive growth in ~~devices~~ by which incumbent managements attempt to make their companies less desirable as takeover targets, and acquirers' managements ~~attempt to entice~~ key employees of the acquired companies into staying following the takeover.

One such device, which has received considerable publicity and which can result in the claiming of substantial costs by contractors following business combinations, is the so-called "golden parachute" agreement concerning whose use there is a good, lengthy discussion ~~in the~~ Business Section of the New York Times of 26 January 1986. A "golden parachute" is a termination agreement ~~usually applicable only to a limited number of key executives~~ which normally has several ~~other distinctive features~~. The termination or severance payments involved are characteristically not based on length of service, are well in excess of normal severance payments, and are paid only if the employee leaves or is dismissed following a transfer of control over the company. In fairness it should be added that the motive for establishing such agreements may not simply be to discourage hostile takeovers, but also to hold on to key company executives during the period in which a company is the object of a takeover, and enable them to make decisions on whether to encourage acceptance or rejection of takeover offers unencumbered by personal financial considerations.

The counterpart of the "golden parachute" agreement is the so-called "golden handcuff" agreement in which the acquiring company commits to making payments in addition to normal compensation to key personnel of the acquired company provided only that they remain in its employ for a specified period ~~following the acquisition.~~ Whereas the "golden parachute" pays the manager or other key employee should he leave following the acquisition of his company, the "golden handcuff" encourages him to stay on.

There are three cost principles that contain language relevant to the allowability of such costs, namely, FAR 31.205-6 ("Compensation for personal services," formerly DAR 15-205.6, 31.205-27 ("Organization costs," formerly 15-205.23) and 31.205-28 ("Other business costs," formerly 15-205.24). Even prior to the creation of something like the modern body of cost principles in 1959, the ASPR made certain costs of business "organization or reorganization" unallowable, while making the costs of routine expenses incurred to maintain some business structure such as those for stockholder meetings, the issuance of annual reports, and security registry and transfer charges allowable. The underlying rationale for this unallowability provision seems to have been two-fold. First, there seems to have been a concern that, because of the pass-through nature of companies' costs in Government contracting, making such costs allowable would tempt contractors to engage in reorganizations when their business mix was such that the Government would absorb a large share of the cost. Second, and perhaps more fundamentally, was the belief that such costs normally had no real relationship to the work of the existing business entity, and, as such, provided insufficient benefit to be allocable to Government work.

While there have been several subsequent changes to these two cost principles, essentially they have been intended to further clarify, not redraw, the original dividing line. One such change of interest to us here was made in 1959 in Revision No. 50 to the 1956 ASPR. The ASPR Committee added to the list of allowable "other business expenses" the cost of "normal (italics ours) proxy solicitations." While the Committee has been unable to find any formal record of the ASPR Committee's intent, it seems likely that its use of the word "normal" reflected an assumption that "abnormal" proxy solicitation costs, such as those incurred in attempted acquisitions, should be unallowable as tantamount to reorganization costs. At any rate, it is clear that later the ASPR Committee thought so. Its minutes for October 30, 1968, record a discussion in which the members rejected a suggestion by the Chairman of the Section XV, Part 2 Subcommittee that the cost of proxy solicitations in takeover situations be made specifically unallowable. One of the reasons given was that "the . . . paragraph which permits normal proxy solicitations. . . by implication would make abnormal solicitations unallowable." Another change was the addition in 1969 to the "organization costs" principle of the clarification that unallowable costs of business "organization or reorganization" included the cost of planning or executing "mergers and acquisitions." With this change, this pair of cost principles took essentially the form that they have today in the FAR at least insofar as the costs generated by business combinations are concerned.

To summarize, then, the present language makes the costs of planning or ~~executing the "organization or reorganization of the corporate structure of a~~ business, including mergers and acquisitions" unallowable. However, no explicit mention is made of the status of the cost of resisting an attempted business acquisition. In the current environment, such costs can be substantial, and, in one recent case reported by DCAA, a contractor has used this silence to argue that such costs are indeed allowable.

No cost treatment

The third relevant rule is that on severance pay, which was originally contained in a separate cost principle but is now part of the principle on "Compensation for personal services" (FAR 31.205-6(g)). The coverage in this section is obviously relevant to payments made under so-called "golden parachute" plans. FAR 31.205-6(g)(1) defines severance pay as "a payment in addition to regular salaries and wages . . . to workers whose employment is being involuntarily terminated." While severance pay is normally an allowable cost, subdivisions (g)(2)(i)-(iii) put various restrictions on its allowability, none of which, however, deal precisely with the situation faced in the case of "golden parachute" agreements. In view of this, the Air Force proposed in March 1984 that specific coverage be added on this subject to the existing severance pay provisions. The Air Force argued at that time that payments made pursuant to such agreements were tantamount to reorganization costs and should accordingly be made completely unallowable. The Air Force proposal was included by the DAR Council within the purview of Case 83-62 in April 1984. However, to date, no action has been taken on this particular recommendation. **

Finally, the compensation cost principle does not provide specific guidance on so-called "golden handcuff" agreements. To the best of the Committee's knowledge, no one has as yet formally proposed coverage on this topic although the logic of the Air Force proposal of 1984 on "golden parachutes" seemingly would have applied to this other kind of agreement as well had the Air Force been aware of their existence at that time. Subsequently, however, the Committee itself has learned of them. In the case of the General Motors' acquisition of Hughes Aircraft, for example, such a plan covered approximately 1,000 employees, and had a potential cost of $250 million.

2. Committee Comments

So far as the first issue, namely, the proper treatment of costs incurred to resist attempted takeovers is concerned, the Government has in practice long regarded such costs as unallowable. It would, after all, make little sense to disallow the cost of "planning" an acquisition while at the same time allowing the cost of resisting the same acquisition since both are part of the same event as seen from opposite sides. The absence of specific coverage of this topic, the Committee believes, is due in part to the infrequency until recently of "hostile" takeover attempts and in part to the belief that the language of the cost principles already implied the unallowability of such costs. Since, however, the absence of specific language is apparently occasioning arguments in the field, the Committee is recommending that the language of FAR 31.205-27 be changed as shown in Part 2 of TAB A to make this matter clear beyond dispute. 1

The second issue concerning the appropriate treatment of benefits received pursuant to "golden parachute" and "golden handcuff" agreements seems equally cut-and-dried to the Committee. The central feature of such agreements is that they only come into play upon the actual or anticipated transfer of control over a company. In view of this, it is difficult to regard such benefits, insofar as they exceed normal termination or compensation payments, as compensation for work performed. Rather, they constitute a cost incidental to a transfer of ownership or control of a company. As such, consistency with the longstanding Government policy of not recognizing costs falling into this category dictates, in the Committee's opinion, the disallowance of benefits received pursuant to such "golden parachute" and "golden handcuff" agreements. Therefore, the Committee recommends that the language shown in Part 2 of TAB A be added to the existing coverage on compensation as a separate paragraph. While it would have been possible to fit coverage on these two items into existing paragraphs of the compensation cost principle (specifically paragraphs (g)("severance pay") and (k)("deferred compensation"), this would have meant separating the coverage. In the end, the Committee judged it preferable to write a new paragraph so that coverage of both items could be located in the same place.

It should be noted that the Committee's recommended coverage on "golden parachutes" differs from that proposed by the Air Force in its March 1984 memorandum in making only that portion of such payments in excess of normal severance benefits unallowable. The reason for this is simply that the Committee does not consider it equitable to disallow in full the payment of such benefits when the employee's departure is involuntary and normal severance benefits are not otherwise forthcoming. It should further be emphasized that the Committee's recommended coverage deals only with employee termination agreements triggered by the transfer of control over a company, not with special employee termination agreements in general. To the best of the Committee's knowledge, it is only this small subgroup that represents a problem, and, in any case, consideration of the broader subject falls outside the scope of this case. Finally, the Committee notes that it has examined the language on "golden parachutes" in the Deficit Reduction Act of 1984, and has attempted to ensure that its definition of this practice is consistent with that provided in the law.

3

C. Asset Revaluation

1. Background

By far the most important and contentious issue connected with the topic of business combinations is that of asset revaluation. This is so because such revaluation can significantly change the recorded cost structure of a company on which the pricing of Government contracts is often directly based. In the following sections, we shall discuss first why and how such revaluations are created by normal financial accounting, and then consider previous Government policy relating to the central issue of whether to recognize such revaluations. All of this is necessarily preparatory to providing the Committee's own comments and recommendations on this subject.

a. Financial Accounting Practices

The basic document on this subject is Accounting Principles Board (APB) Opinion No. 16, which was issued in 1970. Prior to the issuance of this opinion, there were two widely used methods to account for business combinations. One, called the "pooling" method, essentially assumed that two or more business entities had simply joined on an equal footing to create a new organization. On this assumption, there was no need to adjust the asset and liability values on the existing books of either company to reflect this event, and hence, under this method, recorded asset values remained unchanged. "pooling" B

The second technique, called the "purchase" method, assumed that in certain business combinations, whatever the precise form of the event, one entity essentially had bought the net assets of the other. Given the basic accounting tenet that assets should be valued at historical cost, this assumption led to comparison of the cost paid for the acquired company with the recorded value of its net assets, and, in the case of any difference, adjustment of the previously recorded values to reflect what was thought of as the new purchase price. While this oversimplifies somewhat, APB Opinion 16 drastically restricted the situations to which the "pooling" approach could be applied, and made the "purchase" approach the standard one to be used in all other situations. As a result, for all practical purposes, after APB 16 it has become typical for transactions regarded as business combinations to result in asset revaluations. "purchase"

Some detail concerning the precise implementation prescribed by Opinion 16 of this basic principle of "purchase" accounting is necessary to follow the subsequent discussion. The first prescribed step is to determine the purchase price for the acquired business entity. This is simple when the acquiring entity pays cash, but can become far more complex when the transaction is consummated by the incurrence of liabilities, the issuance of stock, or the disbursement of non-cash assets. The next step is to compare this figure with the net book value of the assets of the acquired entity. In the unlikely event that the two figures are equal, there is, of course, no need for revaluation of the assets of the acquired entity. However, in the almost universal event that the purchase price is greater or smaller than the net book value of the acquired entity's assets, those assets must then be revalued.

Since rarely if ever does the actual business acquisition process establish values for individual items among the myriad assets belonging to the acquired entity, a key step in this process is normally the performance of appraisals to establish the value of such long-term assets as land and plant and equipment. Using such appraisals and other techniques appropriate to the valuation of other kinds of asset and liability, every asset and liability of the acquired entity is assigned a value. After this process is complete, the total net asset value of the acquired entity can be determined and compared with the purchase price for the entity. If, as is common, the purchase price exceeds the sum of the value newly assigned to the net assets of the acquired entity, then the assigned values for existing assets are maintained and a new asset, normally called "goodwill," is created to account for the difference. However, in the unusual event that the purchase price is less than the values tentatively assigned to existing net assets, then Opinion 16 requires that, rather than creating reverse "goodwill," the value of certain noncurrent assets be adjusted downward.

There are several things to note concerning the asset revaluation process prescribed by Opinion 16. First, it should be realized that, while the total amount of the excess over (or deficiency under) the previously recorded net book value of the acquired entity's assets is established by the price paid by the acquiring entity, the portion of that total amount attributable to any particular existing asset or to the newly created asset "goodwill" normally results directly from an appraisal, and is not established by the terms of the business acquisition itself. This is a consequence of the fact that it is really the acquired entity as a whole that is in fact purchased. The reason for going beyond the purchase price to an appraisal (or some other valuation process) of individual assets, rather than treating the total difference in some simple, uniform way, is the fact that the recorded value of individual noncurrent assets is charged to income over time as depreciation or amortization expense in significantly different ways. Accordingly, from the standpoint of accounting theory, the process of distributing the difference between the purchase price of an entity and its recorded net book value to individual assets is undertaken to provide a more refined measurement of the income of the new combined entity in future accounting periods.

It should also be noted that there are differences between the ways in which the accounting entries required by such combinations are recorded on the books of the business entities involved. In cases in which an entity is acquired directly, or, however acquired, is later formally merged or consolidated out of existence, the new asset values resulting from the purchase and subsequent asset appraisals must obviously be recorded on the books of the acquiring or surviving entity.

On the other hand, however, in cases in which control is obtained by stock purchase and the acquired entity maintains its previous legal form, the accounting records of the acquired entity are maintained as before and the purchase is shown on the books of the acquiring entity as simply a single entry recording the amount of the investment in the acquired entity. In these circumstances, it is in what are called consolidated financial statements, that is, statements showing the position of the combined entity, that the new values for individual assets resulting from the purchase and subsequent appraisal are reflected. However, even in this circumstance, it is typical for contractors to seek to have the Government recognize the new asset values in the costing of the acquired entity's Government contracts. It should be noted that, in the recent Marquardt case, the ASBCA ruled that Government contracts held by the Marquardt were appropriately costed using the original asset values on its books, not the reappraised values reflected in the consolidated financial statements of Marquardt and its new parent company. This case, however, is now under appeal.

b. Existing Government Regulations

As the Committee has repeatedly emphasized throughout this report, the revaluation of long-term assets which normally results from a business combination is of obvious concern to the Government since these asset values may enter into the determination of the depreciation and amortization expense and the Facilities Capital Cost of Money (FCCM) to be priced into and charged to Government contracts. The question of how to treat the sharp changes in the amounts of such costs chargeable to Government contracts resulting from business combinations is one to which many strands of previous Government policy are relevant. The following discussion will briefly consider certain of these strands, and then describe how specific business combinations have been handled in practice by the Government.

(i) Standard Novation Agreement Language

FAR 42.1204(e) gives the text of a standard novation agreement which includes the following language at subdivision (b)(7):

> The Transferor and the Transferee agree that the Government is not obligated to pay or reimburse either of them for, or otherwise give effect to, any costs, taxes, or other expenses, or any related increases, directly or indirectly arising out of or resulting from the transfer or this Agreement, other than those that the Government in the absence of this transfer or Agreement would have been obligated to pay or reimburse under the terms of the contracts.

The substance of this paragraph is quite old, going back in all essentials to revisions to the ASPR made in 1956 and 1959, respectively, as a result of Cases 54-50 and 58-133. The Committee's research has turned up no evidence that asset revaluation was a specific concern in these cases, which is not surprising given the fact that "purchase" accounting for business combinations was less common then than it would become subsequent to the issuance of APB Opinion 16 in 1970. The record does show, however, that the ASPR Committee was concerned about possible increased costs of contract performance by the transferee including increased overhead expense in situations involving cost-type Government contracts. The durability of the language it developed testifies to the strength of the belief within the Government contracting community that an ownership change should not adversely affect the price of Government work that had already been contracted for.

(ii) The Treatment of the Sale of Individual Assets

It is possible to draw an analogy between the purchase of a used asset or complement of assets by one company from another and the purchase of an entire business entity (conceived as simply a collection of assets) by another organization. It is necessary, therefore, to include some discussion of the prior regulatory treatment of the sale of individual assets in the background to this case.

Prior to 1965, the handling of such transactions prescribed by the cost principles was as follows. So far as the purchaser was concerned, the new (new to him) asset was capitalized at the purchase price in accordance with the basic tenet that asset valuation should be based on acquisition cost. So far as the seller was concerned, his "gain" or "loss" on the transaction (defined as the difference between the sale price of the asset and its "book value," i.e., original acquisition cost less accumulated depreciation) was not recognized as a credit or charge, but rather was regarded as a non-cost or "profit" item.

In 1965, however, ASPR Case 65-107 was established to study whether these rules needed revision. The initial concern was that contractors might be experiencing significant gains overall on the sale of assets, rather than experiencing a pattern of offsetting gains and losses, due to the use of accelerated depreciation methods. If this were true, then it would follow that in ignoring the gain or loss on sale the Government was acquiescing in an inequitable arrangement in which it bore a share of excessive depreciation costs during an asset's useful life without any recoupment of the excess at the point of asset disposition.

During the long and weary course of this case, a DCAA study indicated that this concern was well-founded, and that contractors were indeed normally experiencing gains on the disposition of depreciable assets. Accordingly, the debate under this case came to focus on the question of how to define the gain which was to be recaptured by the Government (via a credit to the seller's overhead in the year of asset disposition) and on whether the Government should also recognize losses on asset disposition (via a charge to the seller's overhead) which could potentially increase Government contract costs. This latter issue was easily decided, since almost all involved realized that the recognition of gains alone would be inequitable.

The former issue, however, caused extensive debate. There is little point in recapitulating here all of the various alternatives considered. The reason for the plethora of proposals was the fact that contractors sometimes used different depreciation methods for contract costing, financial reporting, and tax purposes, and also the complexity of Internal Revenue Service rules on the same issue. Obviously, the amount of the gain or loss on disposition calculated would depend on the depreciation method used.

In the end, the basic issue, as seen by the Section XV, Part 2 Subcommittee at that time, was whether the new rule should aim to recapture excess depreciation using contract cost, or Federal tax, accounting as the basis for measurement. The rule finally promulgated in 1969 permitted either approach if followed consistently, although its language suggested that the preferred method was to use depreciation amounts calculated for contract costing as the basis for determination. However, this "either or" rule was changed in 1978 to allow measurement of the gain only on the basis of depreciation amounts used for contract costing. The coverage established at that time is essentially identical to that currently in the FAR on this topic.

What is perhaps of more interest to us here is that the Section XV, Part 2 Subcommittee was plainly aware that even its preferred approach was not perfectly equitable. It was realized, for example, that Government contracts' share of the gain in the year of asset disposition could easily exceed or fall short of the share of excess depreciation borne by Government contracts in previous years due to fluctuations in business mix. However, the approach of recapturing the excess asset depreciation, rather than the precise amount of excess depreciation borne by the Government in the past, was considered the only administratively feasible one, and believed to be fair over-all in normal situations of frequent disposition of individual assets. The Subcommittee was, however, sufficiently concerned about the potentially inequitable results of a rigid application of its new recapture rules in situations of mass asset disposition that it expressly provided for the use of case-by-case settlement in such instances if equity required. This provision has remained in the coverage essentially in the form promulgated in 1969.

It is clear from the record of Case 65-107 that none of those involved envisioned the application of the specific "depreciation recapture" rule under consideration to business combination situations. They clearly had in mind only the transfer of individual assets or small groups of assets between independent companies. Nevertheless, if one adopts the basic premise underlying "purchase" accounting for business combinations by viewing this process as the sale of one company's total asset complement to another, it is a natural step to apply this rule for individual asset sales to business combination situations. This has in fact sometimes been done as a means of achieving equity for the Government in such situations.

While the Committee will have much more to say below concerning this subject, one special problem that has arisen when this has been attempted is worth noting here. In situations in which only individual asset sales are concerned and one is dealing with ongoing, independent business entities, questions seldom arise about the credit resulting from a gain on disposition. However, in the case of business acquisitions, disputes have arisen between the Government and contractors on various grounds concerning the recognition of this credit.

Perhaps the most persistent (but not the only) argument concerns situations in which control is transferred by stock purchase. In such cases, as we have seen, revaluation of the assets of the acquired company is mandatory for consolidated financial statement purposes under generally accepted accounting principles, and companies have claimed that increased depreciation expense and FCCM resulting from such revaluation should be recognized on the acquired entity's present and future Government contracts. At the same time, however, some of these same companies have claimed that, from a strict legal standpoint, the only transaction involved has taken place between the acquiring entity and the stockholder(s) of the acquired organization, not between the two organizations themselves. Therefore, it is argued, since the acquired entity was simply not involved in the transaction, it need not reflect on its accounting records any gain on the sale in which the Government might then share through a credit to overhead. While the intellectual merits of this and all other arguments to the effect that the Government must somehow bear a share of any increased costs resulting from asset revaluation, while at the same time not being entitled to share in the recapture of excess depreciation, seem to the Committee to be nil, it is important to be aware that such arguments have been a frequent feature of attempts to extend this approach from situations involving individual assets to those involving whole businesses. Indeed, it is the Committee's understanding that essentially this issue is about to be litigated in the case of the acquisition of Cutler Hammer, Inc. by Eaton Corporation.

(iii) Cost Accounting Standards 404 and 409

Cost Accounting Standards (CAS) 404, "Capitalization of Tangible Assets," published in 1973, and CAS 414, "Cost of Money as an Element of the Cost of Facilities Capital," published in 1976, contain provisions that directly or indirectly relate to the accounting treatment of long-term assets subsequent to business combinations. The most direct statement is contained in CAS 404.50(d), which provides that:

> Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company not to exceed their fair value at date of acquisition. Where the fair value of identifiable acquired assets less liabilities assumed exceeds the purchase price of the acquired company in an acquisition under the "purchase method," the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.

This passage is clearly modeled on the provisions of APB Opinion 16. When taken together with the provisions of CAS 409.40(a)(1) (which states that, "the depreciable cost of a tangible capital asset shall be its capitalized cost less its estimated residual value") and CAS 414, Appendix A (which states that, "facilities capital values used should be the same values that are used to generate depreciation"), it indicates the CAS Board's assumption that asset revaluations resulting from business combinations form the basis for the calculation of allocable depreciation expense and FCCM in subsequent accounting periods.

The other passages of interest to us here occur in CAS 409. CAS 409.40(a)(4) and 409.50(j)(1) state that normally the "gain" or "loss" to be recognized upon asset disposition will be limited to the difference between the asset's acquisition cost and its undepreciated balance, and will be assigned as a credit or charge to the accounting period in which the disposition occurs. However, subparagraph 409.50(j)(3) adds that in the case of "gains and losses arising from mass or extraordinary dispositions," the contracting parties can account for gains or losses in some other manner that results in treatment equitable to all parties. All of this language in CAS 409 dealing with asset disposition is modeled closely on that introduced into the cost principles by ASPR Case 65-107 (see Section ii above), which, as we have seen, contemplated only asset transfers between continuing business entities, and not business acquisitions themselves. The Committee is unaware of any evidence indicating that the CAS Board intended by its language anything more than the ASPR Committee.

To sum up, then, while it is far from clear why the CAS Board felt it necessary to address these issues in the Standards (since all it did was repeat preexisting GAAP or DAR rules), the CAS does prescribe asset revaluation following a business acquisition in accordance with generally accepted accounting principles, and the calculation of depreciation expense and FCCM based upon such new valuations in subsequent accounting periods. The CAS also prescribes recognition of gains and losses on the disposition of individual assets, but does not explicitly address the situation in which it is the entire business that is disposed of.

(iv) Previous Cost Principles Cases

There are two recent DAR cases that are relevant to the subject of asset revaluation attendant upon a business combination. The earlier one, Case 83-100-5, was brought by the Navy Policy Member of the DAR Council in January 1983. The main impetus for the case was a very complex situation in which the ownership structure of a major Navy shipbuilder, Bath Iron Works, had changed several times within a brief period, thereby facing the Navy with the possibility of increased cost due to asset revaluations on long-term programs with inadequate competitive restraints. The Navy Policy Member pointed out that the Department of Defense had no consistent policy on the treatment of such costs, and noted that the increased frequency of business acquisitions made it imperative to develop one. He went on to argue that, since asset revaluation could increase future Government costs without any concomitant benefit (in that a change in ownership did not necessarily alter the productive capabilities of the assets in question), the proper Government policy was simply to disallow under the appropriate cost principles any increased depreciation expense or FCCM resulting from asset revaluations attendant on ownership changes. It is interesting to note that the Navy discussion made no mention of the obvious alternative approach of seeking a credit up to the amount of the depreciation expense previously taken on the assets in question.

The Navy case was commented on by the Cost Principles Committee in a February 1983 memorandum directly to the Navy member. In the memorandum, the Committee pointed out that it had long been Department of Defense policy to base depreciation expense on acquisition cost, and that the Navy proposal violated this policy. The appropriate solution, the Committee continued, was to accept the altered asset values, and then apply the "depreciation recapture" rule contained in DAR 15-205.32. The Committee noted in passing that, due to fluctuations in business mix and contract type, application of this solution might in certain circumstances result in an inequity to the Government, but brushed this point aside with the argument that circumstances could equally well be such that this approach would result in a financial advantage to the Government. Insofar as cost of money was concerned, on the other hand, where there was no basis for a "recapture" approach, the Committee expressed a preference for the policy suggested by the Navy.

The Committee's negative report seems to have persuaded the Navy Policy Member to simply let the case become dormant, and it was apparently finally closed out by the DAR Council as having been superseded by Case 84-18. It is interesting, however, that later, in May 1983, the Defense Contract Audit Agency (DCAA) wrote to the DAR Council concerning the case of a company for which, because of the predominance of firm fixed-price contracts in the year of asset revaluation, the concomitant credit became virtually worthless. This was, of course, an instance of precisely the kind of situation which the Committee had brushed aside as of no great concern in its February report. The DCAA memorandum concluded by suggesting that the Committee reconsider the recommendations made by the Navy Policy Member of the DAR Council.

The second relevant DAR case is 83-43, the "goodwill" case. "Goodwill," as we have already noted in Section C.1.a. above, is created by the "purchase" method of accounting for business combinations when the purchase price exceeds the values assigned to the acquired entity's identifiable net assets. Like other intangible assets, the recorded value of goodwill is charged off over time to operations as amortization expense. Case 83-43 came about as the result of an Armed Services Board of Contract Appeals decision (ASBCA Case No. 24881) in June 1983 which held that, in the particular circumstances of one contractor, amortization of his recorded goodwill was an allowable cost on Government contracts, and that its unamortized value could be included in the asset base for computing FCCM. The reaction to this decision within the Department of Defense was immediate. Direction was given to the DAR Council to make amortization of, and FCCM on, goodwill expressly unallowable on Government contracts. These directed changes were finally implemented by changes to both the DAR and FAR in January and June 1984, respectively.

From our present standpoint, the main interest of this case lies not so much in the changes made as in the underlying arguments it created within the Commercial Cost Principles Committee. The majority of the Committee clearly agreed with the direction given. There were several reasons for this. In the first place, as the Committee majority noted in its 21 November 1983 report, goodwill had been regarded since the very beginning of Government cost accounting as the result of a financial transaction relating to the ownership of a business, and not as an ordinary, necessary, or proper cost of performing Government contracts.

Moreover, recognition of goodwill, it was pointed out, could cause a serious inequity to the Government by causing it to pay more for the same product after a merger than before due to the unique character of goodwill as an unidentifiable intangible asset. The Committee's reasoning was that, normally, the Government's interest is protected in situations of asset revaluation by the requirement that any increase up to the original asset cost be offset by a credit in the period of sale for excess depreciation or amortization (see Section III.C.1.b(ii) above). In the case of goodwill, however, if there is no goodwill on the selling entity's books, then any dollar of the purchase price assigned to goodwill rather than to an identifiable asset is one that reduces the size of the credit without reducing the Government's potential liability for future costs (assuming the allowability of goodwill amortization). And, even if the selling entity does already have goodwill on its books, the unspecific nature of such goodwill makes it possible to argue that the excess of the purchase price over the appraised value of the net identifiable assets is a new and different asset, so that no credit for excess amortization of the "old" goodwill is appropriate.

Finally, the Committee majority believed that goodwill normally resulted from overpayment by the acquiring entity, and hence should not be reimbursed by the Government. The Committee's remarks on this subject are worth quoting:

> In a purchase transaction, upon its completion, the assets of the acquired company are appraised and current market values established. Usually this process is performed by outside appraisers who may take several different approaches in arriving at their estimates. The process is so subjective that rarely will two independent appraisers agree on the value of the underlying assets. Many of the assets "written up" include fully depreciated assets; assets which were written off when acquired such as staplers, chairs, ashtrays, etc., and assets for which values are not normally established, such as accounting/engineering manuals and software costs. In effect, anything that has, could have, or avoids an outlay is capitalized. The point to be made is that the process provides a company every chance to assign part of the purchase price to a tangible or identifiable intangible asset. If goodwill still results, a realistic conclusion that can be drawn is that an excessive price was paid for the right to own the acquired assets. Simply because the contractor has paid on excessive price does not mean DoD must accept this excess in the price of its contract. (p. 8)

The Committee was not unanimous in this opinion, however. One member disagreed with the decision to treat goodwill differently from other assets on the grounds that to do so would be inconsistent with the basic accounting tenet that asset value is established at acquisition cost. He wrote:

> The fact is the amount of goodwill flows from a price paid in an arm's-length transaction. That is how American accounting sets values for everything from expendable supplies to whole corporations. Any alternative valuation technique would very likely contain an unmanageable and unacceptable element of subjectivity. (TAB C)

The Committee's reply to this was simply that the mere fact that accounting recognized a cost did not in itself lead automatically to the conclusion that it should be reimbursed by DoD.

In considering the record of Case 83-43, the Committee is struck by two things. The first is the ease with which the DoD jettisoned the basic accounting principle that asset values are determined by purchase price when it was convinced that it would lead to inequitable results and violate good business judgment. The second is the Committee's continued assumption, which was already reflected in its handling of Case 83-100-5, that the "depreciation recapture" rule was an entirely adequate solution to the problems of equity presented by asset revaluations following business acquisitions.

(v) Government Actions When Faced with Specific Business Combinations

The Committee has not done a systematic survey of the various approaches taken by Government procurement activities to ensure equity when faced with business acquisitions. However, even a limited review indicates that there has been no unanimity of approach among the major Government components. One approach, which has been pursued particularly aggressively by the Army, and has also recently been taken up by the Air Force, is to require that the acquiring contractor agree to continue to use for costing and pricing Government work the acquired entity's asset values regardless of any revaluations required by generally accepted accounting principles. A second approach has been to recognize asset revaluations, but attempt to ensure that existing Government contracts receive their proper share of the depreciation or amortization "recapture" credit in the year of sale. As has already been noted (see C.1.b(ii) above), the Government's entitlement to such a credit has not been readily conceded by contractors in cases in which the acquisition is effected by stock purchase.

What is perhaps just as important as this lack of unanimity in approach, however, is the fact that sometimes the issue of asset revaluation is not resolved in a timely fashion or may be overlooked altogether by the Government. The classic instance of the former is the Bath Iron Works case, which is now in its seventh year without a final agreement on whether asset write-ups will or will not be permitted in contract costing and pricing. Moreover, the DOD IG has told the Committee that it has found cases of relatively small contractors, with sparse audit coverage, whose purchase was overlooked by the Government with the result that asset write-ups were unknowingly accepted without Government receipt of any concomitant credit.

2. Committee Comments

a. General Considerations

It is evident that Government activities have approached the question of asset revaluations resulting from business acquisitions differently and that those confronted with specific situations have sometimes acted hesitantly or not at all because of the absence of adequate guidelines in this area. This lack is also reflected in the fact that there are at least two separate cases being, or about to be, litigated between the Government and defense contractors involving aspects of the asset revaluation issue. In one of these cases, moreover (that involving the Marquardt Company), the Committee is concerned that the initial ASBCA decision, while favorable to the Government in the specific circumstances, would logically lead to treating the same event (namely, the acquisition of a business) differently for contract costing purposes depending upon the legal form of the acquisition. There is, therefore, a real need for clear Government policy in this area; indeed, with the possible exception of the area of pension cost, it represents the most significant issue under consideration by the Committee.

The Committee believes further that only two basic approaches to this issue through the cost principles are conceivable (although variations on either approach are possible). One is to recognize asset revaluations resulting from business acquisitions, thereby accepting altered depreciation and FCCM amounts in accounting periods subsequent to the acquisition. On this approach, equity is obtained for the Government by requiring that, in cases of upward revaluation, current Government contracts receive their fair share of the "recapture" of excess depreciation borne by previous contracts. The other approach is to simply not recognize for purposes of Government contract costing and pricing asset revaluations resulting from business combinations.

2 paragraphs

In choosing between these two broad approaches, the Committee majority is persuaded that the fundamental issue here is one of how best to achieve fairness. Both the "depreciation recapture" and the "no recognition" approaches are, in the final analysis, nothing more than devices to ensure that what constitutes good accounting for business acquisitions does not create a situation that is "unfair" to the Government. In the opinion of the Committee, it is on this basis that the choice between these two approaches should be made.

Measured by this standard, the Committee believes that the approach of simply not recognizing depreciation or FCCM charges flowing from asset revaluation ought to be the basic Government rule. In reaching this judgment, the Committee was heavily influenced by the fact that one is dealing with a relatively small number of events of widely different magnitude. The recent purchase of Hughes Aircraft Company by the General Motors Corporation, for example, will result in an increase in recorded asset values totaling in the billions of dollars, whereas, in the Bath Iron Works situation which was the main impetus for DAR Case 83-100-5, the comparable total was less than fifty million dollars. The Committee was also influenced by the perception that much of DoD contracting for major weapon systems is done on a sole-source or very limited competition basis in which the award of future contracts to the incumbent contractors at a price based on their recorded cost structures is unavoidable.

In view of this, the Committee believes that extending the "depreciation recapture" approach to business acquisition situations does not make sense. This approach was designed to deal with the quite different situation of the transfer of individual assets between independent, on-going companies. The transactions contemplated were numerous and typically of relatively low dollar value. Those who developed this approach were well aware that, because of variations over time in contract type and business mix, the treatment prescribed could be inequitable to either the Government or the contractor for any particular asset disposition in that Government contracts would likely "recapture" more or less depreciation at the time of asset disposition than they had actually borne in previous periods. However, they believed that over numerous transactions such variations would normally offset one another so that the outcome would be fair over-all.

Indeed, for precisely this reason, the ASPR Committee provided expressly for the abandonment of this approach, and the substitution of case-by-case negotiation in instances of "mass disposition." The point, of course, is that every business combination is obviously tantamount to a "mass disposition" situation. The Committee believes, therefore, that it would be imprudent to impose on such situations a rigid "depreciation recapture" rule designed to achieve equity under very different circumstances. Given a certain combination of business mix, contract type, and program status, acceptance of asset revaluations can lead to substantially higher depreciation and FCCM expense on future Government contracts, while the Government's actual, realized share in the offsetting "depreciation recapture" credit amounts to nothing. Few are likely to view this outcome with equanimity particularly if it were to happen in the case of some massive acquisition whose size dwarfs that of the more typical purchase.

This brings us to the question which, in the opinion of the Committee, is at the heart of this case, namely, what really constitutes "fairness" in such situations? As we have noted repeatedly in this report, both the "depreciation recapture" rule contained in the cost principles and its restatement in the CAS, contemplate situations in which that rule will fail to create equity and should be abandoned, without, however, defining what "equity" is. There is, however, a long-standing tradition in Government contracting, expressed in both the cost principle on "Organization costs" and in the language of the standard novation agreement, that the Government should be placed in no worse a position by a change in business ownership than it would have been in had the change not taken place. In the final analysis, the Committee majority believes that this is a reasonable and practical way to define what is equitable in such situations not only to the Government, but also to the contractors involved who are, after all, as much at risk as the Government under the "depreciation recapture" approach.

Accordingly, we recommend coverage which accomplishes this by simply not recognizing for Government contract costing in most circumstances any changes to depreciation expense or FCCM flowing from asset revaluations following business acquisitions. As a consequence, of course, such events will also result in no "gain" or "loss", and no attendant credit or charge for Government contract costing.

The Committee is, of course, aware that this recommendation is likely to be controversial. This is not the place to respond to every objection that will be raised against such a policy. However, the Committee does feel it appropriate to comment on what it believes will be two of the main complaints.

(i) One will be that such a policy violates good accounting, which requires asset revaluation based on the price paid for the acquired entity, as well as the DoD's own long-standing policy of basing asset valuation on acquisition cost. In the Committee's view, however, to make this the primary consideration in this case represents a serious failure of perspective. What is really at issue here is the best means to ensure that the Government and the contractors in question are treated fairly in these uncommon, yet financially very significant, events, given the peculiarity of Government procurement that so much of its pricing is based on companies' recorded cost structures. The dogmatic insistence that asset revaluations resulting from business acquisitions must be respected as good accounting leads to seeking equity through a "depreciation recapture" approach. And this approach in turn leads to the possibility that either the Government or the acquiring contractor can obtain a significant financial advantage as a result of a business acquisition. In these circumstances, it seems appropriate to the Committee majority to simply abandon the tenets of good "purchase" accounting, just as the Government abandoned them in the analogous case on "goodwill."

(ii) Second, some will no doubt complain that this proposed approach is unfair to the acquiring contractor in that it does not permit him to recover the cost of his investment in the acquired entity, and will result in a disincentive to invest in defense assets that, in the long run, will shrink the defense industrial community and increase Government procurement costs. The Committee finds this argument flawed, however. It would be more comprehensible if the conceivable alternative approach were to simply recognize upward asset revaluations without requiring recognition of a concomitant credit. In comparison with such an approach, the Committee's position would indeed be financially disadvantageous to the acquiring contractor. However, as we have stressed throughout this report, the determination of financial advantage is not so simple or clear-cut when the "depreciation recapture" credit is taken into account, and it is perfectly possible for this approach to be <u>more</u> disadvantageous to the acquiring contractor than that supported by the Committee. In view of this, it hardly seems necessary to go further and comment on other questionable links in this chain of argument.

b. <u>Specific Coverage</u>

The main issue concerning the appropriate means of implementing the basic approach chosen by the Committee was how to properly circumscribe its applicability. It should be noted that a similar problem was not faced in the case of goodwill. Those who drafted the coverage on that subject ultimately included in the cost principles believed that they were merely making explicit what had always been a DoD policy understood and accepted by ethical contractors. Consequently, there was in their minds no doubt that the appropriate coverage was to disallow without qualification or exception amortization of, or FCCM on, goodwill. In the case of identifiable asset revaluation following a business acquisition, on the other hand, the situation is complex and requires a more nuanced approach.

In the first place, the Committee believes that there may be contractors who have been involved in past business acquisitions in which assets were revalued upward and Government contracts received a concomitant "depreciation recapture" credit. In such cases, the new asset values will likely affect depreciation and FCCM expense for many years in the future. Under these circumstances, it would clearly be unfair to contractors to disallow depreciation expense based on the revalued asset amounts from the time of implementation of the proposed new rule forward. To do so would upset the bargain made at the time of combination in which the Government accepted asset revaluation in return for receipt of a "depreciation recapture" credit.

Moreover, it is conceivable that the Government will be confronted with asset revaluations due to a business combination that took place when the acquired contractor had no, or virtually no, Government business. It would again be unfair to the contractor not to recognize these values for identifiable assets which were on the contractor's books when he began contracting with the Government. On the other hand, the Committee can conceive of situations in which, either because of uncertainties about the character of the contractor's future business or for administrative reasons, it would be in the Government's best interest to accept an immediate cost recapture credit rather than to disallow future costs flowing from asset revaluations.

The Committee has dealt with the existence of legitimate exceptions by creating a rule that, while laying down a general policy of disallowance, leaves some latitude for the exercise of judgment in making exceptions by the contracting officer faced with the specific business combination. In the Committee's opinion, such latitude is necessary for a fair and workable rule, and it would stress that it has placed the contracting officer in a very strong position to allow only those exceptions for which a strong case can be made by mandating that without his agreement the disallowance of costs resulting from asset revaluation is automatic.

The Committee believes that its proposed regulation parallels that of the IRS Code (Tax Reform Act of 1986) in that it assures that, in most circumstances, the Government will either recognize no additional costs resulting from asset revaluations, or, if it does, will receive an appropriate "depreciation recapture" credit. The Committee would also add that its approach of leaving some latitude in this matter to the contracting officer has been used before in the cost principles, most recently in the case of the cost principle on travel (-46), with regard both to the standard class airfare limitation on the allowability of corporate aircraft costs and to the Government employee limitation on the allowability of contractor travel per diem costs. Indeed, as the current regulatory climate pushes the cost principles into more and more areas in which fairness and common sense require exceptions to overall Government policy, the Committee expects to see it become still more common.

Several other features of the Committee's recommended coverage also merit explanatory comment. The first is the decision to put the new coverage on asset writeups in a single place, rather than scattering it among the relevant cost principles, namely, those on depreciation and cost of money. The Committee had two reasons for doing so. The first was simply to give the new policy an emphasis that would be lacking if it were spread among lengthy, preexisting cost principles dealing with many other issues. More substantively, however, one issue, namely, the status of the amortization of identifiable intangible assets (e.g., patents), which the Committee felt ought to be covered in any adequate rule on asset writeups, had no obvious home in the existing cost principles. Given this, the Committee judged it preferable to put all the new coverage in a single location (with appropriate cross-references to and from existing rules), and the obvious location was the existing cost principle on "goodwill", which is, after all, like identifiable asset writeups, a creation of the purchase method of accounting for business combinations. The recommended coverage is shown in Part 3 of TAB A.

Second, the Committee also felt it necessary to recommend revising the present coverage at 31.205-16 ("Gains and losses ...")at several points with a view toward both adequately backstopping the more fundamental changes being proposed at 31.205-49 and also making other desirable changes in coverage that has not been looked at for many years. In paragraph (a) of that cost principle, the Committee is proposing first to add the words "including any transaction(s) in which the acquirer employs the purchase method of accounting for subsequent valuation of the property" in the opening sentence. This language is intended to further clarify what is meant by a "sale" of depreciable property, and, in particular, to rule out once and for all the argument that business acquisitions effected by stock purchase and accounted for under the "purchase" method of accounting nevertheless do not constitute a sale of depreciable property. In that same paragraph, the Committee is also proposing to add a sentence explaining that a depreciation recapture credit may be moved out of the year of sale if necessary to achieve equity in pricing and costing Government contracts. It is the Committee's understanding that this has long been done in practice even absent explicit coverage. However, the Committee believes that such coverage is now advisable particularly since its recommended coverage in 31.205-49 permits the contracting officer in appropriate circumstances to choose the depreciation recapture approach in dealing with asset revaluations resulting from business acquisitions.

In paragraph (b) of 31.205-16, the Committee is recommending a revised rule regarding the maximum credit to be obtained when an asset is sold at a gain. The present coverage limits the credit for the disposition to the amount of depreciation taken over the life of the asset. Thus, if an asset acquired in Year 1 at a cost of $1,000 and depreciated for six years at a rate of $100 per year, having a net book value of $400, were sold for $1,500, the gain recorded on the books would be $1,100. However, the credit to Government contracts would only be $600, the absolute amount of depreciation taken. Putting a ceiling on depreciation recapture that does not recognize the changing value of the dollar makes little economic sense to the Committee. We therefore recommend that the limitation at 31.205-16(b) refer to the inflation-adjusted amount of depreciation previously taken. This is again a particularly necessary step if the depreciation recapture approach is to be a viable option in dealing with business acquisitions.

Lastly, the Committee has added language to this cost principle in both paragraphs (c) and (e) cross-referencing the new coverage at 31.205-49, and explaining the interrelationship between the two rules.

The final noteworthy feature of the Committee's recommended approach concerns the CAS. The Committee is recommending that the passages in CAS 404 dealing with the accounting for business combinations (see Section C.1.b(iii) above) and the passages in CAS 409 dealing with "depreciation recapture" (again see Section C.1.b(iii) above) be deleted. The recommended action regarding CAS 404 is necessary to eliminate the inconsistency between that standard (which accepts the "purchase" method of accounting for business combinations) and the new cost principles coverage (which disallows asset writeups in most circumstances). The Committee does not believe that this inconsistency would constitute an "impermissible conflict" between the CAS and the cost principles of the kind found by the courts in the Boeing SERP case (since the new cost principles coverage would constitute an "allowability" rule in the narrowest sense). However, the Committee sees no reason for the Government to run whatever litigative risk is inherent in letting the inconsistency stand, and the simplest, cleanest way to remove it is just to eliminate the language in the CAS. The same rationale also applies for our recommended deletion of certain CAS 409 passages, especially with regard to the Committee's proposed inflation-adjusted depreciation recapture rule which comes nearer to being an accounting rule as the courts used that concept in the Boeing SERP decisions than anything else in this case. Accordingly, the Committee has included at Part 4 of TAB A the necessary revisions to Part 30 of the FAR (where the CAS is on the way to being located).

D. The OSD Task Force Report and its Commenters

The OSD Task Force on the cost principles, which met in November 1985, was aware of the existence of this case and of at least some of the Cost Principles Committee discussion material generated by it up to that point. Not surprisingly, its report contained several recommendations on the issues of this case. First, insofar as the additional executive compensation costs sometimes resulting from business acquisitions were concerned, the Task Force report contained no new recommended coverage. However, in its comments on paragraph (g) of the compensation cost principle dealing with severance pay, the report noted approvingly the Committee's apparent intention to restrict the allowability of "golden parachute" payments. Second, the Task Force report recommended that language be added to the "organization costs" cost principle disallowing the cost of "defending against hostile take-over attempts." Finally, the report recommended that new paragraphs be added to the cost principles on cost of money and depreciation disallowing any increases resulting from asset revaluation attendant on an acquisition provided only that the Government had borne a share of asset depreciation prior to the acquisition.

Both CODSIA, in its comments of April 22, 1986 on the Task Force report, and the DOD IG, in its comments of February 28, 1986, discussed certain of these recommendations. CODSIA noted that the Task Force report's position on asset revaluation conflicted with CAS 404 and with generally accepted accounting principles, but deferred taking any final position until language resulting from Case 84-18 was published for comment. CODSIA did, however, recommend that the report's proposed language on the cost of "defending against hostile take-over attempts" be deleted on the grounds that this was an ordinary and necessary business expense which ought to be allowable. The DOD IG, on the other hand, disagreed with the Task Force report's position on asset revaluation because it would "unfairly penalize the buyer", and recommended instead that a "depreciation recapture" approach be adopted with additional coverage ensuring that contractors not be able to avoid conceding the Government its fair share of previous excess depreciation.

The Committee believes that its recommended coverage at TAB A is fully consistent with the spirit of the Task Force report's recommendations, and that such differences as do exist involve relatively minor matters of implementing language. The DOD IG's comment that the "no writeup" approach is "unfair" to the purchaser is dealt with in Section C.2.a. above. Finally, the Committee cannot agree with the CODSIA complaint about the policy of disallowing the cost of resisting hostile takeover attempts. While, in today's economic climate, such expenditures may indeed be increasingly common, this is equally true of the analogous costs of the suitor firm or of the firm that chooses to cooperate in its own takeover. It has been longstanding Government policy that costs relating to changes in ownership and control provide insufficient benefit to be borne by Government contracts. The proposed clarification on this matter is fully consistent with that policy.

All members of the Committee concur with the contents of this report.

J. W. ERMERINS
Chairman
Commercial Cost Principles Committee

Commercial Cost Principles Committee Members

DoD Members	Other Members
Sherman Dillon, Army	Frank T. Van Lierde, GSA
Charles A. Zuckerman, Air Force	Robert W. Lynch, NASA
Donald W. Reiter, DLA	William T. Stevenson, DOE
Tim J. Foreman, OASD(A&L)	
Charles D. Brown, OASD(C)	
Frances Brownell, DCAA	

Attachments:
TAB A - Part 1, Ppsd Rev. to 42.1200 & 31.109
" Part 2, Ppsd Rev. to 31.205-6 & 31.205-27
" Part 3, Ppsd Rev. to 31.205-10, 31.205-11, 31.205-16, & 31.205-49
" Part 4, Ppsd Rev. to 30.404 & 30.409
TAB B - Ppsd Transmittal Memo to CAAC
TAB C - Ppsd Federal Register Notice

42.1200 Scope of subpart.

This subpart prescribes policies and procedures for--

(a) Recognition of a successor in interest to Government contracts when [either] contractor assets [or control over contractor assets] are transferred;

(b) Recognition of a change in a contractor's name; and

(c) Execution of novation agreements and change-of-name agreements by the responsible contracting officer.

42.1201-1203 - Unchanged.

42.1204 Agreement to recognize a successor in interest (novation agreement).

(a) The law (41 U.S.C. 15) prohibits transfer of Government contracts. However, the Government may, in its interest, recognize a third party as the successor in interest to a Government contract when the third party's interest in the contract arises out of the transfer of [either] (1) all the contractor's assets[,] (2) the entire portion of the assets involved in performing the contract[, or (3) controlling interest in the ownership of the original contractor]. (See 14.404-2(k) for the effect of novation agreements after bid opening but before award.) Examples include but are not limited to--

(i) Sale of these assets with a provision for assuming liabilities;

(ii) Transfer of these assets incident to a merger or corporate consolidation; ~~and~~

[(iii) *Transfer of the complete or controlling interest in the ownership** of a contractor through a stock purchase transaction when there is no change in the legal form of the contractor, or by any other means***; and]

~~(iii)~~ [(iv)] Incorporation of a proprietorship or partnership, or formation of a partnership.

42.1204(b)-(e) - Unchanged.

NOTES

* The language in this new subparagraph should be compared with that published in DAC 76-48 which is given in Section A.1 of this report.

** Where the above coverage has the words "complete or controlling interest in the ownership", DAC 76-48 simply had "ownership" and the ADPA recommended the words "complete or partial ownership". The Committee agrees with ADPA's point that the old DAR language was flawed in that it could conceivably be construed as referring only to situations in which the entire voting stock of a company was acquired, not to situations in which effective control was acquired through purchase of less than the entire outstanding stock. However, the Committee has modified ADPA's recommended language as indicated in order to make clear that only those stock purchases which result in the creation of a new "controlling interest", and do not involve merely nominal amounts, are contemplated. It should be noted that the phrase "controlling interest" has a reasonably precise meaning, normally connoting ownership of one-half or more of the voting stock. The Committee has also added language in 42.1200(a) and 42.1204(a) to make those passages consistent with the addition here.

*** Following the word "means", the DAC 76-48 coverage had the phrase "when the Secretary concerned determines that the sale may significantly affect the Government's rights and interests under existing and future contracts." ADPA recommended placing the determination referred to here at the level of the administrative contracting officer, that is, the same level as decisions in other circumstances concerning the need for a novation agreement. The Committee agrees with ADPA's reasoning here as far as it goes but feels that the most appropriate way to implement it is by simply deleting the whole phrase in question. Language indicating that this form of acquisition somehow requires a special determination of the need for an agreement that the others do not is really more consistent with the alternative approach of including acquisition through stock purchase among the situations for which an advance agreement on cost is advisable.

31.109 Advance agreements.

(a) through (g)(16) - Unchanged.

[(17) Costs resulting from the acquisition of one company by another, particularly when execution of a novation agreement (see 42.12) is not required.]

31.205-6 Compensation for personal services.

(a) through (k) -- Unchanged.

(l) ~~Reserved.~~ [Compensation incidental to business acquisitions. The following costs are unallowable:

(1) Payments to employees under special agreements (commonly referred to as "golden parachutes") in which they are to receive compensation in excess of the contractor's normal severance pay practice if their employment terminates following a change in the management control over or ownership of the contractor or a substantial portion of its assets.

who refers to
[illegible]

(2) Payments to key employees under special plans introduced in connection with a change (whether actual or prospective) in the management control over or ownership of the contractor or a substantial portion of its assets in which those employees receive compensation in addition to their normal pay provided that they remain with the contractor for a specified period of time.]

words
golden
handcuff

(m) - Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) below, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) [resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and (3)] raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) - Unchanged.

31.205-10 Cost of money.

(a)(1) - Unchanged.

(2) Allowability. Whether or not the contract is otherwise subject to CAS, facilities capital cost of money is allowable if--

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with CAS 414;

(ii) The contractor maintains adequate records to demonstrate compliance with this standard; ~~and~~

(iii) The estimated facilities capital cost of money is specifically identified or proposed in cost proposals relating to the contract under which this cost is to be claimed~~.~~[; and

(iv) The requirements of 31.205-49, which may limit the allowability of facilities capital cost of money, are observed.]

(3) and (4) - Unchanged.

(5) The cost of money resulting from including goodwill (however represented) in the facilities capital employed base is unallowable~~.~~[(see 31.205-49).]

(b)(1) - Unchanged.

(2) Allowability[.] Whether or not the cont[r]act is otherwise subject to CAS, and except as specified in subdivision (ii) below, the cost of money for capital assets under construction, fabrication, or development is allowable if--

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with CAS 417;

(B) The contractor maintains adequate records to demonstrate compliance with this standard; ~~and~~

(C) The cost of money for tangible capital assets i~~f~~[s] included in the capitalized cost that provides the basis for allowable depreciation costs, or, in the case of intangible capital assets, the cost of money is included in the cost of those assets for which amortization costs are allowable~~.~~[; and

(D) The requirements of 31.205-49, which may limit the allowability of cost of money for capital assets under construction, fabrication, or development, are observed.]

(2)(ii)-(4) - Unchanged.

31.205-11 Depreciation

(a) through (m) - Unchanged.

[(n) The requirements of 31.205-49, which may limit the allowability of depreciation, shall be observed.]

31.205-16 Gains and losses on disposition of depreciable property or other capital assets.

(a)(1) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property[, including any transaction(s) in which the acquirer employs the purchase method of accounting for subsequent valuation of the property,] shall [normally] be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) below). [However, the timing (or the amount, if necessary) of the recognition of such credits should be adjusted when the impact upon contract prices of current year recognition does not achieve equity.

(2) When the assets or controlling interest in the ownership of a contractor are acquired or transferred and the individual assets are revalued under the purchase method of accounting for a business combination, 31.205-49 shall apply rather than this subparagraph. No gain or loss shall be recognized when allowable depreciation or amortization is limited to the amount that would have been allowable had the combination not taken place.]

(b) Gains and losses on disposition of tangible capital assets including those acquired under capital leases (see 31.205-11(m)[()], shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the ~~difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance~~ [inflation-adjusted amount of depreciation previously taken] (except see subdivision (c)(2)(i) or (ii) below).

(c) and (d) - Unchanged.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis. [However, when the assets or controlling interest in the ownership of a contractor are acquired or transferred and the individual assets are revalued under the purchase method of accounting for a business combination, 31.205-49 shall apply rather than this paragraph.]

(f) - Unchanged.

31.205-49 Goodwill [and other asset valuations resulting from business combinations.]

~~Goodwill, an unidentifiable intangible asset, originates~~ [(a)(1) When,] under the purchase method of accounting for a business combination[,] ~~when~~ the price paid by the acquiring company exceeds the ~~sum of the identifiable~~ [net book value of the] individual assets acquired less [the] liabilities assumed, ~~based on their fair values. The~~ [the] excess is [distributed first to the identifiable individual assets acquired based upon their market or appraised values and, if any excess still remains, to a newly created, unidentifiable intangible asset] commonly referred to as goodwill. ~~Goodwill may arise from the acquisition of a company as a whole or a portion thereof.~~ [In such situations, allowable amortization, cost of money, and depreciation expense shall be limited to the amount that would have been allowable had the combination and subsequent asset revaluation or creation not taken place.

(2) However, except for goodwill, costs in excess of this limitation may be allowed on a case-by-case basis to achieve equity or protect the Government's interests in special situations, providing the contracting officer agrees. Examples of circumstances in which it may be appropriate for the contracting officer to allow such costs are:

(i) When the Government, before the effective date of this cost principle, had agreed to a settlement covering a business combination which implied acceptance of such costs in the future (as, for instance, when the Government had agreed to accept an immediate credit for contract costing purposes for excess depreciation and amortization costs recognized prior to the business combination (see 31.205-16));

(ii) When the receipt of an immediate credit for contract costing purposes for excess depreciation and amortization recognized prior to a business combination (see 31.205-16) represents an administratively preferable and roughly financially equivalent course of action when compared with that of disallowing future costs flowing from the revaluation of assets pursuant to a business combination; and

(iii) When the acquired company had no, or an insignificant amount of, Government business before being acquired (so that no material credit exists for excess depreciation and amortization previously recognized), and subsequently entered Government business with the asset valuations established by the combination.

(b)] Any costs for amortization, expensing, write-off or write-down of [, or cost of money on,] goodwill (however represented) are unallowable.

30.404 Capitalization of tangible assets.

.10 through .50(c) - Unchanged.

~~(d) Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company, not to exceed their fair value at date of acquisition. Where the fair value of identifiable acquired assets less liabilities assumed exceeds the purchase price of the acquired company in an acquisition under the "purchase method," the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.~~

~~(e) Under the "pooling of interest method" of accounting for business combinations, the values established for tangible capital assets for financial accounting shall be the values used for determining the cost of such assets.~~

~~(f)~~ [d] Asset accountability units shall be identified and separately capitalized at the time the assets are acquired. However, whether or not the contractor identifies and separately capitalizes a unit initially, the contractor shall remove the unit from the asset accounts when it is disposed of and, if replaced, its replacement shall be capitalized.

.60 - Unchanged.

30.409 Depreciation of tangible capital assets.

.10 through .40(a)(3) - Unchanged.

~~(4) The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.~~

.40(b) through .50(i) - Unchanged.

~~(j)(1) Gains and losses on disposition of tangible capital assets shall be considered as adjustments of depreciation costs previously recognized and shall be assigned to the cost accounting period in which disposition occurs except as provided in paragraphs (j)(2) and (3) of this section. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds in the event of involuntary conversion, and its undepreciated balance. However, the gain to be recognized for contract costing purposes shall be limited to the difference between the original acquisition cost of the asset and its undepreciated balance.~~

(j)~~(2)~~[(1)] Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) Assets are grouped and such gains and losses are processed through the accumulated depreciation account, or, (ii) the asset is given in exchange as part of the purchase price of a similar asset and the gain or loss is included in computing the depreciable cost of the new asset. Where the disposition results from an involuntary conversion and the asset is replaced by a similar asset, gains and losses may either be recognized in the period of disposition or used to adjust the depreciable cost base of the new asset.

(j)~~(3)~~[(2)] The contracting parties may account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties.

(j)~~(4)~~[(3)] Gains and losses on disposition of tangible capital assets transferred in other than an arm's-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

(k) through .60 - Unchanged.

TAB B
DAR Case 84-18

PROPOSED TRANSMITTAL MEMO TO CAAC

MEMORANDUM FOR CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: DAR Case 84-18, Mergers and Other Business Combinations

The DAR Council has approved proposed revisions to FAR 30.404.50(d) and (e), 30.409.40(a)(4) and .50(j)(1), 31.205-6, 31.205-10, 31.205-11, 31.205-16, 31.205-27, and 31.205-49 to provide clear rules on the allowability of costs flowing from asset writeups resulting from business acquisitions and on the allowability of certain other costs incidental to such combinations. The rationale for these decisions is contained in the attached report. If the CAAC agrees with our position, please forward the case to the FAR Secretariat for further processing as appropriate.

OTTO J. GUENTHER, COL, USA
Director
Defense Acquisition
Regulatory Council

Attachment

TAB C
DAR Case 84-18

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Parts 30 and 31

Federal Acquisition Regulation (FAR); Mergers and Other Business Combinations.

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 30.404.50(d) and (e), 30.409.40(a)(4) and .50(j)(1), 31.205-6, 31.205-10, 31.205-11, 31.205-16, 31.205-27, and 31.205-49 to set forth new or clarified rules on the allowability of costs stemming from business combinations.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405.

Please cite FAR Case 87-XX in all correspondence related to this issue.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat, telephone (202) 523-4755.

A. Background.

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing for some time the subject of business combinations, and particularly the appropriate Government contract costing resulting from such combinations. This review has been occasioned both by the increased pace and size of such events in recent years, and also by the Councils' perception that existing regulations on certain aspects of this subject are inadequate as evidenced by the fact that they have been the subject of recent litigation. A principal conclusion of this review is that, in most circumstances, the Government should not recognize depreciation, amortization, or cost of money expense flowing from asset writeups that result from the "purchase" method of accounting for business combinations. The Councils do not believe that, in the special circumstances of Government procurement in which companies' recorded cost structures are often directly reflected in price, the Government should be at risk of paying higher prices simply because of ownership changes at its suppliers. Accordingly, the Councils are proposing a change to FAR 31.205-49, and corollary changes to FAR 30.404.50(d) and (e), 30.409.40(a)(4) and .50(j)(1), 31.205-10, 31.205-11, and 31.205-16, to implement this decision. The Councils have also tentatively concluded that additional coverage at FAR 31.205-6 and 31.205-27 is necessary to protect the Government from having to bear the costs of special compensation arrangements and various organization costs often attendant upon such combinations.

B. Regulatory Flexibility Act.

The proposed changes to FAR 30.404.50(d) and (e), 30.409.40(a)(4) and .50(j)(1), 31.205-6, 31.205-10, 31.205-11, 31.205-16, 31.205-27, and 31.205-49 are not expected to have a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C., 601 et. seq.) because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply.

C. <u>Paperwork Reduction Act.</u>

The Paperwork Reduction Act does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements. Therefore, OMB approval under 44 U.S.C. 3501 et seq. is not required.

List of subjects in 48 CFR Parts 30 and 31

Government procurement.

Dated: ______________

Lawrence J. Rizzi
Director, Office of Federal Acquisition and Regulatory Policy

Part 30 and 31 - (Amended)

Therefore, it is proposed that 48 CFR Parts 30 and 31 be amended as follows:

1. The authority citation for Parts 30 and 31 continues to read as follows: Authority: 40 U.S.C. 486(c); 10 U.S.C. Chapter 137; and 42 U.S.C. 2453(c).

(See TAB A, Parts 2, 3, and 4 as approved)

SUMMARY OF COMMENTS
DAR Case 84-18B, Accounting for Mergers
and Other Business Combinations

	No comment/ Objection	Concur/ Support	Non-concur	Partial Objection
1. Davey Compressor Company			X	
2. William J. Ryan, Jr.		X		
3. U.S.A. Occupational Safety Health Review Commission	X			
4. Avco Research Laboratory, Textron				X
5. McKenna, Conner & Cuneo			X	
6. U.S. Department of Housing and Urbane Development	X			
7. Federal Home Loan Bank Board	X			
8. Armed Forces Communications and Electronics Association	X			
9. Agency for International Development	X			
10. National Endowment for the Humanities	X			
11. Central Intelligence Agency	X			
12. Pennsylvania Avenue Development Corporation		X		
3. U.S.A. Railroad Retirement Board	X			
14. U.S. Arms Control and Disarmament Agency	X			
15. National Labor Relations Board	X			
16. U.S. Small Business Administration	X			
17. U.S. Commission on Civil Rights	X			
18. Vincent T. Noone				X
19. American Institute of Certified Public Accountants			X	
20. American Defense Preparedness Association		X		
21. Panama Canal Commission	X			

SUMMARY OF COMMENTS
DAR Case 84-18B, Accounting for Mergers
and Other Business Combinations

	No comment/ Objection	Concur/ Support	Non-concur	Partial Objection
22. Professional Services Management Association			X	
23. Veterans Administration, Office of the Administrator	X			
24. DoD, Inspector General		X		
25. Emerson Electric Company Electronics & Space Division			X	
26. Council of Defense and Space Industry Associations			X	
27. American Bar Association			X	
28. Equal Employment Opportunity Commission	X			
29. General Accounting Office Office of General Counsel				X
30. Office of GSA Acquisition Policy and Regulations				X
31. Steiger and Evans			X	
32. Gregory A. Smith, Pettit & Martin			X	
Totals	15	4	9	4

Objections/Issues	Commenters
1. Real Cost/GAAP The provisions of APB No. 16 are equitable and sufficient to govern business combinations. The purchase method of accounting for business combinations is backed by significant historical accounting precedent and is based on good common business sense. Increased depreciation and cost of money are allowable and allocable on government contracts since they represent the companies investment base.	1,18,25,27,31,32
2. Competition Competition should determine the price, not the suppliers structure or ownership history. To reject the purchase method of accounting places the government in a more favorable position than commercial customers.	4,26,27
3. Capital Generation One of the objectives of business combinations is to generate capital and the ability to acquire capital by stepping up asset values. the imposition of limitations on revaluation of assets severely depresses the attractiveness of aerospace and defense oriented companies in the marketplace.	5,20,26,27,31,32
4. Novation Increased depreciation and cost of money should be allowed on contracts entered into after the effective date of the business combination, but should not be allowed on contracts entered into on or before the effective date of the combination. Clarifying FAR 42.12 would reduce the opportunities for the government to secure concessions on unrelated points.	5,18,25,26,27,31
5. Requests Meeting This subject presents significant legal, business, and economic issues which should be addressed by discussion with the CPC.	5,19,26,27

Concur/Support

6. Sharing Recognition of Gain

The excess of the selling price received over the the stated net book value is a gain to the sellers in which the Government should share.	24,30

7. Strengthen Novation Process

Increased costs on current contracts can be avoided through the proper use of novation agreements.	24

8. Clarify Appraisal Process

Specific criteria should be included in the procurement regulations to address both the requirements for appraisals and the treatment and definition of long-term contracts as intangible assets.	24

9. Permit Write-up if Beneficial

Stepped-up assets should be permitted on a case-by-case basis where it can be shown that a business combination will result in increased benefits to the Government, for example, lower unit costs.	29

10. Marquardt and Related Cases

Various commenters have cited the relevant ASBCA/Court cases, some in more depth than others. Most limited their comments to a restatement of the judgements.	18,27,31,32

C. Paperwork Reduction Act.

The Paperwork Reduction Act does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements. Therefore, OMB approval under 44 U.S.C. 3501 et seq. is not required.

List of subjects in 48 CFR Part 31

Government procurement.

Dated: _______________

Lawrence J. Rizzi
Director, Office of Federal Acquisition and Regulatory Policy

Part 31 - (Amended)

Therefore, it is proposed that 48 CFR Part 31 be amended as follows:

1. The authority citation for Part 31 continues to read as follows: Authority: 40 U.S.C. 486(c); 10 U.S.C. Chapter 137; and 42 U.S.C. 2453(c).

(See Attached)

COST PRINCIPLES COMMITTEE
Taskings from Navy Policy Member
3 December 1986

DAR Case	Subject	Rept Date
86-177	Selling Costs (P.L. 99-591, Sec. 9061)	22 Dec 86
86-128	Public Relations Costs	15 Jan 87
86-721	OSD Cost Principles Report	15 Jan 87
84-18	Accounting for Mergers and Business Combinations	30 Jan 87
85-252	Symposia Costs	15 Feb 87
86-027	Litigation Costs	28 Feb 87
86-030	IR&D/B&P	28 Feb 87
85-248	Relocation Costs	1 Mar 87
86-029	Leasing	1 Mar 87
86-032	Special Tooling & Test Equipment Definition	31 Mar 87
86-033	Franchise Taxes	31 Mar 87

Except for 86-177, all of the indicated report dates are new, based on present priorities and current status.

A

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D C 20360

19 December 1985

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Cost Principles Committee Report Due Dates for DAR Cases 82-76, Banked Vacations; 84-18, Accounting for Mergers and Business Combinations; 85-192, Severance Pay; 85-193, Pensions

I request the Cost Principles Committee report due dates for subject cases be revised to read as follows:

DAR Case 82-76	31 Jan 86
DAR Case 84-18	28 Feb 86
DAR Case 85-192	14 Feb 86
DAR Case 85-193	28 Feb 86

Consideration of these cases by the Committee has been postponed in order to complete case work to implement the 1986 DoD Authorization Act and in consideration of holiday absences. Your approval of these report due dates is recommended.

JW Ermerins
J. W. Ermerins
Chairman
Cost Principles Committee

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D C 20360

A

30 October 1985

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Cost Principles Committee Report Due Date for DAR Case 85-180, "Termination of Defined Benefit Pension Plans," DAR Case 84-18, "Accounting for Mergers and Business Combinations," and DAR Case 85-108, "Stock Appreciation Rights (SARs) and Pay-As-You-Go Pension Costs (FAR 31.205-6)"

I request the Commercial Cost Principles Committee report due dates be revised to read as follows:

DAR Case 85-180	22 Nov 85
DAR Case 84-18	20 Dec 85
DAR Case 85-108	22 Nov 85

Greater than anticipated complexity, identification of additional factors bearing on the case problem, and a recent ASBCA decision have delayed completion of the subject case reports. Your approval of these report due dates is recommended.

JWErmerins

J. W. ERMERINS
Chairman
Cost Principles Committee

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D C 20360

DAR Staff
Case 84-18

31 July 1985

MEMORANDUM FOR MR. MICHAEL D. STAFFORD, ACTING DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 84-18, Accounting for Mergers and Business Combinations

In my last memorandum to the DAR Council with regard to the submission date of my Committee report on subject case, I explained that the member assigned to prepare the straw-man report was on a special assignment and has been unable to prepare the report. Consequently, I reassigned this responsibility to another member. He estimates that he will complete the draft and submit it to the Committee by 30 August 1985. Given the legal and accounting complexities of this case, I estimate the discussions and report refinement will take another six weeks. Therefore, I request the due date for this Committee report be established at 16 October 1985.

JWErmerins
J. W. ERMERINS
Chairman
Commercial Cost Principles
Committee

DEPARTMENT OF THE NAVY

OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D C 20360

B

DAR Staff
Case 84-18

24 May 1985

MEMORANDUM FOR MR. JAMES T. BRANNAN, DIRECTOR DAR COUNCIL

Subj: DAR Case 84-18, Mergers and Business Combinations

In my memorandum of 28 March 1985, I advised that a new draft report was being prepared on subject case, that it would be available no sooner than 23 April 1985, and that with discussion to follow, the Commercial Cost Principles Subcommittee report would be available for submission to the DAR Council by 24 May 1985.

To date, the draft report has not been prepared. The designated subcommittee member, OASD(C), has been on a special assignment of a high priority since late April, and is expected to be so occupied at least until 10 June, and possibly later. If he can resume his efforts on this case by then, I estimate the Subcommittee report could be submitted by 9 August. If his special assignment is extended, I will re-assign the task of drafting the report to another Subcommittee member in order to resume progress on this case.

In view of this workload problem, the present workload assignments and planned absences for TDY and vacations, I expect to be able to submit the Subcommittee report by 9 August 1985. If this report date is not acceptable, please advise.

JW Ermerins

J.W. ERMERINS
Chairman
Commercial Cost Principles
Subcommittee

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
FOR ACQUISITION AND LOGISTICS

Date ____________

Memo for ____________________________________
** Senate Levine Staff

Peter Levine
224-3682

**Route this by ~~Cost~~ Finance Committee

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Accounting for Mergers and Business Combinations, DAR Case 84-18

Problem: Asset revaluations, resulting from changes in corporate financing or accounting, can result in increased depreciation and facilities capital cost of money (FCCM) costs charged to government contracts, with no benefit received by the government.

Recommendation:

1. Revise FAR 42.1204 by adding the following paragraph (e): If the contractor has any active contracts which have been awarded based on the submission of certified cost or pricing data, the contracting officer shall not agree to any novation unless the contractor agrees that assets will not be revalued in any manner which increases government costs for depreciation or facilities capital cost of money on this or any future government contract or subcontract.

See Committee Report Page 11

2. Refer this report to the CAS Policy Group for consideration.

3. Close case 86-46 without action.

4. Make no additional changes as a result of this case.

25 MAR 1987

Discussion:

The Committee report identifies two situations where a contractor (or its successor) may attempt to "write up" contractor assets. These are 1) a transfer of stock ownership, and, 2) a business consolidation, by merger or otherwise.

As a result of the recent ASBCA decision in Marquart Co. ASBCA 29888, 85-3 BCA 18245, reconsideration denied, 86-3 BCA 19,100, it is clear that a contractor can not revalue assets, and charge the government using a stepped-up basis, when a transfer of stock ownership occurs. Therefore, to the extent that Marquart was correctly decided, no "real" problem exists in the transfer of stock ownership situation. The committee appears to recognize this result in their report. See committee report at 4 and 10-11. The committee apparently believes Marquart was incorrectly decided. See committee report at 18-19. A copy of the Marquart decision is attached. A review of that decision shows that it was correctly decided. The case has been appealed to the Court of Appeals for the Federal Circuit. I have been advised by Mr. Schechter, the Justice Department attorney on the appeal, that the Court of Appeals for the Federal Circuit normally issues its decisions within six months, but that a complicated case, such as this, could require nine months or more. The Court of Appeals heard oral arguments on February 3, 1987. If Marquart is reversed by the CAFC, then perhaps, the committee's recommendations should be implemented. If Marquart is upheld on appeal, the committee's recommendations should not be accepted.

The remaining discussion assumes that Marquart was correctly decided. Based on this assumption, the only times when "asset revaluation" will be a problem are when business consolidations, by merger or otherwise, occur. A business consolidation will result in a change in accounting practices, corporate financing, or both.

For CAS covered contractors, changes in accounting practices must be disclosed pursuant to the CAS clause (FAR 52.230-3). In addition, the clause provides that the government is entitled to an equitable adjustment for any increased costs resulting from a change in accounting practices. Thus, for CAS covered contractors, the government should not be subject to increased costs resulting from accounting changes which in turn result from business consolidations. In addition, for non-CAS covered contractors, no problem has been identified in the area of accounting changes resulting from business consolidations.

As a practical matter, when changes in corporate financing result from a business consolidation, a novation agreement will be required. A novation agreement is necessary to recognize the obligations of the successor in interest and to extinguish the obligations of the transferring entity. The government can adequately protect itself in this situation by adopting the recommended change to FAR 42.1204(e).

respect to excess reprocurement costs for these two orders. In the event that such a final decision is issued, appellant, by taking a timely appeal, will have an opportunity for review of the termination of default on the merits.

Purchase order N-W-58011-1 was issued sometime in November 1983 for delivery on December 14, 1983. Appellant requested an extension of time until January 27, 1984, and, although its request was denied, the delivery date was extended to February 13, 1984. Appeal File, Exhibit 7.

The supplies called for by purchase order N-W-58011-1 still had not been received on the February 13 delivery date. This purchase order was terminated for default by decision of the contracting officer dated March 23, 1984. From this decision appellant has taken a timely appeal.

In its appeal, appellant alleges adverse financial circumstances and a misquoting of prices in its bid. Appellant has offered no evidence in support of either of these positions and the Government has offered evidence that the bids were verified by appellant. Appeal File, Exhibit 15.

It is our opinion that appellant has failed to sustain the necessary burden of proof.

Decision

The appeal from the contracting officer's decision dated September 1, 1983, as to purchase orders FW-25067-3 and SW-50698-1 is dismissed for lack of jurisdiction.

The appeal from the contracting officer's decision dated March 23, 1984, as to purchase order N-W-58011-1 is denied.

[¶ 18,245] The Marquardt Company

ASBCA No. 29888. July 18, 1985. Contract No. N00014-84-C-2052.

Cost Principles—Cost Accounting Standards—Capitalization of Tangible Assets—Business Combinations

A contractor acquired in a business combination was not entitled to use the purchase method of accounting prescribed by Cost Accounting Standard 404.50 in order to revalue its assets for government contract costing purposes, because that method is prescribed for an acquiring business to value its assets, not for an acquired business. Only stock, not assets, had been exchanged in the sale, and the contractor remained an independent, autonomous entity for all practical purposes. After the contractor incorporated a revalued asset base into his overhead rates for proposals and billings to the government, costs resulting from the revaluation were properly disallowed. The contractor appealed the disallowance, arguing that the purchase method of accounting for business combinations controlled this transaction and required the revaluation of its assets to the extent that their book values differed from fair market values on the date of acquisition. However, CAS 404.50(d) applies only when an acquiring business is to value the assets it has acquired and has nothing to do with how the acquired business is to value its assets. Moreover, no benefit to the contractor's government contract resulted from his acquisition by another business, and the contractor incurred no costs in the acquisition. If the acquiring company were to recover any costs, it would have to do so under its own government and commercial contracts.

For the appellant: Fried, Frank, Harris, Shriver & Kampelman, Washington, D.C., by Melvin Rishe. For the government: Ralph E. Guderian, Defense Contract Administration Services Region, Los Angeles (DLA).

Opinion by Administrative Judge Duval with Administrative Judges Arons and Vasil S. Vasiloff concurring.

[Text of Opinion]

This appeal raises issues concerning the proper Government contract accounting treatment for the acquisition of The Marquardt Company by ISC Electronics, Inc. (ISCE). The Government has disallowed all costs attributable to the write up of Marquardt's assets following the acquisition. The parties have filed motions for partial summary judgment and summary judgment on the threshhold issue of whether appellant may properly revalue its assets for Government contract costing purposes in accordance with the "purchase method" of accounting for business combinations. No material facts relevant to this fundamental issue are in dispute.

Statement of Facts

Prior to the acquisition involved in this dispute, Marquardt was a wholly-owned corporate subsidiary of CCI Corporation (CCI). Marquardt was and is engaged in the research, development and manufacture of advanced propulsion systems, special defense systems, turbo products for aircraft power requirements and precision control space rockets. For the year ending April 1983, Marquardt's net income was about $3 million on revenues of $67 million. Duly organized and existing pursuant to the laws of the State of Delaware, it maintains its principal place of business in Van Nuys, California. All outstanding shares of the stock of Marquardt were owned by CCI prior to 15 August 1983.

On 1 January 1983, CCI converted from status as a publicly-held corporation to a personal holding company. ISC Electronics, Inc. (ISCE) is a wholly owned U.S. subsidiary of International Signal & Control Group PLC (ISC PLC) which is a United Kingdom company. ISCE is a prime contractor for the Department of Defense for certain electronic equipment, and internationally markets electronic security, defense, electronic countermeasure, and communications systems (R4, tab 15). ISC PLC is engaged in two principal business areas: international systems and technical services and electronic and aerospace design and production.

On July 12, 1983, CCI, the holder of all outstanding shares of Marquardt, agreed to sell those shares to ISCE for $43,500,000 in cash and 600,000 "A" ordinary shares of ISC PLC stock. The effective date of the Marquardt acquisition was August 15, 1983. Of the $43,500,000 cash price, $39,500,000 was paid as of that date and the remaining $4,000,000 was placed in escrow to be distributed in accordance with the terms of the escrow agreement. The 600,000 "A" ordinary shares were issued to the President of Marquardt, in exchange for his stock investment in CCI. ISCE also assumed all liabilities of CCI with regard to Marquardt.

As of August 15, 1983, Marquardt was performing under numerous Government and commercial contracts. In addition, subsequent to August 15, 1983, Marquardt entered into new Government contracts, such as Contract N00014-84-C-2052, the only contract cited by specific number in the final decision of the contracting officer. Phase I of that contract was awarded on 22 December 1983; it is a cost plus fixed fee R&D contract, incorporating standard clauses for such contracts.

Before the sale, Marquardt sought an opinion from the ACO concerning the need for a novation agreement. By letter dated 10 August 1983, the ACO advised Marquardt that a novation would not be required since the sale involved a transfer of stock and not assets.

Accounting Principles Board Opinion No. 16, (APB 16) sets forth the generally acceptable accounting principles applicable to business combinations. Para. 1 of the opinion states:

> 1. A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.

APB 16 recognizes two methods of accounting for business combinations, "purchase" and "pooling of interests". The purchase method accounts for a business combination as the acquisition of one company by another. The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by the exchange of securities.

The opinion specifies conditions for utilization of the pooling of interests method. Combinations not meeting those conditions are accounted for under the purchase method.

Under the purchase method:

> The cost to an acquiring corporation of an entire acquired company should be determined by the principles of accounting for the acquisition of an asset. That cost should then be allocated to the identifiable individual assets acquired and liabilities assumed based on their fair values; the unallocated cost should be recorded as goodwill. (Para 8, APB 16)

Para 94 of the opinion states:

> 94 The cost of an acquired company and the values assigned to assets acquired and liabilities assumed should be determined as of the date of acquisition....

The principles included in APB 16 are also reflected in Cost Accounting Standard 404—Capitalization of Tangible Assets—which provides in part:

> § 404.50 Techniques for application.
>
> * * *
>
> (d) Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company, not to exceed their fair value at date of acquisition....
>
> (e) Under the "pooling of interest method" of accounting for business combinations, the values established for tangible capital assets for financial accounting shall be the values used for determining the cost of such assets.

After the sale ISCE recorded the acquisition of Marquardt on its own books using the Purchase method of accounting set forth in APB 16. The total cost of the acquisition was apportioned among the specific, identifiable Marquardt assets based on these values at the time of acquisition as determined through an independent appraisal, resulting in an increase, or "step-up" in the asset value.

On February 2, 1984, Marquardt made a written proposal to the Government to increase the net book value of its assets from approximately $8 million to $48,405,652. The proposal was retroactive to August 15, 1983. On February 8, 1984, the proposed valuation was rejected by the Government. In February 1984, Marquardt incorporated the stepped-up asset base into its overhead rates for the purpose of proposals and billings to the Government.

By final decision dated June 20, 1984, the ACO informed Marquardt that $41,759,652.00 of Marquardt's claimed fixed asset base for Government contract costing purposes was disallowed, so as not to give recognition to ISCE acquisition. This decision was issued pursuant to the provisions of the referenced contract and other unspecified Government contracts. The reasons for the disallowance were stated by the ACO to be as follows:

1. The sale of The Marquardt Company was represented by TMC to the Government as a transfer of stock from CCI to ISC[E] with no change to the company, i.e., same management, same name, and the same asset base.

2. Based upon the foregoing, the Government agreed in writing that no novation was required to protect existing contracts from absorbing any additional costs due to the acquisition. This agreement to no novation was dated 10 August 83. Paragraph one, second sentence is specific as to when a novation would be required. The sentence reads, "Their finding is that TMC is an incorporated company, that the sale involves a transfer of stock, *not assets,* therefore a novation is not required." Since assets are now being claimed by TMC on a stepped-up basis, a novation is necessary to protect existing contracts. Also, a novation could be required under DAR 26-402(b)(iii).

3. The sale of stock between CCI and ISC is strictly an equity transaction based upon the fact TMC remains an autonomous company, no effect on management, and no proof of the sale or transfer of assets from TMC to ISC.

4. Since TMC remains an autonomous company, the same autonomous company as before the sale of stock, its assets must be depreciated on the basis of cost less residual value in accordance with DAR 15-205.9(a). It does not meet the requirements of DAR 15-205.9(h) allowing depreciation on the basis of price, and thus the amount of step up in basis is not depreciable and chargeable to the Government as part of overhead. This amount is also unallowable under DAR 15-201.3 and 15-201.4.

Marquardt appealed the ACO's final decision to the Armed Services Board of Contract Appeals on 3 July 1984. On October 9, 1984, the parties held a prehearing conference with the Board. At that time, it was agreed that one fundamental issue should be considered by the parties and the Board before any other secondary or peripheral issues would be considered. Specifically, the issue to be considered was whether the accounting method used by the appellant for the valuation of assets was proper.

Appended to Marquardt's reply brief to the Government's Motion for Summary Judgment was an affidavit and opinion of Mr. Jerry Walker, a Certified Public Accountant with Arthur Anderson & Company. According to Mr. Walker, the acquisition of Marquardt by ISCE was a "business combination" within the meaning and purview of APB 16, and was required to be accounted for under the purchase method under the terms of the opinion. Mr. Walker also found that the pooling of interests method of accounting was impermissible under APB 16 due to the failure of the combination to satisfy at least three prerequisites specified for use of that method.

Decision

Marquardt's motion is premised mainly on the applicability of APB 16. Marquardt advances the following contentions: The purchase of Marquardt by ISCE is a business combination under the purview of APB 16; of the two methods of accounting for business combinations established by this accounting standard, the purchase method and the pooling of interests method, the former clearly applies to this transaction; use of the purchase method requires the revaluation of the acquired company's assets to the extent its book values differ from its fair market values on the acquisition date. Appellant also argues that revaluation of the Marquardt's tangible capital assets was required to comply with CAS 404.50.(d).

Marquardt's arguments lose sight of the fact that Marquardt and not its new parent, ISCE, is the contracting party here. Paragraph 1 of APB 16 states that a business combination occurs when one or more businesses are brought together in one accounting entity, and "The single entity carries on the activities of the previously separate, independent enterprises." Appellant's reliance on APB 16 is misplaced, since Marquardt remained an independent entity. It alone remained responsible for performing its Government contracts. There has been no novation agreement between the Government, Marquardt and ISCE which would make ISCE, and not Marquardt, ultimately responsible for Marquardt's performance, and the parties had agreed that none was required.

APB 16, under these circumstances, has nothing to do with how the *acquired* corporation is to value its assets when it is acquired by another company. APB 16 deals solely with how an *acquiring* corporation (ISCE) is to value the assets it has acquired. Nothing in APB 16 suggests a contrary view. For the same reason the revaluation of assets contemplated by CAS 404.50(d) does not apply to the acquired company in this transaction.

Appellant relies on *Gould Defense Systems, Inc.*, ASBCA No. 24881, 83-2 BCA ¶ 16,676 which concerned costs allowability in connection with a business combination involving Gould and the Clevite Corporation.

The Board noted in its decision that:

> The Government does not contest the general propriety of using the purchase method of accounting for business combinations for Government contract pricing and costing purposes (finding 62). It accepts depreciation and amortization based upon stepped-up asset valuations when purchase accounting properly is used. (*Gould*, 83-2 BCA at 82,979)

We find this reliance misplaced because Gould, unlike this appeal, involved a merger whereby Clevite was merged into Gould and Gould, the purchaser, was the appellant attempting to recover costs on *its* contracts based on a stepped-up evaluation of Clevite assets acquired by Gould.

We also find that appellant's position would contravene DAR standards with respect to allowable and allocable costs. DAR 15-201.4 states, *inter alia,* that a cost is allocable to a Government contract if it is incurred specifically for the contract and benefits the contract. There is no benefit to Marquardt's Government contract resulting from the purchase by ISCE. See *Metropolitan Life Insurance Company,* ASBCA No. 27161, 85-2, BCA ¶ 17,973 and cases cited therein.

The "Allowable Cost, Fixed Fee, and Payment" clause of appellant's contract (DAR 7-203.4(a)) authorizes the payment of allowable cost of performance of the contract. Marquardt was completely passive in the transaction between CCI and ISCE, and incurred no costs whatsoever. As a result of the transaction, ISCE incurred the cost, not Marquardt, and if ISCE is to recover the purchase cost of acquiring Marquardt it can only do so under its own Government and commercial contracts. Marquardt remains a separate legal entity, obligated to perform its contracts and these contracts cannot be burdened with costs incurred by a third party.

We conclude that Marquardt used an improper accounting method for the valuation of its assets upon its acquisition by ISCE. The purchase method of accounting is inapplicable for the reason stated above.

The Government's motion is granted, the appellant's motion is denied and the appeal is denied.

[¶ 18,246] R&J Construction Company

AGBCA No. 85-217-1. April 22, 1985. Contract No. S50-7A86-4-155.

Timeliness of Appeals to Boards—Filing—Ninety Day Deadline

A contractor's appeal was dismissed with prejudice because he failed to file it with the board within the 90-day period allowed. The contracting officer's final decision was received by the contractor's office manager on November 16. His notice of appeal was dated February 21, postmarked February 27, and received by the board on March 7. Accepting, without deciding the validity of the metered postmark of February 27, the board held that the notice of appeal was untimely filed after expiration of the 90-day statutory period.

For the appellant: Wilcoxen & Cate, Muskogee, Oklahoma, by Clifford R. Cate, Jr. For the government: Michael L. Cruse, Office of the General Counsel, U.S. Department of Agriculture, Little Rock, Arkansas.

wall which intersected with a window sill, a gap of approximately two inches by four inches was left in the window sill. Appellant's position is that the gap of two inches by four inches was not a surface condition within the meaning of the legend note appearing on Drawing No. 6170611 (brief at 11). In reviewing the language appearing on Drawing No. 61760611 we conclude that it clearly covers the situation in this claim. Appellant knew that the wall had to be removed. It also knew or should have known that in the removal process there could be some destruction of the surfaces where the wall and window still intersected. The wall and the window still interfaced and appellant was required to patch the surface.

Appellant points to Modification P00005 for support of its position (brief at 11). Modification P00005 reads in pertinent part (R4, tab 6):

b. Fill corridor window in Room 103 so as to be flush with existing walls on each side.

There is no evidence in the record pertaining to Modification P00005 to explain the circumstances surrounding the execution of the modification nor what actual work was done to the window and why the work was necessary.

This portion of the appeal is denied.

Claim 4

Due to the fact that the floor was uneven appellant argues that it was directed to trim the door so it would fully open and thus this constituted additional work (brief at 14).

Paragraph 8 of section 08210 of the specifications set forth designated tolerances for the door to meet. To be operable a door must be able to open fully when necessary. Appellant in this instance has not done any more work than what the contract required. Appellant has failed to prove that the uneven floor differed materially from what it could have reasonably expected.

This portion of the appeal is denied.

Claim 6

Modification P00009, argues the Government, constitutes an accord and satisfaction in regard to this claim. This modification was executed to carry out PCO 10 which was to compensate appellant for the first installation of the carpet strips beneath the newly installed doors. Appellant is not seeking compensation for the first installation. What appellant is seeking is compensation for the second installation of the carpet strips beneath the newly installed doors.

This portion of the claim is sustained.

Conclusion

Claim 1 is denied.

Claim 2 is sustained.

Claim 3 is denied.

Claim 4 is denied.

Claim 5 is dismissed with prejudice.

Claim 6 is sustained.

This appeal is remanded to the contracting officer to determine the quantum due on the claims sustained by this Board.

[¶ 19,100] The Marquardt Company

ASBCA No. 29888. June 2, 1986. Contract No. N00014-84-C-2052 et al.

Cost Principles—Cost Accounting Standards—Capitalization of Tangible Assets—Business Combination Cost Types—Business Expenses.—On motion for reconsideration, a board of contract appeals affirmed its original decision (85-3 BCA ¶ 18,245), disallowing the costs of a business combination, because the contractor failed to show that the board committed legal or factual error, or that it had actually incurred any costs chargeable to a government contract. The contractor had tried to use the purchase method of accounting to revalue its assets for government contract costing purposes, but the board disallowed the costs because that method was only to be used by an acquiring business, not an acquired one. On reconsideration, the contractor argued that the board had misinterpreted key facts and misapplied the law regarding cost accounting principles applicable to business combinations. However, notwithstanding any factual errors made by the board, the single most important undisputed fact on which the board rested its original cost disallowance was that the contractor had incurred no costs with respect to the performance of its government contracts as the result of the business combination. Moreover, any fact errors the board had made, if corrected, would not have changed the outcome. The contractor's use of the purchase of its stock by another company as the basis for converting that third party expenditure into a cost it incurred amounted to an attempt to create something out of nothing and then charge it against the contractor's government contracts.

For the appellant: Fried, Frank, Harris, Shriver, & Kampelman, Washington, D.C., by Melvin Rishe. For the government: Ralph E. Guderian, Defense Contract Administration Services Region, Los Angeles, California (DLA).

Opinion by Administrative Judge Duvall with Administrative Judges Arons and Vasil S. Vasiloff concurring.

[Text of Opinion]

Appellant has filed a motion for reconsideration of the Board's 18 July 1985 decision (85-3 BCA 18,245) denying its motion for partial summary judgment and granting the Government's motion for summary judgment, resulting in denial of the appeal. The summary judgment motions concerned the proper Government contract accounting treatment for the acquisition of the Marquardt Company by ISC Electronics, Inc. (ISCE). The dispute involves both pre-existing contracts and contracts awarded after the sale.

On 20 July 1984 the contracting officer issued a final decision disallowing all costs attributable to the write up of Marquardt's assets following the acquisition. After the pleadings were filed following appeal of this decision, the Board scheduled a preliminary telephone conference for the purpose of ascertaining counsels' views of the issues and establishing a schedule for further proceedings. During the conference appellant's counsel proposed that the Board limit the proceeding to the primary issue, *i.e.*, was the accounting method used by the appellant for the evaluation of assets proper. Government counsel concurred, and the Board agreed to the proposal. Appellant's motion for partial summary judgment and the Government's motion for summary judgment together with replies were then filed. In its motion appellant requested that the Board find in its favor on the ground that there were no genuine disputes as to the material facts set forth in appellant's motion. In their motions the parties presented differing interpretations regarding the application of Accounting Principles Board Opinion No. 16 (APB 16), which sets forth the generally accepted accounting principles applicable to business combinations. The Government also contended that the application of the "purchase method" of accounting under APB 16 to step up Marquardt's asset base over cost, as advocated by appellant, would contravene the standards of DAR Section XV with respect to allowable and allocable costs.

In its decision granting the Government's motion, the Board held that appellant's reliance on APB 16 was misplaced since Marquardt remained a separate legal entity and no business combination occurred; that APB 16, under the circumstances, had nothing to do with how the acquired corporation is to value its assets; that the purchase costs were not incurred specifically for the Marquardt contracts and because there was no benefit to Marquardt's Government contracts resulting from purchase by ISCE, appellant's position violated DAR 15-201.4; and that since Marquardt itself incurred no costs its contracts could not be burdened with costs incurred by a third party.

In its motion for reconsideration, the appellant now takes the position that "Summary Judgment was a particularly inappropriate means of disposing of the present case" and that "This case raises genuine issues of material fact and complicated legal issues." (supporting memorandum to Mot. for Recon., p. 12) Appellant states that the Board's decision is premised on an inadequate record, and argues that the Board's decision exceeded the scope of the limited issue before it, denying appellant the opportunity to present "relevant facts to the Board in a full and complete manner." (*Id.*, p. 12) Appellant contends that the Board's decision drew incorrect assumptions from material facts that were in dispute, that it was based on erroneous conclusions of fact and law regarding APB 16 and other aspects of the case, and that the decision "sanctifies form over substance." Appellant now wants to reopen the record.

Appellant attached affidavits of officers of ISCE and Marquardt and an opinion from a member of an accounting firm to its motion for reconsideration. The appellant avers that the statements in the affidavits and opinion support its contentions that ISCE and Marquardt constitute a single accounting entity, that a business combination thus occurred under APB 16, that the purchase method of accounting was therefore required, that the step up of Marquardt's assets was in accordance with this standard accounting practice, and that Marquardt received benefits from the acquisition.

The Government in its reply to the motion for reconsideration cites *Fischbach and Moore International Corporation*, ASBCA No. 14216, 71-2 BCA ¶ 9081 for the proposition that new evidence should not be received with respect to the motion because appellant has failed to show that the criteria established in that opinion were met, viz, that it appears likely that an injustice has been done and whether the additional evidence would probably produce a different result.

The Government maintains that the material facts stated in the Board's opinion are not the subject of dispute, that the Board correctly found that no business combination in the context of this dispute took place, that Marquardt remained a separate entity and its assets could not be burdened with the purchase costs, and that under DAR Section XV the costs associated with the acquisition of Marquardt were not allowable and allocable to Marquardt's Government contracts.

Decision

At the outset we find no merit to appellant's contention that the Board's opinion exceeded the limits of the issue before it, presumably because of its reliance on DAR Section XV principles as well as APB 16 in arriving at its decision. The DAR principles were relied upon by the Government in its motion for summary judgment and were pertinent to consideration of the propriety of the appellant's accounting practice in connection with the valuation of assets.

We do not accept appellant's contention that material facts recounted in the opinion's Statement of Facts concerning the acquisition and accounting of the sale and with respect to appellant's written proposal to increase the asset values are in dispute. Our statements of fact coincide with the appellant's statements of undisputed facts in its memorandum in support of its partial summary judgment motion. Other facts in the opinion which the appellant now contends are disputed or involve incorrect assumptions were based on documents in the Rule 4 file and statements in pleadings or memorandum which were not controverted by appellant prior to the Board's adverse decision.

As an example, the Board's statement of facts indicated that ISCE was a prime contractor for the U.S. Department of Defense for electronic equipment. That fact was taken directly from an ISCE news release regarding its acquisition of appellant in the Rule 4 file. In his affidavit appended to the motion for reconsideration ISCE's vice president and controller now states that ISCE is not and never was a signatory to a contract with the Department of Defense. If the statement of fact in our opinion concerning ISCE Government contracts was in error, it was, nevertheless, not material to our determination in this matter.

In its opinion, the Board quoted portions of the contracting officer's final decision, which was in the Rule 4 file, including reference to agreement between the parties that no novation was required. The Board later noted the lack of a novation agreement in its decision. On reconsideration, appellant contends that the facts and circumstances surrounding the parties' decision relating to a need for a novation agreement are in dispute, and that the Board drew erroneous conclusions regarding the requirements for a novation agreement. While the Board noted the lack of a novation agreement it is clear from a careful reading of the Board's decision that it was based on other grounds. If there had been no mention of a lack of a novation agreement in the opinion, our decision would have been the same.

In advancing its argument of interpretive error on the part of the Board, appellant cites in its motion for reconsideration, *inter alia*, Cost Accounting Standard 403, an American Institute of Certified Public Accountants study on the "push down" basis for accounting, Securities and Exchange Commission regulations, the Internal Revenue Code, and the Defense Contract Audit Agency's Contract Audit Manual. The Government argues that the CAS, AICPA, SEC and IRC references do not support appellant's position, and indicates that the CAM in fact supports the Board's decision. We need not resolve the dispute concerning the relevance or applicability of these sources since none are determinative of the summary judgment motions.

Appellant argues that the Board's reliance on *Metropolitan Life Insurance Company*, ASBCA No. 27161, 85-2 BCA ¶ 17,973, was inappropriate since that appeal dealt with direct costs and not indirect costs, which appellant contends are involved here. However the fact that *Metropolitan* concerned the disallowance of a direct cost is a distinction without a meaningful difference. That opinion held that in order to be allocable to a Government contract and reimbursable under the contract Payment clause, a cost has to be incurred in the performance of the contract. This precept is valid whether the cost is properly classifiable as a direct or indirect cost, and is applicable here.

The Payment clause of Marquardt's contracts (DAR 7-203.4) provides for payments to the contractor to cover the cost of performance of the contracts in accordance with the provisions of Part 2 of Section XV of the DAR. DAR 15-201.1, Composition of Total Cost, provides:

> The total cost of a contract is the sum of the allowable *direct and indirect costs* allocable to the contract, *incurred or to be incurred*, less any allocable credits. In ascertaining what constitutes costs, any generally accepted method of determining or estimating costs that is *equitable under the circumstances* may be used, including standard costs properly adjusted for applicable variances. [Emphasis added]

As we recently stated in *R&D Associates*, (ASBCA Nos. 30738 and 30750, decided 7 May 1986): "it is axiomatic that 'costs' chargeable either directly or indirectly to Government contracts must actually be incurred." The fundamental undisputed fact governing the outcome of this appeal is that Marquardt, the separate legal entity solely responsible for the performance of its Government contracts, and which remained completely passive in the transaction involving the purchase of its stock, incurred no costs with respect to performance of its Government contracts as the result of the purchase of its stock by ISCE.

It follows that Marquardt's Government contracts should not be burdened with ISCE's purchase costs. Marquardt, not ISCE, holds these Government contracts.

We can perceive of no equitable basis for reaching a different result. Marquardt now seeks to use the purchase of its stock by ISCE as a basis for converting an expenditure by a third party into a "cost" incurred by itself. In short, its seeks to create something out of nothing and charge it against its Government contracts.

Although appellant's motion has not demonstrated that our holdings concerning its reliance on APB 16 were in error, we need not have even considered APB 16 in reaching our decision since that decision was mandated by DAR Section XV, applied to these contracts by the contracts' payment provisions. Consequently, reopening the record for evidence regarding implementation of APB 16 would not produce a different result. Under DAR 15-201.2, generally accepted accounting principles are applicable when appropriate to the particular circumstances. This standard has not been satisfied where, as here, the threshold requirement of cost incurrence has not been met.

We have held that generally accepted financial accounting principles do not necessarily govern cost accounting, and even if allocations are consistent with generally accepted financial principles, they cannot dictate reimbursability by the Government when the cost item in question does not meet DAR allowability criteria, as is the case here where the contractor has not incurred a cost. *See Physics International Company*, ASBCA No. 17700, 77-2 BCA ¶ 12,612 at 61,144.

On reconsideration, appellant has failed to demonstrate that the Board committed legal error or that the Board's opinion contained disputed or erroneous statements of fact that were material to the decision.

We affirm our decision granting the Governments' motion for summary judgment and denying the appeal. Appellant's request that this matter be presented to the senior deciding group is denied.

[¶ 19,101] P & A Construction Company, Inc.

ASBCA No. 29901. December 18, 1985. Contract No. N62474-78-C-0632.

Delays—Sequence and Scheduling—Access to Work Site.—Even though the overall project was completed on time, a contractor was entitled to recover the additional costs of earthwork because the government took an unreasonable amount of time to review the contractor's quality control plan or to provide him full access to the work site and thereby caused the contractor to lose his earthwork subcontractor and incur the additional costs. The government contended that the work was delayed because the contractor failed to meet administrative prerequisites, such as the submission of soil testing results and a quality control plan. However, the actual go-ahead notice depended on when the government decided to close a main gate to traffic, rather than on approval of the quality control plan, and soil testing was only required before fill work began, not before work on the project began. Postponing the closing of the gate and the road that passed through it over the work site was a proper basis, under the Suspension of Work clause, for an adjustment in the contract price.

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B

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-8000

ACQUISITION AND LOGISTICS
P/DARS

08 APR 1987

In reply refer to
DAR Case: 84-18

MEMORANDUM FOR MR. LAWRENCE J. RIZZI, CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: DAR Case 84-18, Mergers and Other Business Combinations

The DAR Council has approved proposed revisions to FAR 31.205-6 and 31.205-27 to provide clear rules on the allowability of certain costs incidental to business acquisitions. Also attached is a February 4, 1987, report from the Cost Principles Committee which discusses the changes proposed above as well as other issues associated with business acquisitions e.g., asset write-ups. The DAR Council has tasked the CAS Policy Group to report on these additional issues by May 15, 1987. We will provide you with our recommendations in these areas by separate cover. If the CAA Council agrees with our position, please establish a FAR case and forward the case to the FAR secretariat for further processing as a proposed rule.

for Michael Sullivan
OTTO J. GUENTHER, COL, USA
Director
Defense Acquisition
Regulatory Council

Attachment

SAME FEB 4, 1987 REPORT THAT APPEARS ELSEWHERE WITHOUT A COVERSHEET

CASE MANAGEMENT RECORD

ORIGINAL	
UPDATED	✓

CASE NUMBER:	DAR: 84-18	CAAC:	FAR:

TITLE: Accounting for Mergers and Business Combinations

REFERENCE: Cost Principles Committee report of 2/4/87

ORIGINATION DATE:

SYNOPSIS: Costs incidental to mergers and business combinations should be unallowable.

PRIORITY:	ORIGINATOR CODE:

KEYWORDS				
CASE REFERENCES				
FAR CITES				
DFARS CITES				

CASE MANAGER: N	SUBCOUNCIL ASSIGNMENT:

COGNIZANT COMMITTEES			

RECOMMENDED ACTION:

Docket 2/18/87

BOX RECORD	1)	2)	3)	4) 2/11/87	5)	6)
7a)	7b)	7c)	8a)	8b)	8c)	9)
10)	11)	12)	13a)	13b)		

DISCUSSION DATE:	DOCKET DATE:

REPORT DATE:

FAC	NUMBER:	DATE:	ITEM:
DAC	NUMBER:	DATE:	ITEM:

DEPARTMENTAL	NUMBER:	DATE:
BULLETIN	NUMBER:	DATE:

CASE CLOSED:	CASE COMPLETED:
REG FLEX APPLICABLE: No	PAPERWORK REDUCTION: No

PROPOSED RULE: Yes	INTERIM RULE:	FINAL RULE:

31.205-6 Compensation for personal services.

(a) through (k) -- Unchanged.

(l) ~~Reserved.~~ [Compensation incidental to business acquisitions. The following costs are unallowable:

(1) Payments to employees under agreements in which they are to receive special compensation, in excess of the contractor's normal severance pay practice, if their employment terminates following a change in the management control over, or ownership of, the contractor or a substantial portion of its assets. These arrangements are commonly known as "golden parachutes".

(2) Payments to employees under plans introduced in connection with a change (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets in which those employees receive special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time. These arrangements are commonly known as "golden handcuffs".]

(m) - Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) below, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, ~~or~~ (2) [resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business,] and [(3)] raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) - Unchanged.

31 March 1987
TAB C
DAR Case 84-18

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31

Federal Acquisition Regulation (FAR); Extraordinary Compensation and Certain Organization Costs in connection with Mergers and Other Business Combinations.

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 31.205-6 and 31.205-27 to clarify the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405.

Please cite FAR Case 87-XX in all correspondence related to this issue.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat, telephone (202) 523-4755.

A. Background.

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing for some time the subject of business combinations, and particularly the appropriate Government contract costing resulting from such combinations. This review has been occasioned both by the increased pace and size of such events in recent years, and also by the Councils' perception that existing regulations on certain aspects of this subject are inadequate. Of special concern are the costs of golden parachutes and golden handcuffs, which are extraordinary payments above and beyond ordinary, customary and reasonable compensation payments to employees for services rendered. Also of concern is the fact that there is no explicit coverage on the allowability of the costs of resisting a corporate takeover. In the special circumstances of Government procurement, in which companies' recorded cost structures are often directly reflected in price, the Councils believe the Government should not be at risk of paying higher prices simply because of ownership changes at its suppliers. Instead, the Councils have concluded that additional coverage at FAR 31.205-6 and 31.205-27 is necessary to protect the Government from having to bear the costs of special compensation arrangements and various organization costs often attendant upon business combinations.

B. Regulatory Flexibility Act.

The proposed changes to FAR 31.205-6, and 31.205-27 are not expected to have a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C., 601 et. seq.) because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply.

C. Paperwork Reduction Act.

The Paperwork Reduction Act does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements. Therefore, OMB approval under 44 U.S.C. 3501 et seq. is not required.

List of subjects in 48 CFR Part 31

Government procurement.

Dated: _______________

Lawrence J. Rizzi
Director, Office of Federal Acquisition and Regulatory Policy

Part 31 - (Amended)

Therefore, it is proposed that 48 CFR Part 31 be amended as follows:

1. The authority citation for Part 31 continues to read as follows:

Authority: 40 U.S.C. 486(c); 10 U.S.C. Chapter 137; and 42 U.S.C. 2453(c).

(See Attached)

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON D C 20360

DAR Staff
Case 84-18

4 February 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 84-18, Accounting for Mergers and Other Business Combinations

I. PROBLEM:

By DAR Council letter dated 24 February 1984, the Commercial Cost Principles Committee was requested to study issues relating to the appropriate treatment of costs arising from mergers and other business combinations, and to recommend any changes in the cost principles coverage on such costs deemed appropriate. The DAR Council's initial assignment letter noted that certain of these issues had already been considered under Case Numbers 83-100-5, 83-100-47, 83-43, and 83-56. Shortly thereafter, by letter dated 17 April 1984, the DAR Council requested that the Committee consider material sent in by the American Defense Preparedness Association (ADPA) and by the Army concerning the kinds of business combination requiring a novation agreement. Finally, in the approved DAR Council action plan issued in February 1986 in response to publication of the OSD Task Force Report on the cost principles, the Council committed itself to consideration of the report's comments on three cost principles (-10, -11, and -27) under this case. Later, by letters dated 27 May 1986 and 5 June 1986, the Council added the relevant comments on the Task Force report sent in by CODSIA and the DOD IG to the case material.

II. RECOMMENDATIONS:

A. That the DAR Council review FAR 31.109 and 42.12 in light of the Committee's comments in Section III.A.2 below, and decide on the appropriate course of action.

B. That FAR 31.205-6(1), and 31.205-27 be revised as shown in Part 2 of TAB A.

C. That FAR 31.205-10, 31.205-11, 31.205-16 and 31.205-49 be revised as shown in Part 3 of TAB A.

D. That FAR 30.404.50(d) and (e), and 30.409.40(a)(4) and .50(j)(1) be revised as shown in Part 4 of TAB A.

III. DISCUSSION:

Anyone who even casually peruses a newspaper is aware that business combinations within American industry in general, and, more specifically,

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within the defense industry have become far more common in recent years. This development, while it is obviously of broad public concern, is of particular importance to the Government procurement community because business combinations can dramatically alter a company's cost structure on which in turn much of Government contract pricing is ultimately based. Specifically, there are several areas in which the adequacy of current FAR coverage needs to be examined in light of recent developments:

1. New forms of business combination and the requirement for a novation agreement;

2. The treatment of certain organization costs and special compensation arrangements incidental to attempted or successful business combinations;

3. The treatment of increased asset values created by business combinations under generally accepted accounting principles.

This is not to say that these are the only areas of regulatory concern having a connection with the phenomenon of business combinations. For example, business combinations and pension plan terminations can be interrelated since the acquiring company may be tempted to seize excess assets in the acquired company's pension fund to help pay for the acquisition. However, the whole issue of pension plan terminations is being dealt with under another case (namely, 85-180), which would affirm the Government's right to a credit in these circumstances. While the subject of business combinations is highly dynamic, the Committee is unaware of any issues other than those listed that need to be addressed here.

The remainder of this section will provide background information and Committee comments on each of these areas of concern.

A. Need for a Novation or Other Agreement

1. Background

While many variations obviously exist, there are only two basic ways for one company or group to obtain control over another company or some part of it. The acquiring entity can either buy the assets of the target company, or, more commonly, some desired piece of that company, directly, or it can acquire a controlling interest in the voting stock of the target entity. In the latter case, the acquisition of stock is often, but not always, followed by a change in the legal form of the acquired entity through merger or consolidation. Since the 1950s, Department of Defense procurement regulations have consistently and explicitly required that certain types of acquisition, namely, those in which the original contractor's assets are transferred to another legal entity, require a novation agreement, that is, a formal agreement between the Government, the acquiring entity, and the selling entity. In such an agreement the Government recognizes the purchaser as the successor in interest to the acquired entity's Government contracts and makes any arrangements deemed necessary to protect the Government's interest.

assets or stock

The basic remaining issue is whether a novation or some other similar agreement should be required in all situations in which control over a company having Government contracts is transferred, and, more specifically, in the case of stock purchase transactions, in which the acquired company remains a separate legal entity (i.e., is not subsequently merged or consolidated out of existence).

Stock Purchase

(1) Some within the legal community have taken the position that this kind of stock purchase transaction does not create a successor in interest, and hence does not require a novation agreement. The argument is straightforward enough. It is simply that, under such circumstances, the legal entity with which the Government has been doing business has not changed. The Government's relationship is with a company, not with its stockholders. When only the identity of the stockholders changes, there has been no change in the entity with which the Government does business. (2) The opposed position is also quite straightforward. It is that the acquisition of a controlling interest in the stock of a corporation gives the investor the same ability to affect performance under the acquired entity's Government contracts as would a situation in which the legal form of the acquired entity is altered through merger or consolidation.

This whole issue was previously considered in 1983 under DAR Cases 83-100-47 and 83-56. These cases were proposed by the Army, which sought an explicit regulatory statement that a stock purchase transaction in itself could give rise to the requirement for a novation agreement. Under the latter case, the DAR Council approved the Army's proposal, which was then implemented as a revision to DAR 26-402 by Item XVI of DAC 76-48, dated January 25, 1984, which reads as follows:

> (iii) transfer of the ownership of a contractor through a stock purchase transaction, or by any other means, when the Secretary concerned determines that the sale may significantly affect the Government's rights and interests under existing and future contracts.

Through a clerical error, the new DAR coverage was promulgated as a subparagraph within DAR 26-402(b), rather than DAR 26-402(a). Moreover, the new coverage was not incorporated into the corresponding FAR section promulgated on April 1, 1984. As best the Committee can tell, this omission was not the result of a considered decision, but was due to the fact that the new language was overlooked by those responsible for the final stages of drafting the FAR.

This situation soon generated further suggestions for revision. In a letter to the DAR Council dated January 26, 1984, the American Defense Preparedness Association (ADPA) suggested that the new coverage in the DAR be revised in two ways. First, ADPA recommended that the words "complete or partial" be added before "ownership" (see the first line of the above quotation) in order to make clear that a novation agreement may still be required when ownership of less than the entire stock is transferred. Second, ADPA recommended that the decision on which stock purchase transactions require a novation agreement be transferred from the Service Secretary to the administrative contracting officer, who was responsible for obtaining novation agreements under all other circumstances. Moreover, the Army itself, in a letter dated April 13, 1984, pointed out that the new DAR coverage had not been incorporated in the FAR, and requested its inclusion in the DoD FAR

Supplement or at least authorization to include it in Departmental acquisition regulations.

There has also been a recent decision of the ASBCA (in Case 29888 involving an appeal by the Marquardt Company) that is relevant to this issue. The background of this case is that, prior to 1983, all outstanding shares of the Marquardt Company were owned by the CCI Corporation. In late 1983, those shares were sold to ISC Electronics, Inc. Based on the fact that the transaction in question involved simply the transfer of stock from CCI to ISC, without any change in the management or legal structure of the Marquardt Company itself, the cognizant administrative contracting officer and the Marquardt Company agreed that no novation agreement was required. Subsequently, however, Marquardt attempted to have the Government recognize stepped-up asset values based on the price paid for the Marquardt stock by ISC (see C.1.a. below). When the contracting officer refused to do so, Marquardt appealed his decision to the ASBCA. The ASBCA found for the Government on the grounds that Marquardt remained the same legal entity after the transaction between CCI and ISC as before. Therefore, its contracts should not be burdened with costs incurred by an independent party, namely, ISC. The relevance of this case to our discussion here is that in it the ASBCA seemed to accept as a given that a change in ownership effected by stock purchase without subsequent legal reorganization does not require a novation agreement. It should be added that Marquardt is now appealing the ASBCA's decision.

"Marquardt Case"

2. Committee Comments

The DAR Council's taskings of 24 February and 17 April 1984 under this case requested the Committee's opinion on whether it would be advisable to adopt the Army's and ADPA's suggestion and expand the current FAR coverage on situations requiring novation agreements to include stock purchase transactions along the broad lines of the change made to the DAR in early 1984. The Committee is sympathetic to the concerns underlying this proposal. For all practical purposes, the investor has, in such circumstances, acquired control over the investee so that in substance, if not in form, the Government is faced with a new entity and should have the opportunity to iron out in advance with the new party any issues of concern to it. Nevertheless, the Committee does perceive some problems with such an approach.

First, it is struck by how awkwardly the subject of stock purchase transactions fits into the existing coverage on novation agreements. The definitions and terminology used in that coverage contemplate situations in which assets required to perform Government contracts are transferred from one legal entity to another, so that the contracts themselves must also be transferred. This is simply not the case for situations in which control of a company is transferred by stock purchase, since assets and contracts remain throughout the property and responsibility of the same legal entity. What is even more important, there is a statutory basis for the requirement to execute a novation agreement in situations in which Government contracts are transferred that is lacking for transfers of control over a company through stock purchase. Even if, therefore, the DAR Council were to adopt coverage modeled on that contained in DAC 76-48, the Committee wonders whether, in the absence of a contract clause, contractors would in fact really be under any greater obligation than they are now to execute "novation" agreements after acquiring businesses through stock purchase.

At this point, the Committee feels obliged to point out that this whole issue lies outside its primary area of expertise. Accordingly, it recommends that the DAR Council seek competent legal advice on it. However, in case the Council remains interested in pursuing the approach proposed by the ADPA and the Army, the Committee has included some detailed comments and suggestions on their proposed coverage at TAB A, Part 1, pgs. 1-2.

Legal advice

The Committee would also add here that, should the Council feel that new FAR coverage is necessary to encourage or require advance agreements for these kinds of business acquisition, there are other possibilities besides placing such coverage within the existing language on novation agreements. It would, for example, be possible to locate such coverage in a separate section in Subpart 42.12 parallel to that on novation agreements. It would also be possible to include acquisition of a business through stock purchase in the list of situations for which an advance agreement on the treatment of cost is especially advisable. Since this latter alternative is within the Committee's area of expertise, it has provided language for such an approach at TAB A, Part 1, p. 3 should the DAR Council wish to pursue this possible course of action.

Option to putting stock purchase in Novation Agreement Coverage ?

In any case, however--and this is the important point--the Committee believes that the new cost principles coverage it is recommending elsewhere in this report will go a long way towards protecting the Government's interest in situations in which a Government contractor is acquired regardless of the form of the purchase. Thus, while the issue of whether to require or encourage some form of agreement whenever a business acquisition occurs remains of some importance in that each acquisition has unique aspects, its urgency will be diminished if the Committee's recommended cost principles language is enacted. Accordingly, the Committee recommends that, however this issue is handled, deliberations on it not be permitted to impede action on the rest of this case. *

B. Costs Generated to Effect or Resist a Business Combination (2)

1. Background

The economic background is the increase in recent years in the number of attempted business combinations, particularly those in which the management and senior personnel of the entity to be acquired is either opposed to the proposed acquisition or at least deeply ambivalent about it. Such events, especially so-called "hostile" takeover attempts, can result in the expenditure of significant sums by companies, including Government contractors. Moreover, in recent years, the frequency of "hostile", or at least "lukewarm", acquisitions has resulted in an explosive growth in devices by which incumbent managements attempt to make their companies less desirable as takeover targets, and acquirers' managements attempt to entice key employees of the acquired companies into staying following the takeover.

One such device, which has received considerable publicity and which can result in the claiming of substantial costs by contractors following business

Golden Parachute

combinations, is the so-called "golden parachute" agreement concerning whose use there is a good, lengthy discussion in the Business Section of the New York Times of 26 January 1986. A "golden parachute" is a termination agreement usually applicable only to a limited number of key executives which normally has several other distinctive features. The termination or severance payments involved are characteristically not based on length of service, are well in excess of normal severance payments, and are paid only if the employee leaves or is dismissed following a transfer of control over the company. In fairness it should be added that the motive for establishing such agreements may not simply be to discourage hostile takeovers, but also to hold on to key company executives during the period in which a company is the object of a takeover, and enable them to make decisions on whether to encourage acceptance or rejection of takeover offers unencumbered by personal financial considerations.

Golden Handcuff

Parachute - Pay - Leave

Handcuff "Pay-Stay"

The counterpart of the "golden parachute" agreement is the so-called "golden handcuff" agreement in which the acquiring company commits to making payments in addition to normal compensation to key personnel of the acquired company provided only that they remain in its employ for a specified period following the acquisition. Whereas the "golden parachute" pays the manager or other key employee should he leave following the acquisition of his company, the "golden handcuff" encourages him to stay on.

There are three cost principles that contain language relevant to the allowability of such costs, namely, FAR 31.205-6 ("Compensation for personal services," formerly DAR 15-205.6, 31.205-27 ("Organization costs," formerly 15-205.23) and 31.205-28 ("Other business costs," formerly 15-205.24). Even prior to the creation of something like the modern body of cost principles in 1959, the ASPR made certain costs of business "organization or reorganization" unallowable, while making the costs of routine expenses incurred to maintain some business structure such as those for stockholder meetings, the issuance of annual reports, and security registry and transfer charges allowable. The underlying rationale for this unallowability provision seems to have been two-fold. First, there seems to have been a concern that, because of the pass-through nature of companies' costs in Government contracting, making such costs allowable would tempt contractors to engage in reorganizations when their business mix was such that the Government would absorb a large share of the cost. Second, and perhaps more fundamentally, was the belief that such costs normally had no real relationship to the work of the existing business entity, and, as such, provided insufficient benefit to be allocable to Government work.

While there have been several subsequent changes to these two cost principles, essentially they have been intended to further clarify, not redraw, the original dividing line. One such change of interest to us here was made in 1959 in Revision No. 50 to the 1956 ASPR. The ASPR Committee added to the list of allowable "other business expenses" the cost of "normal (italics ours) proxy solicitations." While the Committee has been unable to find any formal record of the ASPR Committee's intent, it seems likely that its use of the word "normal" reflected an assumption that "abnormal" proxy solicitation costs, such as those incurred in attempted acquisitions, should be unallowable as tantamount to reorganization costs. At any rate, it is clear that later the ASPR Committee thought so. Its minutes for October 30, 1968, record a discussion in which the members rejected a suggestion by the Chairman of the Section XV, Part 2 Subcommittee that the cost of proxy solicitations in takeover situations be made specifically unallowable. One of the reasons given was that "the . . . paragraph which permits normal proxy solicitations. . . by implication would make abnormal solicitations unallowable." Another change was the addition in 1969 to the "organization costs" principle of the clarification that unallowable costs of business "organization or reorganization" included the cost of planning or executing "mergers and acquisitions." With this change, this pair of cost principles took essentially the form that they have today in the FAR at least insofar as the costs generated by business combinations are concerned.

To summarize, then, the present language makes the costs of planning or executing the "organization or reorganization of the corporate structure of a business, including mergers and acquisitions" unallowable. However, no explicit mention is made of the status of the cost of resisting an attempted business acquisition. In the current environment, such costs can be substantial, and, in one recent case reported by DCAA, a contractor has used this silence to argue that such costs are indeed allowable. Present Status

The third relevant rule is that on severance pay, which was originally contained in a separate cost principle but is now part of the principle on "Compensation for personal services" (FAR 31.205-6(g)). The coverage in this section is obviously relevant to payments made under so-called "golden parachute" plans. FAR 31.205-6(g)(1) defines severance pay as "a payment in addition to regular salaries and wages . . . to workers whose employment is being involuntarily terminated." While severance pay is normally an allowable cost, subdivisions (g)(2)(i)-(iii) put various restrictions on its allowability, none of which, however, deal precisely with the situation faced in the case of "golden parachute" agreements. In view of this, the Air Force proposed in March 1984 that specific coverage be added on this subject to the existing severance pay provisions. The Air Force argued at that time that payments made pursuant to such agreements were tantamount to reorganization costs and should accordingly be made completely unallowable. The Air Force proposal was included by the DAR Council within the purview of Case 83-62 in April 1984. However, to date, no action has been taken on this particular recommendation. AF proposed coverage on severance pay.

Finally, the compensation cost principle does not provide specific guidance on so-called "golden handcuff" agreements. To the best of the Committee's knowledge, no one has as yet formally proposed coverage on this topic although the logic of the Air Force proposal of 1984 on "golden parachutes" seemingly would have applied to this other kind of agreement as well had the Air Force been aware of their existence at that time. Subsequently, however, the Committee itself has learned of them. In the case of the General Motors' acquisition of Hughes Aircraft, for example, such a plan covered approximately 1,000 employees, and had a potential cost of $250 million.

2. Committee Comments

So far as the first issue, namely, the proper treatment of costs incurred to resist attempted takeovers is concerned, the Government has in practice long regarded such costs as unallowable. It would, after all, make little sense to disallow the cost of "planning" an acquisition while at the same time allowing the cost of resisting the same acquisition since both are part of the same event as seen from opposite sides. The absence of specific coverage of this topic, the Committee believes, is due in part to the infrequency until recently of "hostile" takeover attempts and in part to the belief that the language of the cost principles already implied the unallowability of such costs. Since, however, the absence of specific language is apparently occasioning arguments in the field, the Committee is recommending that the language of FAR 31.205-27 be changed as shown in Part 2* of TAB A to make this matter clear beyond dispute.

① Costs to resist unallowable

* New Language

The second issue concerning the appropriate treatment of benefits received pursuant to "golden parachute" and "golden handcuff" agreements seems equally cut-and-dried to the Committee. The central feature of such agreements is that they only come into play upon the actual or anticipated transfer of control over a company. In view of this, it is difficult to regard such benefits, insofar as they exceed normal termination or compensation payments, as compensation for work performed. Rather, they constitute a cost incidental to a transfer of ownership or control of a company. As such, consistency with the longstanding Government policy of not recognizing costs falling into this category dictates, in the Committee's opinion, the disallowance of benefits received pursuant to such "golden parachute" and "golden handcuff" agreements. Therefore, the Committee recommends that the language shown in Part 2 of TAB A be added to the existing coverage on compensation as a separate paragraph. While it would have been possible to fit coverage on these two items into existing paragraphs of the compensation cost principle (specifically paragraphs (g)("severance pay") and (k)("deferred compensation"), this would have meant separating the coverage. In the end, the Committee judged it preferable to write a new paragraph so that coverage of both items could be located in the same place.

② Disallow Golden Parachutes & Handcuffs

It should be noted that the Committee's recommended coverage on "golden parachutes" differs from that proposed by the Air Force in its March 1984 memorandum in making only that portion of such payments in excess of normal severance benefits unallowable. The reason for this is simply that the Committee does not consider it equitable to disallow in full the payment of such benefits when the employee's departure is involuntary and normal severance benefits are not otherwise forthcoming. It should further be emphasized that the Committee's recommended coverage deals only with employee termination agreements triggered by the transfer of control over a company, not with special employee termination agreements in general. To the best of the Committee's knowledge, it is only this small subgroup that represents a problem, and, in any case, consideration of the broader subject falls outside the scope of this case. Finally, the Committee notes that it has examined the language on "golden parachutes" in the Deficit Reduction Act of 1984, and has attempted to ensure that its definition of this practice is consistent with that provided in the law.

Coverage deals only with termination based upon transfer of control.

C. Asset Revaluation

1. Background

By far the most important and contentious issue connected with the topic of business combinations is that of asset revaluation. This is so because such revaluation can significantly change the recorded cost structure of a company on which the pricing of Government contracts is often directly based. In the following sections, we shall discuss first why and how such revaluations are created by normal financial accounting, and then consider previous Government policy relating to the central issue of whether to recognize such revaluations. All of this is necessarily preparatory to providing the Committee's own comments and recommendations on this subject.

a. Financial Accounting Practices

The basic document on this subject is Accounting Principles Board (APB) Opinion No. 16, which was issued in 1970. Prior to the issuance of this opinion, there were two widely used methods to account for business combinations. One, called the "pooling" method, essentially assumed that two or more business entities had simply joined on an equal footing to create a new organization. On this assumption, there was no need to adjust the asset and liability values on the existing books of either company to reflect this event, and hence, under this method, recorded asset values remained unchanged.

The second technique, called the "purchase" method, assumed that in certain business combinations, whatever the precise form of the event, one entity essentially had bought the net assets of the other. Given the basic accounting tenet that assets should be valued at historical cost, this assumption led to comparison of the cost paid for the acquired company with the recorded value of its net assets, and, in the case of any difference, adjustment of the previously recorded values to reflect what was thought of as the new purchase price. While this oversimplifies somewhat, APB Opinion 16 drastically restricted the situations to which the "pooling" approach could be applied, and made the "purchase" approach the standard one to be used in all other situations. As a result, for all practical purposes, after APB 16 it has become typical for transactions regarded as business combinations to result in asset revaluations.

Asset Revaluation Process

Some detail concerning the precise implementation prescribed by Opinion 16 of this basic principle of "purchase" accounting is necessary to follow the subsequent discussion. The first prescribed step is to determine the purchase price for the acquired business entity. This is simple when the acquiring entity pays cash, but can become far more complex when the transaction is consummated by the incurrence of liabilities, the issuance of stock, or the disbursement of non-cash assets. The next step is to compare this figure with the net book value of the assets of the acquired entity. In the unlikely event that the two figures are equal, there is, of course, no need for revaluation of the assets of the acquired entity. However, in the almost universal event that the purchase price is greater or smaller than the net book value of the acquired entity's assets, those assets must then be revalued.

5 Steps 1 2 3

Since rarely if ever does the actual business acquisition process establish values for individual items among the myriad assets belonging to the acquired entity, a key step in this process is normally the performance of appraisals to establish the value of such long-term assets as land and plant and equipment. Using such appraisals and other techniques appropriate to the valuation of other kinds of asset and liability, every asset and liability of the acquired entity is assigned a value. After this process is complete, the total net asset value of the acquired entity can be determined and compared with the purchase price for the entity. If, as is common, the purchase price exceeds the sum of the value newly assigned to the net assets of the acquired entity, then the assigned values for existing assets are maintained and a new asset, normally called "goodwill," is created to account for the difference. However, in the unusual event that the purchase price is less than the values tentatively assigned to existing net assets, then Opinion 16 requires that, rather than creating reverse "goodwill," the value of certain noncurrent assets be adjusted downward.

Goodwill created

There are several things to note concerning the asset revaluation process prescribed by Opinion 16. First, it should be realized that, while the total amount of the excess over (or deficiency under) the previously recorded net book value of the acquired entity's assets is established by the price paid by the acquiring entity, the portion of that total amount attributable to any particular existing asset or to the newly created asset "goodwill" normally results directly from an appraisal, and is not established by the terms of the business acquisition itself. This is a consequence of the fact that it is really the acquired entity as a whole that is in fact purchased. The reason for going beyond the purchase price to an appraisal (or some other valuation process) of individual assets, rather than treating the total difference in some simple, uniform way, is the fact that the recorded value of individual noncurrent assets is charged to income over time as depreciation or amortization expense in significantly different ways. Accordingly, from the standpoint of accounting theory, the process of distributing the difference between the purchase price of an entity and its recorded net book value to individual assets is undertaken to provide a more refined measurement of the income of the new combined entity in future accounting periods.

It should also be noted that there are differences between the ways in which the accounting entries required by such combinations are recorded on the books of the business entities involved. In cases in which an entity is acquired directly, or, however acquired, is later formally merged or consolidated out of existence, the new asset values resulting from the purchase and subsequent asset appraisals must obviously be recorded on the books of the acquiring or surviving entity.

On the other hand, however, in cases in which control is obtained by stock purchase and the acquired entity maintains its previous legal form, the accounting records of the acquired entity are maintained as before and the purchase is shown on the books of the acquiring entity as simply a single entry recording the amount of the investment in the acquired entity. In these circumstances, it is in what are called consolidated financial statements, that is, statements showing the position of the combined entity, that the new values for individual assets resulting from the purchase and subsequent

(ii) The Treatment of the Sale of Individual Assets

It is possible to draw an analogy between the purchase of a used asset or complement of assets by one company from another and the purchase of an entire business entity (conceived as simply a collection of assets) by another organization. It is necessary, therefore, to include some discussion of the prior regulatory treatment of the sale of individual assets in the background to this case.

Prior to 1965, the handling of such transactions prescribed by the cost principles was as follows. So far as the purchaser was concerned, the new (new to him) asset was capitalized at the purchase price in accordance with the basic tenet that asset valuation should be based on acquisition cost. So far as the seller was concerned, his "gain" or "loss" on the transaction (defined as the difference between the sale price of the asset and its "book value," i.e., original acquisition cost less accumulated depreciation) was not recognized as a credit or charge, but rather was regarded as a non-cost or "profit" item.

In 1965, however, ASPR Case 65-107 was established to study whether these rules needed revision. The initial concern was that contractors might be experiencing significant gains overall on the sale of assets, rather than experiencing a pattern of offsetting gains and losses, due to the use of accelerated depreciation methods. If this were true, then it would follow that in ignoring the gain or loss on sale the Government was acquiescing in an inequitable arrangement in which it bore a share of excessive depreciation costs during an asset's useful life without any recoupment of the excess at the point of asset disposition.

Impact of accelerated depreciat

During the long and weary course of this case, a DCAA study indicated that this concern was well-founded, and that contractors were indeed normally experiencing gains on the disposition of depreciable assets. Accordingly, the debate under this case came to focus on the question of how to define the gain which was to be recaptured by the Government (via a credit to the seller's overhead in the year of asset disposition) and on whether the Government should also recognize losses on asset disposition (via a charge to the seller's overhead) which could potentially increase Government contract costs. This latter issue was easily decided, since almost all involved realized that the recognition of gains alone would be inequitable.

The former issue, however, caused extensive debate. There is little point in recapitulating here all of the various alternatives considered. The reason for the plethora of proposals was the fact that contractors sometimes used different depreciation methods for contract costing, financial reporting, and tax purposes, and also the complexity of Internal Revenue Service rules on the same issue. Obviously, the amount of the gain or loss on disposition calculated would depend on the depreciation method used.

In the end, the basic issue, as seen by the Section XV, Part 2 Subcommittee at that time, was whether the new rule should aim to recapture excess depreciation using contract cost, or Federal tax, accounting as the basis for measurement. The rule finally promulgated in 1969 permitted either

(1) cost or (2) tax. accoun

approach if followed consistently, although its language suggested that the preferred method was to use depreciation amounts calculated for contract costing as the basis for determination. However, this "either or" rule was changed in 1978 to allow measurement of the gain only on the basis of depreciation amounts used for contract costing. The coverage established at that time is essentially identical to that currently in the FAR on this topic. **

What is perhaps of more interest to us here is that the Section XV, Part 2 Subcommittee was plainly aware that even its preferred approach was not perfectly equitable. It was realized, for example, that Government contracts' share of the gain in the year of asset disposition could easily exceed or fall short of the share of excess depreciation borne by Government contracts in previous years due to fluctuations in business mix. However, the approach of recapturing the excess asset depreciation, rather than the precise amount of excess depreciation borne by the Government in the past, was considered the only administratively feasible one, and believed to be fair over-all in normal situations of frequent disposition of individual assets. The Subcommittee was, however, sufficiently concerned about the potentially inequitable results of a rigid application of its new recapture rules in situations of mass asset disposition that it expressly provided for the use of case-by-case settlement in such instances if equity required. This provision has remained in the coverage essentially in the form promulgated in 1969.

The problem! Depreciation Recapture & Bus Comb. not transfer assets.

It is clear from the record of Case 65-107 that none of those involved envisioned the application of the specific "depreciation recapture" rule under consideration to business combination situations. They clearly had in mind only the transfer of individual assets or small groups of assets between independent companies. Nevertheless, if one adopts the basic premise underlying "purchase" accounting for business combinations by viewing this process as the sale of one company's total asset complement to another, it is a natural step to apply this rule for individual asset sales to business combination situations. This has in fact sometimes been done as a means of achieving equity for the Government in such situations.

While the Committee will have much more to say below concerning this subject, one special problem that has arisen when this has been attempted is worth noting here. In situations in which only individual asset sales are concerned and one is dealing with ongoing, independent business entities, questions seldom arise about the credit resulting from a gain on disposition. However, in the case of business acquisitions, disputes have arisen between the Government and contractors on various grounds concerning the recognition of this credit.

Perhaps the most persistent (but not the only) argument concerns situations in which control is transferred by stock purchase. In such cases, as we have seen, revaluation of the assets of the acquired company is mandatory for consolidated financial statement purposes under generally accepted accounting principles, and companies have claimed that increased depreciation expense and FCCM resulting from such revaluation should be recognized on the acquired entity's present and future Government contracts. At the same time, however, some of these same companies have claimed that, from a strict legal standpoint, the only transaction involved has taken place between the acquiring entity and the stockholder(s) of the acquired organization, not between the two organizations themselves. Therefore, it is argued, since the acquired entity was simply not involved in the transaction, it need not reflect on its accounting records any gain on the sale in which the Government might then share through a credit to overhead. While the intellectual merits of this and all other arguments to the effect that the Government must somehow bear a share of any increased costs resulting from asset revaluation, while at the same time not being entitled to share in the recapture of excess depreciation, seem to the Committee to be nil, it is important to be aware that such arguments have been a frequent feature of attempts to extend this approach from situations involving individual assets to those involving whole businesses. Indeed, it is the Committee's understanding that essentially this issue is about to be litigated in the case of the acquisition of Cutler Hammer, Inc. by Eaton Corporation.

Cutler Hammer – Case to be argued!

(iii) Cost Accounting Standards 404 and 409

Cost Accounting Standards (CAS) 404, "Capitalization of Tangible Assets," published in 1973, and CAS 414, "Cost of Money as an Element of the Cost of Facilities Capital," published in 1976, contain provisions that directly or indirectly relate to the accounting treatment of long-term assets subsequent to business combinations. The most direct statement is contained in CAS 404.50(d), which provides that:

> Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company not to exceed their fair value at date of acquisition. Where the fair value of identifiable acquired assets less liabilities assumed exceeds the purchase price of the acquired company in an acquisition under the "purchase method," the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.

This passage is clearly modeled on the provisions of APB Opinion 16. When taken together with the provisions of CAS 409.40(a)(1) (which states that, "the depreciable cost of a tangible capital asset shall be its capitalized cost less its estimated residual value") and CAS 414, Appendix A (which states that, "facilities capital values used should be the same values that are used to generate depreciation"), it indicates the CAS Board's assumption that asset revaluations resulting from business combinations form the basis for the calculation of allocable depreciation expense and FCCM in subsequent accounting periods.

The other passages of interest to us here occur in CAS 409. CAS 409.40(a)(4) and 409.50(j)(1) state that normally the "gain" or "loss" to be recognized upon asset disposition will be limited to the difference between the asset's acquisition cost and its undepreciated balance, and will be assigned as a credit or charge to the accounting period in which the disposition occurs. However, subparagraph 409.50(j)(3) adds that in the case of "gains and losses arising from mass or extraordinary dispositions," the contracting parties can account for gains or losses in some other manner that results in treatment equitable to all parties. All of this language in CAS 409 dealing with asset disposition is modeled closely on that introduced into the cost principles by ASPR Case 65-107 (see Section ii above), which, as we have seen, contemplated only asset transfers between continuing business entities, and not business acquisitions themselves. The Committee is unaware of any evidence indicating that the CAS Board intended by its language anything more than the ASPR Committee.

CAS language modeled after — contemplating asset transfer

To sum up, then, while it is far from clear why the CAS Board felt it necessary to address these issues in the Standards (since all it did was repeat preexisting GAAP or DAR rules), the CAS does prescribe asset revaluation following a business acquisition in accordance with generally accepted accounting principles, and the calculation of depreciation expense and FCCM based upon such new valuations in subsequent accounting periods. The CAS also prescribes recognition of gains and losses on the disposition of individual assets, but does not explicitly address the situation in which it is the entire business that is disposed of. **

(iv) Previous Cost Principles Cases

There are two recent DAR cases that are relevant to the subject of asset revaluation attendant upon a business combination. The earlier one, Case 83-100-5, was brought by the Navy Policy Member of the DAR Council in January 1983. The main impetus for the case was a very complex situation in which the ownership structure of a major Navy shipbuilder, Bath Iron Works, had changed several times within a brief period, thereby facing the Navy with the possibility of increased cost due to asset revaluations on long-term programs with inadequate competitive restraints. The Navy Policy Member pointed out that the Department of Defense had no consistent policy on the treatment of such costs, and noted that the increased frequency of business acquisitions made it imperative to develop one. He went on to argue that, since asset revaluation could increase future Government costs without any concomitant benefit (in that a change in ownership did not necessarily alter the productive capabilities of the assets in question), the proper Government policy was simply to disallow under the appropriate cost principles any increased depreciation expense or FCCM resulting from asset revaluations attendant on ownership changes. It is interesting to note that the Navy discussion made no mention of the obvious alternative approach of seeking a credit up to the amount of the depreciation expense previously taken on the assets in question.

The Navy case was commented on by the Cost Principles Committee in a February 1983 memorandum directly to the Navy member. In the memorandum, the Committee pointed out that it had long been Department of Defense policy to base depreciation expense on acquisition cost, and that the Navy proposal violated this policy. The appropriate solution, the Committee continued, was to accept the altered asset values, and then apply the "depreciation recapture" rule contained in DAR 15-205.32. The Committee noted in passing that, due to fluctuations in business mix and contract type, application of this solution might in certain circumstances result in an inequity to the Government, but brushed this point aside with the argument that circumstances

2 conclusions – past

In considering the record of Case 83-43, the Committee is struck by two things. (1) The first is the ease with which the DoD jettisoned the basic accounting principle that asset values are determined by purchase price when it was convinced that it would lead to inequitable results and violate good business judgment. (2) The second is the Committee's continued assumption, which was already reflected in its handling of Case 83-100-5, that the "depreciation recapture" rule was an entirely adequate solution to the problems of equity presented by asset revaluations following business acquisitions.

(v) Government Actions When Faced with Specific Business Combinations

The Committee has not done a systematic survey of the various approaches taken by Government procurement activities to ensure equity when faced with business acquisitions. However, even a limited review indicates that there has been no unanimity of approach among the major Government components. One approach, which has been pursued particularly aggressively by the Army, and has also recently been taken up by the Air Force, is to require that the (1) acquiring contractor agree to continue to use for costing and pricing Government work the acquired entity's asset values regardless of any revaluations required by generally accepted accounting principles. A second approach has been to (2) recognize asset revaluations, but attempt to ensure that existing Government contracts receive their proper share of the depreciation or amortization "recapture" credit in the year of sale. As has already been noted (see C.1.b(ii) above), the Government's entitlement to such a credit has not been readily conceded by contractors in cases in which the acquisition is effected by stock purchase. 2 approaches currently

stock purchase a problem (1) (2)

What is perhaps just as important as this lack of unanimity in approach, however, is the fact that sometimes the issue of asset revaluation is not resolved in a timely fashion or may be overlooked altogether by the Government. The classic instance of the former is the Bath Iron Works case, which is now in its seventh year without a final agreement on whether asset write-ups will or will not be permitted in contract costing and pricing. Moreover, the DOD IG has told the Committee that it has found cases of relatively small contractors, with sparse audit coverage, whose purchase was overlooked by the Government with the result that asset write-ups were unknowingly accepted without Government receipt of any concomitant credit.

2. Committee Comments

a. General Considerations

It is evident that Government activities have approached the question of asset revaluations resulting from business acquisitions differently and that those confronted with specific situations have sometimes acted hesitantly or not at all because of the absence of adequate guidelines in this area. This lack is also reflected in the fact that there are at least two separate cases being, or about to be, litigated between the Government and defense contractors involving aspects of the asset revaluation issue. In one of these cases, moreover (that involving the Marquardt Company), the Committee is concerned that the initial ASBCA decision, while favorable to the Government in the specific circumstances, would logically lead to treating the same event (namely, the acquisition of a business) differently for contract costing purposes depending upon the legal form of the acquisition. There is, therefore, a real need for clear Government policy in this area; indeed, with the possible exception of the area of pension cost, it represents the most significant issue under consideration by the Committee.

Two approaches Feasible!

The Committee believes further that only two basic approaches to this issue through the cost principles are conceivable (although variations on either approach are possible). (1) One is to recognize asset revaluations resulting from business acquisitions, thereby accepting altered depreciation and FCCM amounts in accounting periods subsequent to the acquisition. On this approach, equity is obtained for the Government by requiring that, in cases of upward revaluation, current Government contracts receive their fair share of the "recapture" of excess depreciation borne by previous contracts. The other approach is (2) to simply not recognize for purposes of Government contract costing and pricing asset revaluations resulting from business combinations.

In choosing between these two broad approaches, the Committee majority is persuaded that the fundamental issue here is one of how best to achieve fairness. Both the "depreciation recapture" and the "no recognition" approaches are, in the final analysis, nothing more than devices to ensure that what constitutes good accounting for business acquisitions does not create a situation that is "unfair" to the Government. In the opinion of the Committee, it is on this basis that the choice between these two approaches should be made.

Facilities Capital Cost of Money The Solution

Measured by this standard, the Committee believes that the approach of simply not recognizing depreciation or FCCM charges flowing from asset revaluation ought to be the basic Government rule. In reaching this judgment, the Committee was heavily influenced by the fact that one is dealing with a relatively small number of events of widely different magnitude. The recent purchase of Hughes Aircraft Company by the General Motors Corporation, for example, will result in an increase in recorded asset values totaling in the billions of dollars, whereas, in the Bath Iron Works situation which was the main impetus for DAR Case 83-100-5, the comparable total was less than fifty million dollars. The Committee was also influenced by the perception that much of DoD contracting for major weapon systems is done on a sole-source or very limited competition basis in which the award of future contracts to the incumbent contractors at a price based on their recorded cost structures is unavoidable.

In view of this, the Committee believes that extending the "depreciation recapture" approach to business acquisition situations does not make sense. This approach was designed to deal with the quite different situation of the transfer of individual assets between independent, on-going companies. The transactions contemplated were numerous and typically of relatively low dollar value. Those who developed this approach were well aware that, because of variations over time in contract type and business mix, the treatment prescribed could be inequitable to either the Government or the contractor for any <u>particular</u> asset disposition in that Government contracts would likely "recapture" more or less depreciation at the time of asset disposition than they had actually borne in previous periods. However, they believed that over numerous transactions such variations would normally offset one another so that the outcome would be fair over-all.

Indeed, for precisely this reason, the ASPR Committee provided expressly for the abandonment of this approach, and the substitution of case-by-case negotiation in instances of "mass disposition." The point, of course, is that every business combination is obviously tantamount to a "mass disposition" situation. The Committee believes, therefore, that it would be imprudent to impose on such situations a rigid "depreciation recapture" rule designed to achieve equity under very different circumstances. Given a certain combination of business mix, contract type, and program status, acceptance of asset revaluations can lead to substantially higher depreciation and FCCM expense on future Government contracts, while the Government's actual, realized share in the offsetting "depreciation recapture" credit amounts to nothing. Few are likely to view this outcome with equanimity particularly if it were to happen in the case of some massive acquisition whose size dwarfs that of the more typical purchase.

This brings us to the question which, in the opinion of the Committee, is at the heart of this case, namely, what really constitutes "fairness" in such situations? As we have noted repeatedly in this report, both the "depreciation recapture" rule contained in the cost principles and its restatement in the CAS, contemplate situations in which that rule will fail to create equity and should be abandoned, without, however, defining what "equity" is. There is, however, a long-standing tradition in Government contracting, expressed in both the cost principle on "Organization costs" and in the language of the standard novation agreement, that the Government should be placed in no worse a position by a change in business ownership than it would have been in had the change not taken place. In the final analysis, the Committee majority believes that this is a reasonable and practical way to define what is equitable in such situations not only to the Government, but also to the contractors involved who are, after all, as much at risk as the Government under the "depreciation recapture" approach.

The approach

Accordingly, we recommend coverage which accomplishes this by simply not recognizing for Government contract costing in most circumstances any changes to depreciation expense or FCCM flowing from asset revaluations following business acquisitions. As a consequence, of course, such events will also result in no "gain" or "loss", and no attendant credit or charge for Government contract costing. *

The Committee is, of course, aware that this recommendation is likely to be controversial. This is not the place to respond to every objection that will be raised against such a policy. However, the Committee does feel it appropriate to comment on what it believes will be two of the main complaints.

I concur

(i) One will be that such a policy violates good accounting, which requires asset revaluation based on the price paid for the acquired entity, as well as the DoD's own long-standing policy of basing asset valuation on acquisition cost. In the Committee's view, however, to make this the primary consideration in this case represents a serious failure of perspective. What is really at issue here is the best means to ensure that the Government and the contractors in question are treated fairly in these uncommon, yet financially very significant, events, given the peculiarity of Government procurement that so much of its pricing is based on companies' recorded cost structures. The dogmatic insistence that asset revaluations resulting from business acquisitions must be respected as good accounting leads to seeking equity through a "depreciation recapture" approach. And this approach in turn leads to the possibility that either the Government or the acquiring contractor can obtain a significant financial advantage as a result of a business acquisition. In these circumstances, it seems appropriate to the Committee majority to simply abandon the tenets of good "purchase" accounting, just as the Government abandoned them in the analogous case on "goodwill."

(ii) Second, some will no doubt complain that this proposed approach is unfair to the acquiring contractor in that it does not permit him to recover the cost of his investment in the acquired entity, and will result in a disincentive to invest in defense assets that, in the long run, will shrink the defense industrial community and increase Government procurement costs. The Committee finds this argument flawed, however. It would be more comprehensible if the conceivable alternative approach were to simply recognize upward asset revaluations without requiring recognition of a concomitant credit. In comparison with such an approach, the Committee's position would indeed be financially disadvantageous to the acquiring contractor. However, as we have stressed throughout this report, the determination of financial advantage is not so simple or clear-cut when the "depreciation recapture" credit is taken into account, and it is perfectly possible for this approach to be <u>more</u> disadvantageous to the acquiring contractor than that supported by the Committee. In view of this, it hardly seems necessary to go further and comment on other questionable links in this chain of argument. 2

b. <u>Specific Coverage</u>

The main issue concerning the appropriate means of implementing the basic approach chosen by the Committee was how to properly circumscribe its applicability. It should be noted that a similar problem was not faced in the case of goodwill. Those who drafted the coverage on that subject ultimately included in the cost principles believed that they were merely making explicit what had always been a DoD policy understood and accepted by ethical contractors. Consequently, there was in their minds no doubt that the appropriate coverage was to disallow without qualification or exception amortization of, or FCCM on, goodwill. In the case of identifiable asset revaluation following a business acquisition, on the other hand, the situation is complex and requires a more nuanced approach.

In the first place, the Committee believes that there may be contractors who have been involved in past business acquisitions in which assets were revalued upward and Government contracts received a concomitant "depreciation recapture" credit. In such cases, the new asset values will likely affect depreciation and FCCM expense for many years in the future. Under these circumstances, it would clearly be unfair to contractors to disallow depreciation expense based on the revalued asset amounts from the time of implementation of the proposed new rule forward. To do so would upset the bargain made at the time of combination in which the Government accepted asset revaluation in return for receipt of a "depreciation recapture" credit.

Second, the Committee also felt it necessary to recommend revising the present coverage at 31.205-16 ("Gains and losses ...")at several points with a view toward both adequately backstopping the more fundamental changes being proposed at 31.205-49 and also making other desirable changes in coverage that has not been looked at for many years. In paragraph (a) of that cost principle, the Committee is proposing first to add the words "including any transaction(s) in which the acquirer employs the purchase method of accounting for subsequent valuation of the property" in the opening sentence. This language is intended to further clarify what is meant by a "sale" of depreciable property, and, in particular, to rule out once and for all the argument that business acquisitions effected by stock purchase and accounted for under the "purchase" method of accounting nevertheless do not constitute a sale of depreciable property. In that same paragraph, the Committee is also proposing to add a sentence explaining that a depreciation recapture credit may be moved out of the year of sale if necessary to achieve equity in pricing and costing Government contracts. It is the Committee's understanding that this has long been done in practice even absent explicit coverage. However, the Committee believes that such coverage is now advisable particularly since its recommended coverage in 31.205-49 permits the contracting officer in appropriate circumstances to choose the depreciation recapture approach in dealing with asset revaluations resulting from business acquisitions.

In paragraph (b) of 31.205-16, the Committee is recommending a revised rule regarding the maximum credit to be obtained when an asset is sold at a gain. The present coverage limits the credit for the disposition to the amount of depreciation taken over the life of the asset. Thus, if an asset acquired in Year 1 at a cost of $1,000 and depreciated for six years at a rate of $100 per year, having a net book value of $400, were sold for $1,500, the gain recorded on the books would be $1,100. However, the credit to Government contracts would only be $600, the absolute amount of depreciation taken. Putting a ceiling on depreciation recapture that does not recognize the changing value of the dollar makes little economic sense to the Committee. We therefore recommend that the limitation at 31.205-16(b) refer to the inflation-adjusted amount of depreciation previously taken. This is again a particularly necessary step if the depreciation recapture approach is to be a viable option in dealing with business acquisitions.

Lastly, the Committee has added language to this cost principle in both paragraphs (c) and (e) cross-referencing the new coverage at 31.205-49, and explaining the interrelationship between the two rules.

CAS
accepts
Purchase
method

The final noteworthy feature of the Committee's recommended approach concerns the CAS. The Committee is recommending that the passages in CAS 404 dealing with the accounting for business combinations (see Section C.1.b(iii) above) and the passages in CAS 409 dealing with "depreciation recapture" (again see Section C.1.b(iii) above) be deleted. The recommended action regarding CAS 404 is necessary to eliminate the inconsistency between that standard (which accepts the "purchase" method of accounting for business combinations) and the new cost principles coverage (which disallows asset writeups in most circumstances). The Committee does not believe that this inconsistency would constitute an "impermissible conflict" between the CAS and the cost principles of the kind found by the courts in the Boeing SERP case (since the new cost principles coverage would constitute an "allowability"

31.205-6 Compensation for personal services.

(a) through (k) -- Unchanged.

(l) ~~Reserved.~~ [<u>Compensation incidental to business acquisitions.</u> The following costs are unallowable:

(1) Payments to employees under special agreements (commonly referred to as "golden parachutes") in which they are to receive compensation in excess of the contractor's normal severance pay practice if their employment terminates following a change in the management control over or ownership of the contractor or a substantial portion of its assets.

"Parachute" "Handcuffs"

(2) Payments to key employees under special plans introduced in connection with a change (whether actual or prospective) in the management control over or ownership of the contractor or a substantial portion of its assets in which those employees receive compensation in addition to their normal pay provided that they remain with the contractor for a specified period of time.] (commonly referred to as "golden ~~parachute~~ handcuffs").

Why not refer "golden handcuffs"

(m) - Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) below, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) [resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and (3)] raising capital (net worth plus long-term

"resisting"

30.404 Capitalization of tangible assets.

.10 through .50(c) - Unchanged.

~~(d) Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company, not to exceed their fair value at date of~~

~~acquis~~ ~~acquired assets less~~

~~liabil~~ Per Dave Reilly this change would ~~pany in an~~

~~acquis~~ inappropriately truncate 409. ~~nable to~~

~~tangib~~ ~~f the~~

~~excess~~

~~r business~~

~~combi~~ ~~for financial~~

~~accou~~ ~~sch assets.~~

separately

capitalized at the time the assets are acquired. However, [illegible] r or not the contractor identifies and separately capitalizes a unit initially, the contractor shall remove the unit from the asset accounts when it is disposed of and, if replaced, its replacement shall be capitalized.

.60 - Unchanged.

30.409 Depreciation of tangible capital assets.

.10 through .40(a)(3) - Unchanged.

~~(4) The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.~~

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C. 20330

31 MAR 1987

MEMORANDUM TO MR DAVID C. RELLY, CHAIRMAN, COST ACCOUNTING STANDARDS POLICY GROUP

SUBJECT: DAR Case 84-18, "Accounting for Mergers and Business Combinations"

Reference is made to Cost Principles Committee report of 4 February 1987 concerning subject case.

The CAS Policy Group (CASPG) is tasked to review and coordinate on Tab A, Part 3 of the referenced Cost Principles Committee report.

a. The CASPB is also requested to advise the DAR Council of any changes required to remove unacceptable conflicts between the proposed changes to the cost principles and the Cost Accounting Standards.

b. If consistency cannot be achieved between the proposed changes to the cost principles and the Cost Accounting Standards, request the CASPG review and comment on the attached memorandum concerning revision of FAR 42.1204.

Request that you submit the CASPG Committee report to the DAR Council by 30 April 1987.

Fred M Halberstadt

FRED M. HALBERSTADT, Col, USAF
Air Force Policy Member
DAR Council

1 Attachment
as

15 APR 87

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C. 20330

25 MAR 1987

MEMORANDUM TO MR DAVID C. RELLY, CHAIRMAN, COST ACCOUNTING STANDARDS POLICY GROUP

SUBJECT: DAR Case 84-18, "Accounting for Mergers and Business Combinations"

1. Reference is made to Cost Principles Committee report of 4 February 1987 concerning subject case.

2. The CAS Policy Group (CASPG) is tasked to evaluate the referenced Cost Principles Committee report and advise the DAR Council of its recommendations concerning the deletion of portions of CAS 404 and 409 called for in that report.

3. Request that you submit the CASPG Committee report to the DAR Council by 15 April 1987.

Fred M. Halberstadt

FRED M. HALBERSTADT, Col, USAF
Air Force Policy Member
DAR Council

Replaces earlier tasker that said 5-15-87

25 MAR 1987

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C. 20330

20 FEB 1987

A

MEMORANDUM FOR MR DAVID C. RELLY, CHAIRMAN OF THE COST ACCOUNTING STANDARDS POLICY GROUP

SUBJECT: DAR Case 84-18, Accounting for Mergers and Business Combinations

On 4 February 1987, the Commercial Cost Principles Committee submitted the attached report to the DAR Council for its review and comments. A Time Certain has been scheduled with the chairman of the committee on 27 February at 1400, at which time, you have also been requested to attend. Before that meeting, the DAR Council would like your group to review the committee report. Thereafter, please be prepared to discuss the results of the evaluation at the Time Certain session.

Fred M. Halberstadt

FRED M. HALBERSTADT, Col, USAF
Air Force Policy Member
DAR Council

1 Atch
a/s

OFFICIAL MASTER CASE RECORD

Return to Owen 4/6/87 OL A

DARC
DARSC

DATE: 4-2-87

CAM POSTED

DAR CASE: 84-18

YES

DISCUSSION:

NO

Approved cost principles committees Tab A, Part 2 draft (dated 3-31-87) and their proposed F.R. notice. DAR staff transmit to CAAC as a proposed rule. "FAST TRACK"

APPROVAL DATE:

(CIRCLE WHERE APPLICABLE)

RULE.	PROPOSED	INTERIM	FINAL
FED. REG. NOTICE.	YES	NO	
REG. FLEX ANAL.	YES	NO	
REG. FLEX. CERT.	YES	NO	
PAPERWORK REDUCTION	YES	NO	
DAC INTRO ITEM.	YES	NO	
FAC INTRO ITEM.	YES	NO	
DEPT'L. AUTH.	YES	NO	
RECLAMA.	YES	NO	

VOTE:

YES	NO	ABSTAINED
A1	A1	A1
F1	F1	F1
S1	S1	S1
D1	D1	D1
N1	N1	N1
O1	O1	O1

STATUS

OFFICIAL MASTER CASE RECORD

DATE: 2/27

CAM POSTED

YES

NO

DARC
DARSC

A

DAR CASE: 84-18

DISCUSSION:

APPROVAL DATE:

(CIRCLE WHERE APPLICABLE)

RULE.	PROPOSED	INTERIM	FINAL
FED. REG. NOTICE.	YES	NO	
REG. FLEX ANAL.	YES	NO	
REG. FLEX. CERT.	YES	NO	
PAPERWORK REDUCTION	YES	NO	
DAC INTRO ITEM.	YES	NO	
FAC INTRO ITEM.	YES	NO	
DEPT'L AUTH.	YES	NO	
RECLAMA.	YES	NO	

VOTE:

YES	NO	ABSTAINED
A1	A1	A1
F1	F1	F1
S1	S1	S1
D1	D1	D1
N1	N1	N1
O1	O1	O1

STATUS

OFFICIAL MASTER CASE RECORD

A

DATE: 2-18-87 CAM POSTED DARC DARSC

DAR CASE: 84-18 YES

DISCUSSION: NO

move to discussion (Friday) 2-27-87. Time certain Emmons & Reilly 14:00.

APPROVAL DATE:

(CIRCLE WHERE APPLICABLE)

RULE.	PROPOSED	INTERIM	FINAL
FED. REG. NOTICE.	YES	NO	
REG. FLEX ANAL.	YES	NO	
REG. FLEX. CERT.	YES	NO	
PAPERWORK REDUCTION	YES	NO	
DAC INTRO ITEM.	YES	NO	
FAC INTRO ITEM.	YES	NO	
DEPT'L AUTH.	YES	NO	
RECLAMA.	YES	NO	

VOTE:

YES	NO	ABSTAINED
A1	A1	A1
F1	F1	F1
S1	S1	S1
D1	D1	D1
N1	N1	N1
O1	O1	O1

STATUS

EXECUTIVE SUMMARY: DAR Case 84-18, "Accounting for Mergers and Business Combinations"

In its report to the DAR Council of 4 February 1987, the Commercial Cost Principles Committee recommended a number of FAR changes (attached). The report was prompted by the increased pace and size of mergers and acquisitions in recent years and a concern that Government contracts should not be adversely affected by such capital formation activities. The recommended FAR changes will result in the following:

a. When the assets or controlling interest of a contractor are transferred under the purchase method of accounting, stepped-up (the "purchase price") asset values shall not be recognized for the purpose of future depreciation, and a gain or loss on the disposition of such assets/ controlling interest on the part of the seller shall not be recognized. Rather, any excess price is considered to be goodwill and is unallowable.

However, the contracting officer may allow the stepped-up asset values provided it is equitable to do so through recovery of the inflation-adjusted amount of depreciation previously taken.

b. Costs of golden parachutes and golden handcuffs will be unallowable.

c. Costs of effecting and resisting takeovers will be unallowable.

d. Cost accounting standards (FAR 30.404 and 30.409) will also be revised to maintain consistency with new cost principles coverage.

A complete text of the report is available from the DAR Council (COL Guenther, x77267).

DAR Case 84-18 Report of 4 Feb. 1987

TAB A - PROPOSED FAR REVISIONS

Part 1 - Novation or Advance Agreements
- FAR 42.1200, Novation Agreements
- FAR 31.109, Advance Agreements

Part 2 - Resisting/Seeking Mergers
- FAR 31.205-6, Compensation for Personal Services
- FAR 31.205-27, Organization Costs

Part 3 - Asset Valuation
- FAR 31.205-10, Cost of Money
- FAR 31.205-11, Depreciation
- FAR 31.205-16, Gains and Losses on Disposition of Depreciable Property or Other Capital Assets
- FAR 31.205-49, Goodwill

Part 4 - Cost Accounting Standards
- FAR 30.404, Capitalization of Tangible Assets
- FAR 30.409, Depreciation of Tangible Capital Assets

42.1200 Scope of subpart.

This subpart prescribes policies and procedures for--

(a) Recognition of a successor in interest to Government contracts when [either] contractor assets [or control over contractor assets] are transferred;

(b) Recognition of a change in a contractor's name; and

(c) Execution of novation agreements and change-of-name agreements by the responsible contracting officer.

42.1201-1203 - Unchanged.

42.1204 Agreement to recognize a successor in interest (novation agreement).

(a) The law (41 U.S.C. 15) prohibits transfer of Government contracts. However, the Government may, in its interest, recognize a third party as the successor in interest to a Government contract when the third party's interest in the contract arises out of the transfer of [either] (1) all the contractor's assets[,] (2) the entire portion of the assets involved in performing the contract[, or (3) controlling interest in the ownership of the original contractor]. (See 14.404-2(k) for the effect of novation agreements after bid opening but before award.) Examples include but are not limited to--

(i) Sale of these assets with a provision for assuming liabilities;

(ii) Transfer of these assets incident to a merger or corporate consolidation; ~~and~~

[(iii) *Transfer of the complete or controlling interest in the ownership** of a contractor through a stock purchase transaction when there is

[ ] = Addition to FAR

no change in the legal form of the contractor, or by any other means***; and]

~~(iii)~~ [(iv)] Incorporation of a proprietorship or partnership, or formation of a partnership.

42.1204(b)-(e) - Unchanged.

NOTES

* The language in this new subparagraph should be compared with that published in DAC 76-48 which is given in Section A.1 of this report.

** Where the above coverage has the words "complete or controlling interest in the ownership", DAC 76-48 simply had "ownership" and the ADPA recommended the words "complete or partial ownership". The Committee agrees with ADPA's point that the old DAR language was flawed in that it could conceivably be construed as referring only to situations in which the entire voting stock of a company was acquired, not to situations in which effective control was acquired through purchase of less than the entire outstanding stock. However, the Committee has modified ADPA's recommended language as indicated in order to make clear that only those stock purchases which result in the creation of a new "controlling interest", and do not involve merely nominal amounts, are contemplated. It should be noted that the phrase "controlling interest" has a reasonably precise meaning, normally connoting ownership of one-half or more of the voting stock. The Committee has also added language in 42.1200(a) and 42.1204(a) to make those passages consistent with the addition here.

*** Following the word "means", the DAC 76-48 coverage had the phrase "when the Secretary concerned determines that the sale may significantly affect the Government's rights and interests under existing and future contracts." ADPA recommended placing the determination referred to here at the level of the administrative contracting officer, that is, the same level as decisions in other circumstances concerning the need for a novation agreement. The Committee agrees with ADPA's reasoning here as far as it goes but feels that the most appropriate way to implement it is by simply deleting the whole phrase in question. Language indicating that this form of acquisition somehow requires a special determination of the need for an agreement that the others do not is really more consistent with the alternative approach of including acquisition through stock purchase among the situations for which an advance agreement on cost is advisable.

31.109 Advance agreements.

(a) through (g)(16) - Unchanged.

[(17) Costs resulting from the acquisition of one company by another, particularly when execution of a novation agreement (see 42.12) is not required.]

31.205-6 Compensation for personal services.

(a) through (k) -- Unchanged.

(l) ~~Reserved.~~ [Compensation incidental to business acquisitions. The following costs are unallowable:

(1) Payments to employees under special agreements (commonly referred to as "golden parachutes") in which they are to receive compensation in excess of the contractor's normal severance pay practice if their employment terminates following a change in the management control over or ownership of the contractor or a substantial portion of its assets.

(2) Payments to key employees under special plans introduced in connection with a change (whether actual or prospective) in the management control over or ownership of the contractor or a substantial portion of its assets in which those employees receive compensation in addition to their normal pay provided that they remain with the contractor for a specified period of time.]

(m) - Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) below, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) [resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and (3)] raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) - Unchanged.

31.205-10 Cost of money.

(a)(1) - Unchanged.

(2) Allowability. Whether or not the contract is otherwise subject to CAS, facilities capital cost of money is allowable if--

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with CAS 414;

(ii) The contractor maintains adequate records to demonstrate compliance with this standard; ~~and~~

(iii) The estimated facilities capital cost of money is specifically identified or proposed in cost proposals relating to the contract under which this cost is to be claimed~~.~~[; and

(iv) The requirements of 31.205-49, which may limit the allowability of facilities capital cost of money, are observed.]

(3) and (4) - Unchanged.

(5) The cost of money resulting from including goodwill (however represented) in the facilities capital employed base is unallowable~~.~~[(see 31.205-49).]

(b)(1) - Unchanged.

(2) Allowability[.] Whether or not the cont[r]act is otherwise subject to CAS, and except as specified in subdivision (ii) below, the cost of money for capital assets under construction, fabrication, or development is allowable if--

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with CAS 417;

(B) The contractor maintains adequate records to demonstrate compliance with this standard; ~~and~~

(C) The cost of money for tangible capital assets i~~f~~[s] included in the capitalized cost that provides the basis for allowable depreciation costs, or, in the case of intangible capital assets, the cost of money is included in the cost of those assets for which amortization costs are allowable~~.~~[; and

(D) The requirements of 31.205-49, which may limit the allowability of cost of money for capital assets under construction, fabrication, or development, are observed.]

(2)(ii)-(4) - Unchanged.

31.205-11 **Depreciation**

(a) through (m) - Unchanged.

[(n) The requirements of 31.205-49, which may limit the allowability of depreciation, shall be observed.]

31.205-16 Gains and losses on disposition of depreciable property or other capital assets.

(a)(1) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property[, including any transaction(s) in which the acquirer employs the purchase method of accounting for subsequent valuation of the property,] shall [normally] be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) below). [However, the timing (or the amount, if necessary) of the recognition of such credits should be adjusted when the impact upon contract prices of current year recognition does not achieve equity.

(2) When the assets or controlling interest in the ownership of a contractor are acquired or transferred and the individual assets are revalued under the purchase method of accounting for a business combination, 31.205-49 shall apply rather than this subparagraph. No gain or loss shall be recognized when allowable depreciation or amortization is limited to the amount that would have been allowable had the combination not taken place.]

(b) Gains and losses on disposition of tangible capital assets including those acquired under capital leases (see 31.205-11(m)[()], shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the ~~difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance~~ [inflation-adjusted amount of depreciation previously taken] (except see subdivision (c)(2)(i) or (ii) below).

(c) and (d) - Unchanged.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis. [However, when the assets or controlling interest in the ownership of a contractor are acquired or transferred and the individual assets are revalued under the purchase method of accounting for a business combination, 31.205-49 shall apply rather than this paragraph.]

(f) - Unchanged.

31.205-49 Goodwill [and other asset valuations resulting from business combinations.]

~~Goodwill, an unidentifiable intangible asset, originates~~ [(a)(1) When,] under the purchase method of accounting for a business combination[,] ~~when~~ the price paid by the acquiring company exceeds the ~~sum of the identifiable~~ [net book value of the] individual assets acquired less [the] liabilities assumed, ~~based on their fair values. The~~ [the] excess is [distributed first to the identifiable individual assets acquired based upon their market or appraised values and, if any excess still remains, to a newly created, unidentifiable intangible asset] commonly referred to as goodwill. ~~Goodwill may arise from the acquisition of a company as a whole or a portion thereof.~~ [In such situations, allowable amortization, cost of money, and depreciation expense shall be limited to the amount that would have been allowable had the combination and subsequent asset revaluation or creation not taken place.

(2) However, except for goodwill, costs in excess of this limitation may be allowed on a case-by-case basis to achieve equity or protect the Government's interests in special situations, providing the contracting officer agrees. Examples of circumstances in which it may be appropriate for the contracting officer to allow such costs are:

(i) When the Government, before the effective date of this cost principle, had agreed to a settlement covering a business combination which implied acceptance of such costs in the future (as, for instance, when the Government had agreed to accept an immediate credit for contract costing purposes for excess depreciation and amortization costs recognized prior to the business combination (see 31.205-16));

(ii) When the receipt of an immediate credit for contract costing purposes for excess depreciation and amortization recognized prior to a business combination (see 31.205-16) represents an administratively preferable and roughly financially equivalent course of action when compared with that of disallowing future costs flowing from the revaluation of assets pursuant to a business combination; and

(iii) When the acquired company had no, or an insignificant amount of, Government business before being acquired (so that no material credit exists for excess depreciation and amortization previously recognized), and subsequently entered Government business with the asset valuations established by the combination.

(b)] Any costs for amortization, expensing, write-off or write-down of [, or cost of money on,] goodwill (however represented) are unallowable.

30.404 Capitalization of tangible assets.

.10 through .50(c) - Unchanged.

~~(d) Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company, not to exceed their fair value at date of acquisition. Where the fair value of identifiable acquired assets less liabilities assumed exceeds the purchase price of the acquired company in an acquisition under the "purchase method," the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.~~

~~(e) Under the "pooling of interest method" of accounting for business combinations, the values established for tangible capital assets for financial accounting shall be the values used for determining the cost of such assets.~~

~~(f)~~[d] Asset accountability units shall be identified and separately capitalized at the time the assets are acquired. However, whether or not the contractor identifies and separately capitalizes a unit initially, the contractor shall remove the unit from the asset accounts when it is disposed of and, if replaced, its replacement shall be capitalized.

.60 - Unchanged.

30.409 Depreciation of tangible capital assets.

.10 through .40(a)(3) - Unchanged.

~~(4) The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.~~

.40(b) through .50(i) - Unchanged.

~~(j)(1) Gains and losses on disposition of tangible capital assets shall be considered as adjustments of depreciation costs previously recognized and shall be assigned to the cost accounting period in which disposition occurs except as provided in paragraphs (j)(2) and (3) of this section. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds in the event of involuntary conversion, and its undepreciated balance. However, the gain to be recognized for contract costing purposes shall be limited to the difference between the original acquisition cost of the asset and its undepreciated balance.~~

(j)~~(2)~~[(1)] Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) Assets are grouped and such gains and losses are processed through the accumulated depreciation account, or, (ii) the asset is given in exchange as part of the purchase price of a similar asset and the gain or loss is included in computing the depreciable cost of the new asset. Where the disposition results from an involuntary conversion and the asset is replaced by a similar asset, gains and losses may either be recognized in the period of disposition or used to adjust the depreciable cost base of the new asset.

(j)~~(3)~~[(2)] The contracting parties may account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties.

(j)~~(4)~~[(3)] Gains and losses on disposition of tangible capital assets transferred in other than an arm's-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

(k) through .60 - Unchanged.

DLA-AA

29 January 1985

MEMORANDUM FOR CHAIRMAN, COMMERCIAL COST PRINCIPLES SUBCOMMITTEE

SUBJECT: DAR Case 84-18, Accounting for Mergers and Business Combinations

By memorandum of 24 February and 13 April 1984 the DAR Council tasked your subcommittee to study issues relating to accounting for mergers and business combinations. At its meeting of 25 January 1985 the DAR Council Ad Hoc Group decided to have you continue the required effort to determine whether changes to the FAR are warranted and, if so, to prepare FAR coverage. In addition, your report should include an explanatory letter, a draft transmittal letter to the CAAC, and a draft Federal Register notice. Your report date is 6 March 1985.

Signed

CORLYSS DRINKARD
Chairman
Ad Hoc Group

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.
20330

17 April 1984

MEMORANDUM FOR THE CHAIRMAN, COST PRINCIPLES SUBCOMMITTEE

SUBJECT: Accounting for Mergers and Business Combinations (DAR Case 84-18)

1. The attached memo from ADPA is forwarded for the information of the subcommittee as it considers subject case. The comments from ADPA were not solicited, but were forwarded in response to material approved for the DAR under case 83-56.

2. The DAR Council did not put material similar to DAR 26-402(a)(iii) in the DOD FAR Supplement. The Army's request to do so is at atch 2.

JACK L. MCCHESNEY, Col, USAF
Air Force Policy Member
DAR Council

2 Atchs
1. ADPA ltr, 26 Jan 84
2. DA/OGC memo, undated

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.
20330

B

24 February 1984

MEMORANDUM FOR THE CHAIRMAN, SECTION XV-2 SUBCOMMITTEE

SUBJECT: Accounting for Mergers and Business Combinations (DAR Case 84-18)

Subject case has been established by the DAR Council as a result of questions that have arisen with regard to treatment of such costs. Elements of this issue have previously arisen under cases 83-100-5, 83-100-47, 83-43, and 83-56.

Your subcommittee is tasked to study these issues and to recommend any changes that are deemed appropriate. Revision to DAR 15-205.32, Gains and Losses on Disposition of Depreciable Property or Other Capital Assets, may be necessary. In addition, revision to DAR 26-400, Novations, may be appropriate. If you determine that changes to the FAR are warranted, your recommendations should be accompanied by a FAR case proposal.

A report date of 28 March 1984 has been established for this task. Please advise if I can be of assistance in this matter.

JACK L. McCHESNEY, Col, USAF
Air Force Policy Member
DAR Council

B

31 March 1987
TAB A, Part 2
DAR Case 84-18
Page 1 of 2 pages

31.205-6 Compensation for personal services.

Vkv [illegible]
4/29/87

(a) through (k) -- Unchanged.

(l) ~~Reserved.~~ [Compensation incidental to business acquisitions. The following costs are unallowable:

(1) Payments to employees under agreements in which they are to receive special compensation, in excess of the contractor's normal severance pay practice, if their employment terminates following a change in the management control over, or ownership of, the contractor or a substantial portion of its assets. These arrangements are commonly known as "golden parachutes".

(2) Payments to employees under plans introduced in connection with a change (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets in which those employees receive special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time. These arrangements are commonly known as "golden handcuffs".]

(m) - Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) below, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, ~~or~~ (2) [resisting or planning to resist the reorganization of the corporate

approved 4-2-87

structure of a business or a change in the controlling interest in the ownership of a business,] and [(3)] raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) - Unchanged.

31 March 1987
TAB C
DAR Case 84-18

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31

Federal Acquisition Regulation (FAR); Extraordinary Compensation and Certain Organization Costs in connection with Mergers and Other Business Combinations.

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 31.205-6 and 31.205-27 to clarify the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405.

Please cite FAR Case 87-XX in all correspondence related to this issue.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat, telephone (202) 523-4755.

A. Background.

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing for some time the subject of business combinations, and particularly the appropriate Government contract costing resulting from such combinations. This review has been occasioned both by the increased pace and size of such events in recent years, and also by the Councils' perception that existing regulations on certain aspects of this subject are inadequate. Of special concern are the costs of golden parachutes and golden handcuffs, which are extraordinary payments above and beyond ordinary, customary and reasonable compensation payments to employees for services rendered. Also of concern is the fact that there is no explicit coverage on the allowability of the costs of resisting a corporate takeover. In the special circumstances of Government procurement, in which companies' recorded cost structures are often directly reflected in price, the Councils believe the Government should not be at risk of paying higher prices simply because of ownership changes at its suppliers. Instead, the Councils have concluded that additional coverage at FAR 31.205-6 and 31.205-27 is necessary to protect the Government from having to bear the costs of special compensation arrangements and various organization costs often attendant upon business combinations.

B. Regulatory Flexibility Act.

The proposed changes to FAR 31.205-6, and 31.205-27 are not expected to have a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C., 601 et. seq.) because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply.

C. Paperwork Reduction Act.

The Paperwork Reduction Act does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements. Therefore, OMB approval under 44 U.S.C. 3501 et seq. is not required.

List of subjects in 48 CFR Part 31

Government procurement.

Dated: ______________

Lawrence J. Rizzi
Director, Office of Federal Acquisition and Regulatory Policy

Part 31 - (Amended)

Therefore, it is proposed that 48 CFR Part 31 be amended as follows:

1. The authority citation for Part 31 continues to read as follows:

Authority: 40 U.S.C. 486(c); 10 U.S.C. Chapter 137; and 42 U.S.C. 2453(c).

(See Attached)