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DEPARTMENT OF DEFENSE

GENERAL SERVICES ADMINISTRATION

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Parts 15, 31, and 52

[Federal Acquisition Circular 84-35]

**Federal Acquisition Regulation (FAR); Truth in Negotiations Act Amendments and Organization Costs and Compensation Incidental to Business Acquisitions**

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

**ACTION:** Final rule.

**SUMMARY:** Federal Acquisition Circular (FAC) 84-35 amends the Federal Acquisition Regulation (FAR) to incorporate amendments to the Truth in Negotiations Act of 1986 required by the Defense Acquisition Improvement Act, and incorporate amendments to the DoD FY 88 Authorization Act to clarify the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations.

**EFFECTIVE DATES:**

Item I—*(Parts 15 and 52)* April 4, 1988, for DoD, NASA, and Coast Guard.
—May 2, 1988, for all other agencies.

Item II—(Part 31) April 4, 1988.

**FOR FURTHER INFORMATION CONTACT:** Margaret A. Willis, FAR Secretariat, Room 4041, GS Building, Washington, DC 20405, (202) 523-4755.

**SUPPLEMENTARY INFORMATION:**

## Paperwork Reduction Act

*FAC 84-35, Item I*

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because this final rule does not change existing paperwork requirements.

*FAC 84-35 Item II*

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because this final rule does not impose any reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

## B. Regulatory Flexibility Act

*FAC 84-35, Item I*

This final rule will not 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 the revisions apply to contracts requiring submission and certification of cost or pricing data, and a substantial number of small entities do not submit cost or pricing data. Public comments were solicited on the Regulatory Flexibilty Act statement published in the **Federal Register** on July 14, 1987 (52 FR 26446), and none were received that addressed the Regulatory Flexibility Act Statement.

*FAC 84-35, Item II*

This final rule will not 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 the incidence of special compensation costs relating to business acquisitions and the costs of resisting takeovers and reorganizations have been concentrated in large businesses. Public comments were solicited on the proposed rule published in the **Federal Register** on May 13, 1987 (52 FR 18158), and no comments from small businesses were received.

## D. Public Comments

*FAC 84-35, Item I*

A notice of the proposed rule was published in the **Federal Register** on July 14, 1987 (52 FR 26446). The comments that were received as a result of the proposed rule were considered by the Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council in the development of this final rule.

*FAC 84-35, Item II* 9-1A

A notice of the proposed rule was published in the **Federal Register** on May 13, 1987 (52 FR 18158), recommending revisions to FAR 31.205-6 and 31.205-27 to control costs and clearly state the policy of the Government regarding the allowability of these costs. Of the 20 comments received, 17 either concurred or had no objection or comment. Two commenters partially objected to the proposed rules and one commenter totally disagreed. Minor editorial changes were made to the definitions of the proscribed costs, and the slang terms, "golden parachutes" and "golden handcuffs," were deleted.

**List of Subjects in 48 CFR Parts 15, 31, and 52**

Government procurement.

Dated: March 29, 1988.

**Harry S. Rosinski,**

*Acting Director, Office of Federal Acquisition and Regulatory Policy.*

**Federal Acquisition Circular**

[Number 84-35]

Unless otherwise specified, all Federal Acquisition Regulation (FAR) and other directive material contained in FAC 84-35 is effective as follows:

Item I—April 4, 1988, for DoD, NASA, and Coast Guard. May 2, 1988, for all other agencies.

Item II—April 4, 1988.

**Eleanor Spector,**

*Deputy Assistant Secretary of Defense for Procurement.*

[Number 84-35]

Unless otherwise specified, all Federal Acquisition Regulation (FAR) and other directive material contained in FAC 84-35 is effective as follows:

Item I—April 4, 1988, for DoD, NASA, and Coast Guard. May 2, 1988, for all other agencies.

Item II—April 4, 1988.

**Paul Trause,**

*Deputy Administrator, GSA.*

[Number 84-35]

Unless otherwise specified, all Federal Acquisition Regulation (FAR) and other directive material contained in FAC 84-35 is effective as follows:

Item I—April 4, 1988, for DoD, NASA, and Coast Guard. May 2, 1988, for all other agencies.

Item II—April 4, 1988.

**S.J. Evans,**

*Assistant Administrator for Procurement, NASA.*

Federal Acquisition Circular (FAC) 84-35 amends the Federal Acquisition Regulation (FAR) as specified below:

**Item I—Truth in Negotiations Act Amendments**

The FY 87 and FY 88/89 DoD Authorization Acts (Pub. L. 99-500 and 100-180) have amended the Truth in Negotiations Act to prohibit certain contractor defenses when defective pricing has occurred, to allow contractor offsets to price reductions otherwise due the Government in certain situations and to prohibit such offsets in other situations. The definition of "cost or pricing data" has also been modified.

These requirements have been extended through FAR implementation to the contracts of all Federal agencies. Changes have been made to FAR 15.800

and the clauses at 52.215-2 (Audit-Negotiation), 52.215-22 (Price Reduction for Defective Cost or Pricing Data), 52.215-23 (Price Reduction for Defective Cost or Pricing Data-Modifications), and 52.214-27 (Price Reduction for Defective Cost or Pricing Data-Modifications-Sealed Bidding).

These revised clauses shall be included in contracts or contract modifications entered into by DoD, NASA, or the Coast Guard on or after April 4, 1988. With respect to all other agencies, these provisions shall be included in solicitations issued on or after May 2, 1988.

Item II—Organization Costs and Compensation Incidental to Business Acquisitions

There has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. The Government found that the previous cost principles at FAR 31.205-6 and 31.205-27, lacked specificity regarding certain costs. FAR 31.205-6 did not address the issue of special compensation in conjunction with a planned or executed merger or business combination. FAR 31.205-27 did not prescribe the treatment to be accorded costs resulting from resistance or planned resistance to the reorganization of the corporate structure of a business or change in the controlling interest in the ownership of a business.

These final rules clarify the policy of the Government regarding these costs and specifically describe the costs which are unallowable. The revisions do not reflect or result from a change in allowability policy. Therefore, 48 CFR Parts 15, 31, and 52 are amended as set forth below.

1. The authority citation for 48 CFR Parts 15, 31, and 52 continues to read as follows:

Authority: 40 U.S.C. 486(c); 10 U.S.C. Ch. 137; and 42 U.S.C. 2473(c).

## PART 15—CONTRACTING BY NEGOTIATION

### 15.801 [Amended]

2. Section 15.801 is amended by removing in the first sentence of the definition "cost or pricing data" the word "time" and inserting in its place the word "date".

### 15.802 [Amended]

3. Section 15.802 is amended by removing in the first sentence of paragraph (a) the citation "10 U.S.C. 2306(f)" and inserting in its place the citation "10 U.S.C. 2306a".

4. Section 15.804-2 is amended by adding a second sentence in paragraph (a)(1)(iii); by revising paragraph (a)(2); and by adding paragraph (c) to read as follows:

### 15.804-2 Requiring certified cost or pricing data.

(a) * * *

(1) * * *

(iii) * * * (But see 15.804-3(i).)

* * * * *

(2) If certified cost or pricing data are needed for pricing actions over $25,000 and not in excess of $100,000, they may be obtained. There should be relatively few instances where certified cost or pricing data and inclusion of defective pricing clauses would be justified in awards between $25,000 and $100,000. The data which the contracting officer requires to be submitted shall be limited to that data necessary to determine the reasonableness of the price. Whenever certified cost or pricing data are required for pricing actions of $100,000 or less, the contracting officer shall document the file to justify the requirement. When awarding a contract of $25,000 or less, the contracting officer shall not require certified cost or pricing data.

* * * * *

(c) The requirements of this section also apply to contracts entered into by the head of an agency on behalf of a foreign government.

5. Section 15.804-3 is amended by revising paragraph (i) to read as follows:

### 15.804-3 Exemptions from or waiver of submission of certified cost or pricing data.

* * * * *

(i) *Waiver for exceptional cases.* The agency head (or, if the contract is with a foreign government or agency, the head of the contracting activity) may, in exceptional cases, waive the requirement for submission of certified cost or pricing data. The authorization for the waiver and the reasons for granting it shall be in writing. The agency head may delegate this authority. When the agency head or designee has waived the requirement for submission of certified cost or pricing data, the contractor or higher-tier subcontractor to whom the waiver relates shall be considered as having been required to make available cost or pricing data for purposes of 15.804-2(a)(1)(iii). Consequently, award of any lower-tier subcontract expected to exceed $100,000 requires the submission of certified cost or pricing data unless exempt or waived under this subsection 15.804-3

6. Section 15.804-7 is amended by revising paragraphs (b) and (e) to read as follows:

### 15.804-7 Defective cost or pricing data

* * * * *

(b)(1) If, after award, cost or pricing data are found to be inaccurate, incomplete, or noncurrent as of the date of final agreement on price given on the contractor's or subcontractor's Certificate of Current Cost or Pricing Data, the Government is entitled to a price adjustment, including profit or fee, of any significant amount by which the price was increased because of the defective data. This entitlement is ensured by including in the contract one of the clauses prescribed in 15.804-8 and set forth at 52.215-22, Price Reduction for Defective Cost or Pricing Data, and 52.215-23, Price Reduction for Defective Cost or Pricing Data—Modifications. The clauses give the Government the right to a price adjustment for defects in cost or pricing data submitted by the contractor, a prospective subcontractor, or an actual subcontractor.

(2) In arriving at a price adjustment, the contracting officer shall consider (i) the time by which the cost or pricing data became reasonably available to the contractor and (ii) the extent to which the Government relied upon the defective data.

(3) The clauses referred to in subparagraph (b)(1) of this subsection recognize that the Government's right to a price adjustment is not affected by any of the following circumstances:

(i) The contractor or subcontractor was a sole source supplier or otherwise was in a superior bargaining position;

(ii) The contracting officer should have known that the cost or pricing data in issue were defective even though the contractor or subcontractor took no affirmative action to bring the character of the data to the attention of the contracting officer;

(iii) The contract was based on an agreement about the total cost of the contract and there was no agreement about the cost of each such item procured under such contract; or

(iv) The prime contractor or subcontractor did not submit a Certificate of Current Cost or Pricing Data relating to the contract.

(4) Subject to subparagraphs (b)(5) and (b)(6) of this subsection, the contracting officer shall allow an offset for any understated cost or pricing data submitted in support of price negotiations, up to the amount of the Government's claim for overstated pricing data arising out of the same pricing action (for example, the initial

pricing of the same contract or the pricing of the same change order).

(5) An offset shall be allowed only in an amount supported by the facts and if the contractor (i) certifies to the contracting officer that, to the best of the contractor's knowledge and belief, the contractor is entitled to the offset in the amount requested, and (ii) proves that the cost or pricing data were available before the date of agreement on price but were not submitted. Such offsets need not be in the same cost groupings (e.g., material, direct labor, or indirect costs).

(6) An offset shall not be allowed if (i) the understated data was known by the contractor to be understated when the Certificate of Current Cost or Pricing Data was signed, or (ii) the Government proves that the facts demonstrate that the price would not have increased in the amount to be offset even if the available data had been submitted before the date of agreement on price.

* * * * *

(e) If (1) both contractor and subcontractor submitted and (2) the contractor certified, or should have certified, cost or pricing data, the Government has the right, under the clauses at 52.215–22, Price Reduction for Defective Cost or Pricing Data, and 52.215–23, Price Reduction for Defective Cost or Pricing Data—*Modifications*, to reduce the prime contract price if it was significantly increased because a subcontractor submitted defective data. This right applies whether these data supported subcontract cost estimates or supported firm agreements between subcontractor and contractor.

* * * * *

7. Section 15.804–8 is amended by revising paragraphs (a) and (b) to read as follows:

### 15.804–8 Contract clauses.

(a) *Price Reduction for Defective Cost or Pricing Data.* The contracting officer shall, when contracting by negotiation, insert the clause at 52.215–22, Price Reduction for Defective Cost or Pricing Data, in solicitations and contracts when it is contemplated that cost or pricing data will be required from the contractor or any subcontractor (see 15.804–2).

(b) *Price Reduction for Defective Cost or Pricing Data—Modifications.* The contracting officer shall, when contracting by negotiation, insert the clause at 52.215–23, Price Reduction for Defective Cost or Pricing Data—Modifications, in solicitations and contracts when (1) it is contemplated that cost or pricing data will be required from the contractor or any subcontractor (see 15.804–2) for the pricing of contract modifications, and (2) the clause prescribed in paragraph (a) of this subsection has not been included.

* * * * *

8. Section 15.806 is amended by revising paragraph (b) to read as follows:

### 15.806 Subcontract pricing considerations.

* * * * *

(b) Except when the subcontract prices are based on adequate price competition or on established catalog or market prices of commercial items sold in substantial quantities to the general public or are set by law or regulation, any contractor required to submit certified cost or pricing data or for whom a waiver was granted under 15.804–3(i) also shall obtain certified cost or pricing data before awarding any subcontract or purchase order expected to exceed $100,000 or issuing any modification involving a price adjustment expected to exceed $100,000 (see example of pricing adjustment at 15.804–2(a)(1)(ii) and see 15.804–6(g) through (i)). To waive subcontractor cost or pricing data, follow the procedures at 15.804–3(i).

## PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

9. Section 31.205–6 is amended by adding paragraph (l) to read as follows:

### 31.205–6 Compensation for personal services.

* * * * *

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they 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.

(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, which is contingent upon the employee remaining with the contractor for a specified period of time.

* * * * *

10. Section 31.205–27 is amended by revising paragraph (a) to read as follows:

### 31.205–27 Organization costs.

(a) Except as provided in paragraph (b) of this subsection, 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.

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## PART 52—SOLICITATION PROVISIONS AND CONTRACT CLAUSES

11. Section 52.214–27 is amended by removing in the title of the clause the date "(APR 1985)" and inserting in its place the date "(APR 1988)" and by adding paragraphs (d)(1) and (d)(2) to read as follows:

### 52.214–27 Price Reduction for Defective Cost or Pricing Data—Modifications—Sealed Bidding.

* * * * *

(d)(1) If the Contracting Officer determines under paragraph (b) of this clause that a price or cost reduction should be made, the Contractor agrees not to raise the following matters as a defense—

(i) The Contractor or subcontractor was a sole source supplier or otherwise was in a superior bargaining position and thus the price of the contract would not have been modified even if accurate, complete, and current cost or pricing data had been submitted;

(ii) The Contracting Officer should have known that the cost or pricing data in issue were defective even though the Contractor or subcontractor took no affirmative action to bring the character of the data to the attention of the Contracting Officer;

(iii) The contract was based on an agreement about the total cost of the contract and there was no agreement about the cost of each item procured under the contract; or

(iv) The Contractor or subcontractor did not submit a Certificate of Current Cost or Pricing Data.

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**SUPPLEMENTARY INFORMATION:** This is a summary of the Commission's Notice of Proposed Rule Making, MM Docket No. 87–[illegible], adopted September 30, 1987, and released October 22, 1987. The full text of this Commission decision is available for inspection and copying during normal business hours in the FCC Dockets Branch (Room 230), 1919 M Street NW., Washington, DC. The complete text of this decision may also be purchased from the Commission's copy contractor, International Transcription Service, (202) 857–3800, 2100 M Street NW., Suite 140, Washington, DC 20037.

Provisions of the Regulatory Flexibility Act of 1980 do not apply to this proceeding.

Members of the public should note that from the time a Notice of Proposed Rule Making is issued until the matter is no longer subject to Commission consideration or court review, all *ex parte* contacts are prohibited in Commission proceedings, such as this one, which involve channel allotments. See 47 CFR 1.1231 for rules governing permissible *ex parte* contact.

For information regarding proper filing procedures for comments, see 47 CFR 1.145 and 1.420.

### List of Subjects in 47 CFR Part 73

Radio broadcasting.

Federal Communications Commission.

Mark N. Lipp,

*Chief, Allocations Branch, Policy and Rules Division, Mass Media Bureau.*

[FR Doc. 87–24856 Filed 10–27–87; 8:45 am]

BILLING CODE 6712-01-M

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### 47 CFR Part 73

**[MM Docket No. 86–410; RM–[illegible], RM–5428, RM–5688 and RM–5792]**

## Radio Broadcasting Services; Columbia, Eldon, Centralia, Mountain Grove and Cabool, MO

**AGENCY:** Federal Communications Commission.

**ACTION:** Proposed rule; orders to show cause.

**SUMMARY:** This document is issued in response to a counterproposal filed by Southwest Communications, Inc., in MM Docket 86–410, requesting the substitution of Channel 224C2 for Channel 224A at Eldon, Missouri. Petitioner also requests the modification of Station KLDN(FM) to reflect the higher class channel. The channel can be allocated to Eldon provided channel substitutions are made at Mountain Grove, Station KLRS (Channel 293A for Channel 224A) and Cabool, Station KVVC (Channel 251A for Channel 292A). The Orders to Show Cause are directed at those two stations to show cause why their channels should not be changed to accommodate Station KLDN(FM)'s proposed upgrade. Comments will only be accepted from the Mountain Grove and Cabool stations as an opportunity for comments was previously given in response to the Public Notice of March 18, 1987 (Report No. 1649).

**DATES:** Comments must be filed on or before December 14, 1987, and reply comments on or before December 29, 1987.

**ADDRESS:** Tom L. Mason, President and General Manager, Radio Station KVVC(FM), KVVC Broadcasting, Inc., Box 514, Junction M and Business Route 60, Cabool, Missouri 65689; Larry D. Spence, President, Radio Station KLRS(FM), Communications Works, Inc., Route 4, Box 1360, Mountain Grove, Missouri 65711; and Martin R. Leader, Alan K. Ford, John J. McVeigh, Fisher, Wayland, Cooper and Leader, 1255—23rd Street, NW., Suite 800, Washington, DC 20037, Counsel for Southwest Communications, Inc.

**FOR FURTHER INFORMATION CONTACT:** Kathleen Scheuerle, Mass Media Bureau, (202) 634–6530.

**SUPPLEMENTARY INFORMATION:** This is a summary of the Commission's Orders to Show Cause, MM Docket No. 86–410, adopted September 28, 1987, and released October 22, 1987. The full text of this Commission decision is available for inspection and copying during normal business hours in the FCC Dockets Branch (Room 230), 1919 M Street, NW., Washington, DC. The complete text of this decision may also be purchased from the Commission's copy contractors, International Transcription Service, (202) 857–3800, 2100 M Street, NW., Suite 140, Washington, DC 20037.

### List of Subjects in 47 CFR Part 73

Radio Broadcasting.

Authority: 47 U.S.C. 154, 303.

Federal Communications Commission.

Mark N. Lipp,

*Chief, Allocations Branch, Policy and Rules Division, Mass Media Bureau.*

[FR Doc. 87–24854 Filed 10–27–87; 8:45 am]

BILLING CODE 6712-01-M

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**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:** Notice of intent to develop a proposed rule.

**SUMMARY:** The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council invite public comment concerning the development of changes to FAR Parts 30 and 31 on the allowability of costs incident to mergers and other business combinations.

**DATE:** Comments should be submitted to the FAR Secretariat at the address shown below on or before December 28, 1987, to be considered in the formulation of a proposed rule. Please cite FAR Case 87–43 in all correspondence related to this issue.

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

**FOR FURTHER INFORMATION CONTACT:** Ms. Margaret A. Willis, FAR Secretariat, Telephone (202) 523–4755.

**SUPPLEMENTARY INFORMATION:**

### Background

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing the subject of business combinations, and particularly the allowability of costs resulting from such combinations. This review has been occasioned by the Councils' concern that existing regulations on certain aspects of this subject may not be adequate, as evidenced by recent litigation. Specifically, the Councils are considering whether, in circumstances where a Government contractor is acquired, the Government should recognize depreciation or cost of money flowing from asset write-ups that result if the "purchase method" is used to account for the business combination. Government representatives have expressed concern whether, in the circumstances when a contract price will be negotiated based upon the contractor's cost, the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. Accordingly, the Councils will consider comments from interested parties regarding approaches the Councils might employ in dealing with this issue.

**List of Subjects in 48 CFR Parts 30, and 31**

Government procurement.

Dated: October 22, 1987.

**Frank Van Lierde,**

*Acting Director, Office of Federal Acquisition and Regulatory Policy.*

[FR Doc. 87-24845 Filed 10-27-87; 8:45 am]

BILLING CODE 6820-61-M

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## DEPARTMENT OF TRANSPORTATION

### National Highway Traffic Safety Administration

### 49 CFR Part 571

**[Docket No. 87-15; Notice 1]**

### Federal Motor Vehicle Safety Standards; Vehicle Classification

**AGENCY:** National Highway Traffic Safety Administration (NHTSA), DOT.

**ACTION:** Advance notice of proposed rulemaking.

**SUMMARY:** This notice follows the NHTSA's granting of a petition from the Insurance Institute for Highway Safety, requesting the agency to redefine its classes of motor vehicles so that vehicles used primarily to transport passengers are not classified together with vehicles used primarily to transport cargo. The agency is publishing this document to request public comment on possible new approaches to motor vehicle classification for purposes of the Federal motor vehicle safety standards. The comments and other available information will be considered by the agency in determining whether to propose any changes in vehicle type definitions.

**DATES:** Comment due date: Comments must be submitted by December 28, 1987. See Part IV of this Preamble for additional information on submitting comments.

**ADDRESS:** Comments should refer to the above docket number and notice number and be submitted to: Docket section, National Highway Traffic Safety Administration, Room 5109, 400 Seventh Street SW., Washington, DC 20590. Docket hours are 8 a.m. to 4 p.m.; Monday through Friday.

**FOR FURTHER INFORMATION CONTACT:** Ms Deborah Parker, NRM-011, National Highway Traffic Safety Administration, Room 5[illegible]20, 400 Seventh Street, SW., Washington, DC 20590 (202 366-4931).

**SUPPLEMENTARY INFORMATION:**

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**I. Statutory and Regulatory Framework**

The National Traffic and Motor Vehicle Safety Act of 1966 (Safety Act, 15 U.S.C. 1381–1431) authorizes the National Highway Traffic Safety Administration (NHTSA or agency) to issue safety standards for new motor vehicles and new motor vehicle equipment. As promulgated by NHTSA, these safety standards establish minimum performance requirements for motor vehicles and items of motor vehicle equipment. Section 103(a) of the Safety Act requires each standard to be "practicable", to meet "the need for motor vehicle safety", and to be "stated in objective terms."

In addition, section 103(f) of the Safety Act requires the agency to consider whether the standard is "reasonable, practicable and appropriate for the *particular type* of motor vehicle or item of motor vehicle equipment for which it is prescribed" (emphasis added) and contributes to "carrying out the purposes of the Act." To aid it in developing safety standards, as well as in determining the applicability and appropriateness of a specific safety standard, the agency has established definitions for basic motor vehicle types. These definitions are contained in § 571.3 of the agency's regulations and are reprinted in Part IV.C. of this Preamble for easy reference. (All references in this notice to NHTSA's regulations are to sections or parts contained in Chapter V of Title 49 of the Code of Federal Regulations.)

The applicability section of each safety standard indicates the vehicle classifications to which the standard applies. It is the responsibility of each manufacturer to make the initial determination of a motor vehicle's type, consistent with the agency's definitions in § 571.3. In addition, NHTSA's certification requirements in Part 567 require the manufacturer to specify each vehicle's type and to certify that the vehicle complies with all of the motor vehicle safety standards applicable to that type. The agency subsequently may reexamine a manufacturer's classification of its vehicles if it appears that they have not been classified properly. Such reexaminations usually are done in the context of a compliance or enforcement proceeding.

The criteria in sections 103 (a) and (f) of the Safety Act also govern the agency in its making any determination to amend a standard, including revoking its applicability to a particular vehicle type. To amend or revoke a standard ordinarily would require a showing that the standard or a particular provision of the standard no longer meets the need for motor vehicle safety (or, perhaps, that it never did meet that need) or that it fails to meet one of the other criteria of section 103 (a) or (f).

**II. Petition of the Insurance Institute for Highway Safety**

The Insurance Institute for Highway Safety (IIHS or petitioner) petitioned NHTSA to begin rulemaking under the vehicle safety program to establish new safety definitions of motor vehicle types that are consistent with current manufacturing and marketing strategies and that are based on vehicle use.

Focusing on motor vehicles used for personal transportation, the petitioner states that the current vehicle classification system is outmoded, which results in safety standards being applied differently to vehicles that have substantially the same use. Specifically, IIHS notes that "light trucks and hybrids such as the so called 'minivans' " compete for the same market as passenger cars, but do not have to meet several important passenger car safety standards including the requirements for automatic occupant crash protection and those for head restraints, side door strength, roof crush resistance, and center mounted brake lights."

In explaining what it believes to be the genesis of this situation, IIHS summarizes the agency's initial safety standard rulemaking proceeding. The agency proposed (December 3, 1966, 31 FR 15212) two distinct vehicle types whose rationales were based on use and

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**DEPARTMENT OF DEFENSE**

**GENERAL SERVICES ADMINISTRATION**

**NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31**

## Federal Acquisition Regulation (FAR); Trade, Business, Technical and Professional Activity Costs

**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 changes to FAR 31.205–43, Trade, business, technical and professional activity costs, that are intended to clarify allowability policy.

**DATE:** Comments should be submitted to the FAR Secretariat at the address shown below on or before July 13, 1987, 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 NW., Room 4041, Washington, DC 20405.

Please cite FAR Case 87–18 in all correspondence related to this issue.

**FOR FURTHER INFORMATION CONTACT:** Ms. Margaret A. Willis, FAR Secretariat, Telephone (202) 523–4755.

**SUPPLEMENTARY INFORMATION:**

### A. Background

There has been a proliferation of non-Federal Government sponsored symposia resulting in possibly unreasonable costs being charged against Government contracts. In addition, Government contracting officers and auditors have found that the present cost principle does not address the attendance of company employees at such activities, it does not describe the circumstances in which the cost of attendance by noncontractor employees' costs might be allowable, and it does not distinguish between setting up or sponsoring meetings, conferences, symposia, and seminars and attending those events. This proposed rule was necessitated by a need to control costs, to clearly state the policy of the Government with respect to these costs, and to describe more specifically the nature of costs which are allowable. The proposed changes do not reflect or result from a change in allowability policy.

### B. Regulatory Flexibility Act

The proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of 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 cost principles do not apply. An initial Regulatory Flexibility Analysis has therefore not been performed. Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected FAR Subpart will also be considered in accordance with Section 610 of the Act. Such comments must be submitted separately and cite FAR Case 87–610 in correspondence.

### C. Paperwork Reduction Act

The Paperwork Reduction Act (Pub. L. 96–511) does not apply because this proposed change to FAR 31.205–43 provides clarifications as to the allowability of trade, business, technical and professional business activity costs, and does not impose any additional reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

### List of Subjects in 48 CFR Part 31

Government procurement.

Dated: May 1, 1987.

**Lawrence J. Rizzi,**

*Director, Office of Federal Acquisition and Regulatory Policy.*

Therefore, it is proposed that 48 CFR Part 31 be amended as set forth below:

## PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

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

**Authority:** 40 U.S.C. 486(c); 10 U.S.C. Ch. 137; and 42 U.S.C. 2473(c).

2. Section 31.205–43 is amended by revising paragraph (c) and the introductory text is republished to read as follows:

**31.205–43 Trade, business, technical and professional activity costs.**

The following types of costs are allowable:

* * * * *

(c) When the principal purpose of a meeting, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information, or the stimulation of production or improved productivity:

(1) Costs of organizing, setting up and sponsoring the meetings, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental and directly associated costs.

(2) Costs of attendance by contractor employees, including travel costs (see 31.205–46).

(3) Costs of attendance by noncontractor personnel provided (i) such costs are not also reimbursed to the individual by the employing company or organization, and (ii) the individual's attendance is essential to achieve the purpose of the conference, meeting, symposium, etc.

[FR Doc. 87–10842 Filed 5–12–87; 8:45 am]

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**48 CFR Part 31**

## Federal Acquisition Regulation (FAR); Extraordinary Compensation and Certain Organization Costs in Connection With Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs)

**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.

**DATE:** Comments should be submitted to the FAR Secretariat at the address shown below on or before July 13, 1987, 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 NW., Room 4041, Washington, DC 20405.

Please cite FAR Case 87–19 in all correspondence related to this issue.

**FOR FURTHER INFORMATION CONTACT:** Ms. Margaret A. Willis, FAR Secretariat, Telephone (202) 523–4755.

**SUPPLEMENTARY INFORMATION:**

### 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., *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 (Pub. L. 96–511) does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

**List of Subjects in 48 CFR Part 31**

Government procurement.

Dated: May 4, 1987.

**Lawrence J. Rizzi,**

*Director, Office of Federal Acquisition and Regulatory Policy.*

Therefore, it is proposed that 48 CFR Part 31 be amended as set forth below:

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

**Authority:** 40 U.S.C. 486(c); 10 U.S.C. Ch. 137; and 42 U.S.C. 2473(c).

## PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

2. Section 31.205–6 is amended by adding paragraph (l) to read as follows:

**31.205–6 Compensation for personal services.**

* * * * *

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they 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."

* * * * *

2. Section 31.205–27 is amended by revising paragraph (a) to read as follows:

**31.205–27 Organization costs.**

(a) Except as provided in paragraph (b) of this subsection, 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.

* * * * *

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**ANALYSIS**

FEDERAL CONTRACTS REPORT

A

## ACQUISITIONS AND MERGERS OF GOVERNMENT CONTRACTORS

Norman Steiger*
Suzy Evans

Mergers and acquisitions among companies that perform a substantial amount of government contract work have become a standard occurrence. Two notable examples are the acquisition by General Motors of Hughes Aircraft in 1985 and the acquisition by Burroughs Corp.—now known as Unisys Corporation—of Sperry Corp. in 1986.

In such instances, issues specific to the law of government contracts often become important—sometimes even deal-breakers. Some of the significant questions that arise are when should a novation agreement be required, what are the terms, how should the allowability and allocability of costs related to or resulting from an acquisition or merger be treated?[1]

### When Should Novation Agreements Be Required?

Subpart 42.12 of the Federal Acquisition Regulation, covering Novation and Change of Name Agreements, prescribes the policies and procedures covering—

— the recognition of a successor in interest to government contracts when a contractor's assets are transferred;

— the execution of novation agreements and change-of-name agreements by the contracting officer.[2]

A novation agreement is defined as "a legal instrument executed by (a) the contractor (transferor), (b) the successor in interest (transferee), and (c) the government by which, among other things, the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the government recognizes the transfer of the contract and related assets."[3]

The assignment of government claims or contracts is expressly prohibited by two separate statutes.[4] However, a transfer or assignment of a claim against the government by operation of law, such as a transfer resulting from a corporate merger, reorganization, or dissolution, has been held to be outside this statutory proscription.[5] Otherwise, neither the statutes nor the FAR offer enlightenment as to when a government contract is considered "assigned" or "transferred," in contravention of the government's rights.

One commonly used method of acquiring another company is to purchase all of its stock rather than to buy its assets, which assets might include rights under its uncompleted government contracts. In the acquisition of Hughes by General Motors and in that of Sperry by Burroughs, the acquiring company in each instance bought all the stock of the acquired government contractor. However, after the initial acquisition, these combinations took different courses. General Motors has maintained Hughes' status as a separate, legally independent corporation of which it was the sole stockholder. Burroughs liquidated the Sperry Corp. by passing its assets through a newly created company, the SP-Acquiring Corp., which was then merged into Burroughs.[6] In both cases, the government required the acquired (and acquiring) corporations to negotiate a novation agreement.

Logically, a change in the ownership of stock in a corporation that retains its separate legal identity, as in the acquisition of Hughes by General Motors, should not be considered either an assignment or a transfer by the acquired corporation of its contracts. Whether, in cases in which the acquired company is merged into the acquiring corporation, the exception for transfers by operation of law applies to contracts with the government is less clear.

In *Seaboard Air Line Ry. v. United States*,[7] the Supreme Court recognized a claim for transportation services asserted by a company that had survived a merger with the original contractor. "We cannot believe that Congress intended to discourage, hinder, or obstruct the orderly merger or consolidation of corporations as the various states might authorize for the public interest. There is no probability that the United States could suffer injury in respect of outstanding claims from such union of interests . . ."

If *Seaboard* is still good law, and if the Court's reasoning applies to the assignment of contracts as it does to the assignment of claims (a point on which apparently there is no case law), then there is no basis under either statute for the government to require contractors that merge with, or are merged into, other companies to enter into a novation agreement.[8]

However, the government requires contractors, such as Sperry and Hughes as well as others whose ownership or identity has changed, to enter into a novation agreement. The government apparently does not use as a criterion for determining when a novation agreement is required either (i) whether a novation agreement would be considered appropriate in the

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commercial context or (ii) whether a "transferor" has survived to "guarantee" the "transferee's" performance.

Whether the government has the right to demand that any contractor in which a third party acquires a controlling interest negotiate a novation agreement under FAR Subpart 42.12 is a question that has never been litigated. *Seaboard* implies that the government's authority to do so must be derived from a source other than the Anti-Assignment Acts. Since the FAR requirements go beyond the acts as interpreted by the courts, a contractor might successfully argue that Congress did not intend to, and in fact has not, proscribed assignments by operation of law such as those described.

However, whether the government had the authority to demand that a particular contractor negotiate a novation agreement was an issue raised, if not decided, in *ITT Gilfillan v. U. S.*[9] ITT Gilfillan argued that the novation agreement that specifically barred the contractor's recovery of costs associated with the transfer of contracts was a nullity because it lacked consideration. ITT contended that the transfer of contracts had taken place by operation of law and therefore there was no legal requirement for a novation agreement.

The Court of Claims rejected that analysis. Instead, the court accepted the government's argument that its good faith forbearance in not asserting a bar against the "transfer" of this contract under the anti-assignment statutes was sufficient consideration for the novation agreement. The court did not find it necessary to examine the nature of the acquisition agreement in order to reach this result.

The court indulged in a rather obvious piece of circular reasoning: the government's demand that ITT Gilfillan enter into a novation agreement providing for the future treatment of costs incurred under these very contracts *was* an assertion of the government's claim. Getting what you demand hardly constitutes forbearance from claiming it.

Logically, the key issues in determining whether a novation agreement is legally required for a government contract are:

(i) whether the transaction in which the contractor's status was changed is a voluntary "assignment" or transfer of the contract that is prohibited by the Anti-Assignment Act, and

(ii) if not, whether there is some other authority for the broader applicability of the FAR.

However, a contractor wishing to determine whether the government does have such a right cannot, without substantial risk, secure a timely ruling on the question.

Furthermore, the government's position on the question has been quite clear, at least since the amendment in 1984 of section 26-402(b) of the Defense Acquisition Regulation.[10]

The earlier version of DAR 26-402(a) had stated that the government could elect to recognize a third party as the successor in interest to any government contractor "where the third party's interest arises out of the transfer of all ... or all that part of the contractor's assets involved in the performance of the contract."

The 1984 revision added a new subsection, (b)(iii), giving the following example of such a transfer:

> "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." (Emphasis supplied)

This broad assumption of authority by the secretary of defense was not carried over to the FAR. Nonetheless, the government apparently takes the position that any contractor which has undergone a change in control must enter into a novation agreement covering all of its previously awarded contracts, even though neither its legal status nor its ability to perform has been altered by that change in control. The government has taken this position even though the application of elementary principles of law almost compels the conclusion that such a change in control constitutes neither an assignment nor a transfer of the corporation's contracts and that no consent or acknowledgement by the government therefore is required under the Anti-Assignment Acts.

Also, the government has demanded that a contractor which is merged with another legal entity, so transferring all of its assets by operation of law (and, presumably increasing—rather than decreasing—its ability to perform any "unexpired" government contracts), novate all such contracts.

To argue that the anti-assignment statutes apply in the first case is specious. To claim that the FAR definition of a "novation" in 42-1201 covers a merger situation, in which the "transferor" of a government contract does not survive to guarantee its performance, is to misread it entirely.

Nevertheless, the government has a powerful weapon to compel contractors, even in these situations, to begin novation discussions: it can refuse to pay for work performed by the contractor after either of these events. Considering the effect of such a refusal, most contractors do not even contest the point.

Clearly, the government has the right to protect its interests as a party to any contract. At a minimum, the government's interest is to ensure that any successor contractor have at least the same capability to perform as did the original contractor. Also, under a cost type contract (which often includes those for high dollar-value items vital to the national security), at least a portion of the contractor's overhead (including general administrative costs and independent research and development costs) is reimbursed. The government therefore has an interest in ensuring that increases in those expenses which result from such a change in control are not reflected in costs under any pre-merger or pre-acquisition contract with a particular company. Finally, the government—as would any commercial contracting party—has an interest in the continuity of contract performance.

Granting all of this, it is nevertheless clear that the FAR requirements (at least as applied to date) fail


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adequately to fulfill the following necessary or useful functions:

• to balance the government's legitimate interests in the performance of its contracts with the interests of the contractor and of the larger community in a free market for ownership interests in companies that engage in government contracting;

• to provide certainty and predictability to both the contracting parties; and

• to treat with appropriate distinctions the variety of transactions by which, under a broad interpretation, a contract may be "transferred" or assigned.

In any case, the government frequently uses the "requirement" for a novation agreement as an opportunity to secure concessions on unrelated points. Clarifying FAR 42.12 by clearly excluding from its coverage transfers that occur by operation of law through corporate mergers or similar events would, at a minimum, reduce the opportunities for overreaching.

Further, the government's enforcement of the novation requirement probably is inconsistent and fragmentary. There is no statutory or regulatory provision requiring a contractor to report to the government a change in its ownership or control which, under either FAR 42.12 or under the Anti-Assignment Acts, would need the government's consent in the form of a novation agreement. Thus, some transactions of the type covered by FAR 42.12 may escape the notice of the cognizant contracting officer when a company is acquired or merged with little or no publicity. It also is reasonable to assume that many small contractors which incorporate, go private, or whose stock changes hands without changing the name under which their government contracts business is conducted, never negotiate a novation agreement with the government. Yet, in at least some of these cases, the change in status or control might well adversely affect the contractor's ability to perform its pre-existing contracts.

Given the government's practice of conditioning a novation agreement on contractors' acceptance of terms in addition to those required by the FAR, and the fact that changes in the status of some contractors which are not reported could or do affect their ability to perform, there are several issues that should be resolved:

• when a novation agreement should be required,

• whether (or how) the government's right to require a novation agreement should be limited, and

• how the requirement for a novation agreement should be enforced.

### Terms of the Agreement

FAR 42.1204 prescribes the basic form and elements of a novation agreement. The contractor (transferor) must document, by authenticated copies of the relevant instruments, each step of the underlying transaction to which the novation is related, and each such agreement must begin with a detailed recitation of the dates and effect of each such document.[11]

Also required are the following:

• a list of all "affected contracts and purchases remaining unsettled,"

• together with the consent of all sureties whose consent is required,

• the opinion of "legal counsel for the transferor and transferee stating that the transfer was properly effected under applicable law, and the effective date of the transfer,"

• evidence of the transferee's ability to perform the contracts, certified balance sheets of the transferor and transferee reflecting their respective financial positions "immediately before" the transfer, and

• evidence that applicable security clearance requirements have been met.

The form for the novation agreement that is prescribed by FAR 42-1204(e) obviously was designed for simple transactions rather than, for example, the series of events by which the merger of Sperry into Burroughs was effected. In a novation agreement, the transferee assumes the transferor's obligations under the listed contracts which the transferor must guarantee, although it waives all of its rights under them[12], and the government accepts the transferee as a substitute contractor.

When a company performs contracts for more than one government agency, the question of identifying the "responsible contracting officer" is answered by FAR 42.1202, which provides:

> (a) If any of the affected contracts held by the transferor have been assigned to an administrative contracting officer ..., the responsible contracting officer shall be —
>
> (1) This ACO; or
>
> (2) The ACO responsible for the corporate office, if affected contracts are in more than one plant or division of the transferor.
>
> (b) If none of the affected contracts held by the transferor have been assigned to an ACO, the contracting officer responsible for the largest unsettled (unbilled, plus billed but unpaid) dollar balance of contracts shall be the responsible contracting officer.

Nothing in FAR 42-12, or, indeed, in any other statute or FAR provision, explicitly gives the government any right to condition its acceptance of a novation upon the surrender by either the transferee or the transferor of any rights either of them might otherwise have. Rather, a reading of all of FAR 42-12 provisions together almost compels the conclusion that the contracting officer, when reviewing a proposed novation agreement, is performing what is almost a ministerial task. That is, the contracting officer should promptly reach agreement with the transferee on a novation agreement that includes all—*but only those*—points covered by the model form incorporated in 42.1204 with any transferee who supplies the processing documents required by 42.1203 and who demonstrates the financial and technical ability to perform the open contracts "transferred," according to the terms of those contacts.

Unfortunately, most novation agreements to which the government is a party have for some time included a number of substantive provisions in addition to the points mandated by FAR 42.12.

Consider—as one example of the problems that face "transferees" because of the government's broad interpretation of the scope of novation agreements—the question of acquisition costs. One provision apparently common to all government novation agreements is a prohibition against any increase in costs associated with any government contract as a result of the transfer.[13] Also, according to FAR 31-205.27, the costs associated with any merger or acquisition involving a government contractor (including all related professional services, legal and accounting) are clearly unallowable.[14]

Granting that the government's interests require such provisions, should not the basic novation agreement provided in FAR 42.1204 specifically include terms by which the transferee accepts these points?

A FAR provision defining or identifying what constitutes an "increase" in costs as a result of the change that prompted the novation would minimize litigation and provide valuable guidance both to government auditors and to prospective purchasers of companies engaged in government contracting.

Moreover, with such a regulation in place, the government would be less likely to insist on including additional protections as part of a novation agreement, such as an agreement by the transferee that no merger or acquisition-related costs will be recovered under *future* contracts for a specified period, or that the transferee will not sell the acquired corporation (or assets) for a minimum period after the novation.

The effort and time required to negotiate the specific wording of each such additional clause are considerable, and benefit neither the government nor the contractor. Moreover, such prolonged negotiations often create opportunities for confusion, such as the need to use two names for the company—the old name for contracts awarded before the transfer and the new corporate name for contracts after transfer.

A more serious problem is that the uncertainty over what additional terms the government may eventually require in a novation agreement can adversely affect the market value of companies involved in government contracting.

### Revaluation Of Assets And Treatment Of Costs

In three cases over the last 20 years, the courts have ruled against transferee contractors on the question of whether the assets of the acquired corporation could be revalued.

In the most recent of these, *Marquardt Co. v. U. S.*,[15] the Federal Cirucit affirmed a grant of summary judgment by which the Armed Services Board of Contract Appeals had upheld a contracting officer's decision that "the sale of a government contractor's stock by one third party to another does not entitle the contractor (1) to write-up its depreciable assets to reflect the price paid for the stock and (2) to charge depreciation thereon to the government."[16]

To "write-up" or "step-up" assets means to increase the book value of an acquired corporation's assets from their original book value to their "fair" value.[17] Since assets can be depreciated only from their book value, to increase the book value of an asset is to increase the depreciation which can be charged against it. A government contractor's depreciation costs are a factor in its indirect rates, therefore the contractor's costs are effectively increased when it steps up its assets.

The dispute, then, has been over when—or whether—contractors may step-up assets after an acquisition. Contractors have argued: (1) that the use of the "purchase method" of accounting is required by Generally Accepted Accounting Practices (GAAP), which are adopted as formal Opinions of the American Institute of Certified Public Accountants' (AICPA) Accounting Practices Board (APB), and (2) that a write-up of assets is required when the "purchase method" is used.

Cost Accounting Standard 404.50, covering the "Capitalization of Tangible Assets," states that:

> (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 assets for financial accounting shall be the values used for determining the costs of such assets.

According to APB Opinion No. 16, under the purchase method of accounting (which is used when one company acquires another):

> 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 required and liabilities assumed based on their fair values; the unallocated cost should be recorded as goodwill. [Para. 8].
>
> 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 . . . [Para. 94].

Nonetheless, Marquardt could not convince the government or the courts that it was entitled to write-up its assets when it was acquired by another company.

In 1983, CCI Corp. sold all of the stock of the Marquardt Co., its wholly owned subsidiary, to ISC Electronics Inc. Interestingly, no novation agreement was entered into among these parties and the government.

When Marquardt allocated the price paid by ISC for its stock among Marquardt's own assets, the company adjusted its schedule of indirect costs under all government contracts—i.e., it attempted to step-up the value of its assets on government contracts from $8 million to $41.8 million and to depreciate using the fair market value as the basis for those assets. This adjustment, Marquardt claimed, merely reflected those "attendant increases in depreciation and 'facilities capital cost of money,'" that had resulted from the change in its ownership.

The contracting officer disallowed the increases, and Marquardt appealed to the ASBCA.[18] The board rejected Marquardt's argument that generally accepted accounting principles permitted, indeed,


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required the use of the purchase method of accounting when a "business combination" is accomplished primarily through a cash purchase.[19]

The government, the board noted, maintains that the purchase method of accounting does not apply in Marquardt's situation—that no "business combination" had occurred, and that use of the purchase method of accounting in these circumstances would not be in accordance with Generally Accepted Accounting Principles and that, in any event, the costs were unallowable under DAR 15-201.2.

The government, the board noted, maintained that the costs were unallowable "because depreciation must be based on actual cost less residual value, the costs claimed were unreasonable in amount, and they were not required for performance of a government contract."[20]

In its initial opinion, the ASBCA determined that the American Institute of Certified Public Accountants' APB Opinion No. 16 applied only to those "business combinations" that result in a single surviving "entity," and therefore did not apply in this case, since Marquardt had retained its separate legal entity. Also, as the ASBCA pointed out, it was ISC rather than Marquardt that incurred the costs of acquisition. Therefore these costs could be reflected only in the costs of any of ISC's government contracts:

> "Marquardt now seeks to use the purchase of its stock by [ISC] as a basis for converting an expenditure by a third party into a 'cost' incurred by itself. In short, it seeks to create something out of nothing and charge it against its government contracts."[21]

Sweeping aside all of Marquardt's arguments, the ASBCA on reconsideration ruled that, under DAR 15-201.2, generally accepted accounting principles are applicable only when appropriate to the particular circumstances. "This standard has not been met where, as here, the threshold requirement of cost incurrence has not been met."[22]

In its own opinion, the court noted Marquardt's argument that a novation agreement was not required because the acquisition of its stock was not an "assignment" of its contracts under the Anti-Assignment Acts. The court, as had the ASBCA, dismissed Marquardt's arguments that APB 16 controlled the outcome of the case, concluding that "principles applicable to an *acquiring* corporation are not necessarily applicable to an *acquired* corporation."

The court further held that, through 31 CFR Sec. 357.2(a), the Defense Contract Audit Agency has the primary responsibility for interpreting accounting and financial aspects of the DAR. The DCAA Manual provided in Para. 7.1702 that a "business combination" exists only when a "single organization carries on the activities of... previously separate, independent enterprises"[23] and, in Para. 7.1707.a(a)(2), that no write-up of assets acquired through a stock purchase is permitted unless the acquired corporation was liquidated.

Therefore, the court rejected Marquardt's argument that requiring a liquidation of the acquired company, as a condition of permitting a step-up in its assets, was irrational. Rather, the court found, the government in doing so was acting responsibly and efficiently in conducting its contracting business by avoiding a duplication in the overhead costs charged.

In an interesting dissent, Judge Bissell argued that the "economic realities" in the case were indistinguishable from those in *Gould Defense Systems, Inc.*[24]

The government, Judge Bissell noted, "contends that *Gould* is distinguishable... because in *Gould* the board was faced with a true business combination that resulted from the merger of two corporations. Hence, the government argues, that in *Gould* the purchaser was properly allowed to record as its costs on its books the fair market value of the assets it purchased and charge those costs against its government contracts."[25]

If, as did Gould, ISC had acquired Marquardt by proceeding with a series of steps that had no economic motive other than gaining for Marquardt the right both to write up its asset base and to charge the associated increased costs to Marquardt's own government contracts, the board and the Federal Circuit would have accepted the same desirable (for the contractor) outcome. To accomplish this, according to the dissenting judge, ISC should first have established a shell subsidiary, funded it with the equivalent of the price it had agreed to pay (in cash and stock) to CCI for its stock in Marquardt, and then caused the shell subsidiary to distribute its assets to CCI by approving a merger of the shell corporation with Marquardt:

> "Under the majority's opinion the formalities of setting up the shell corporation, followed by a merger with a change in name, will have to be continued for the sole purpose of government contracting. Nothing is economically different except that the contractor will incur additional legal and accounting fees...
>
> The substance of the transaction, not the form, should govern for all purposes, including the determination of costs incurred for contracts entered into both pre-acquisition and post-acquisition. Such is not the case here."[26]

Unlike *Marquardt* where there was no novation agreement, in both *Sunstrand Turbo v. U. S.*,[27], and *LTV Aerospace Corp. v. U. S.*,[28] the gravamen of the decision was the court's interpretation of just such an agreement.

In the first case, Sunstrand had purchased the properties and fixed assets of a division of American Machine and Foundry Co. in 1958. These assets included two cost-plus-fixed-fee contracts. At the same time, Sundstrand entered into a novation agreement with the government and American Machine.

Paragraph 7 of the novation agreement stated that the transferor and transferee agreed "that no claim for payment by or reimbursement from the government shall be made by either of them with respect to any costs, increased taxes or other expenses arising out of or attributable to (i) said assignment, conveyance and transfer, or (ii) this Agreement, other than those which the government would have been obligated to pay or reimburse under the terms of the contracts in effect prior to the execution of this Agreement."[29]



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Sundstrand then charged to these two contracts, as part of its costs of performing them, depreciation based on the valuation of the purchased assets which the IRS had approved for tax purposes. Before the ASBCA and the Court of Claims, Sundstrand argued that Paragraph 7 of the novation agreement barred only claims for any increase in *total* contract costs as a result of the acquisition and to the costs of the acquisition itself.

Rejecting this argument, the board ruled that the words "any costs" were too broad to support Sundstrand's position. "They restrain the reimbursement of particular costs on a selective basis where... the cost increase arose out of the transfer."

In affirming the board's decision, the court found that the increase in depreciation value of the assets of American Machine came under the prohibition "because it arose out of and was attributable to the transfer."

In *LTV*, the same court used a similar "but for" test to identify increases in contract costs that were prohibited by a novation agreement. Interpreting almost identical language in the LTV novation agreement, the court reached a similar outcome. Here, the claimant had purchased all of the assets and properties of Chance Vought Corp. in 1961. Chance Vought's assets at the time included at least one cost-plus-fixed-fee contract. LTV then re-valued Chance Vought's depreciable fixed assets and submitted for this government contract cost figures that included an allocation reflecting the re-evaluation. The court summarized LTV's argument as follows:

> "First, the novation agreement, specifically the 'any costs' language, is ambiguous and therefore should be construed unfavorably to its drafter—the government. Plaintiff asserts that the only valid approach is to interpret 'any costs' as being synonymous with 'total cost'... [P]laintiff argues that it should be permitted to prove that its total cost... was not in excess of the total cost which [Chance Vought] would have incurred had it gone on to complete the Contract. Second, plaintiff submits, alternatively, that at the very least, it should be allowed to offset against depreciation cost increases certain identifiable cost decreases (savings) which arose wholly because of the merger."[30]

The court rejected LTV's argument that *Sundstrand* was essentially a case in which the claimant had failed to meet its burden of proof that total contract costs had not increased as a result of the merger and asset step-up with the resulting increase in depreciation costs. Finding unreasonable the plaintiff's definition of the phrase "any costs,"[31] the court held that *Sundstrand* was both correctly decided and clearly applicable to the facts of this case.

From a review of these three cases and a comparison with *Gould Defense Systems* (in which the claimant finally prevailed on an estoppel theory), it is obvious the government will not concede the right of any acquired or acquiring corporation to step-up the value of assets affected by the transaction so as to increase depreciation costs on any contracts predating the transaction. Compounding the problem for contractors is the government's demand that even its cost for option items where the option is exercised *after* the effective date of an acquisition cannot be so affected, if the original contract was executed prior to that date.

This could have unforeseen or burdensome effects long after the acquiring contractor has begun performance of entirely new contracts. For example, to comply, the contractor must at a minimum keep two sets of books until the original contracts and modifications or option items have been completely performed or delivered. The government, too, must expend a disproportionate amount of effort auditing the contractor's records of costs for the novated contracts to ensure to its satisfaction—never easily achieved—that the contractor has fully complied with these cost limitations.

Perhaps the most important impact will be the deterrent effect of these limitations on the market for ownership interests in government contractors. No potential buyer, when considering the value of a target company, can ignore the possible long-term consequences of including in a novation agreement terms such as those the government sometimes demands.[32]

Inevitably, the value of government contractors must be discounted in the marketplace to reflect this risk, as well as the uncertainty as to cost of any additional onerous terms. In the long run, the government loses when this happens, since any contractor's ability to raise equity is diminished by such discounting. In its vigilance to keep down costs on particular open contracts today, the government may unnecessarily be increasing its future costs on all procurements.

It may be true, as the government argued in *Gould*, that "there are no more productive assets the day after an acquisition than the day before."[33] But, the conclusion that the assets were appropriately valued on that day does not necessarily follow. In any case, as the board observed in *Gould*—a case in which the acquisition by one company of another resulted in increased competition for an important torpedo program contract—"numerous other benefits and economies may accrue to the contractor as a result of the merger, including increased capital resources and management."[34]

The DAR Council and the Civilian Agency Acquisition Council in October asked for comments on the allowability of costs incident to mergers and other business combinations, specifically, whether the government should recognize depreciation or cost of money flowing from asset write-ups if the purchase method of accounting is used.[35] The agencies, the FAR Councils noted, have questioned whether, under a cost contract, "the government should be at risk of paying higher prices simply because of a change in ownership of the supplier." Comments were due Dec. 28.

The concern in the contractor community is that the FAR will be amended explicitly to prohibit *any* post-acquisition write-up of intangible assets, or goodwill, whatever accounting method is used for other purposes. The wisdom of such a change is not generally accepted.


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**FOOTNOTES**

[1] This article focuses on acquisitions of and mergers between U.S. contractors, and does not discuss issues raised by the acquisition of U.S. contractors by foreign companies.

[2] FAR 42.1200

[3] FAR 42.1201.

For commercial, i.e., non-government contracts, a novation is. "Substitution of new contract between same or different parties." *Black's Law Dictionary* (4th Ed. Rev. 1968) at 1213. But see, Hunter's Modern Law of Contracts Para. 12.05[1][b] (1986). According to Sec. 1297 of 6 *Corbin on Contracts* (1962) at 213:

> "[t]he term 'novation' is never used except to denote substituted executory contract," and is "generally used only when the substituted contract involves at least one new party; and... this new party must be a substituted obligor in place of a former obligor or debtor who is discharged."

See also *Williams Petroleum Co. v. Midland Cooperatives,* 679 F.2d 815, 819 (CA 10 1982) (applying Oklahoma law):

> "Novation is the replacement of an unexpired contract by another contract reached through renegotiation or the substitution of a new party with the concurrent release of an original party from liability."

[4] The Anti-Assignment Acts, 31 U.S.C. §3727; 41 U.S.C. §15. The latter (and broader) statute provides: "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. All rights of action, however, for any breach of such contract by the contracting parties, are reserved to the United States."

In the Defense Acquisition Regulation (DOD's predecessor to the FAR) Section 26-402, this prohibition is interpreted broadly: " (a)The transfer of a government contract is prohibited by law (41 U.S.C. Sec. 15). However, the government may recognize a third party as the successor in interest to a government contract where the third party's interest arises out of the transfer of all the assets of the contractor or all that part of the contractor's assets involved in the performance of the contract. Examples include, but are not limited to:

(i) sale of such assets;

(ii) transfer of such assets pursuant to merger or consolidation of corporation; and

(iii) incorporation of a proprietorship or partnership."

[5] See, e.g., Novo Trading Corp. v. Commissioner, 113 F.2d 320 (2d Cir. 1940); Consumers Ice Co. v. United States, 475 F.2d 1161 (Ct.Cl. 1973); United States v. Improved Premises, 204 F.Supp. 868 (S.D.N.Y. 1962). Also, according to the authors of "Acquisitions & Mergers," 85-9 *Briefing Papers* 1 (Federal Publications Inc., Sept. 1985):

> "... involuntary transfers pursuant to corporate reorganizations, mergers, or consolidations are not covered by the provisions of the Act. Further, the Act does not apply to certain types of changes in the legal identity of the contractor." (Footnote omitted).

The authors cite for the first proposition Seaboard Airline Railway v. U.S., 256 U.S. 655 (1921) and Consumer's Ice Co. v. U. S., supra, but do not analyze ITT Gilfillan, Inc. v. U. S., 472 F.2d 1382 (Ct.Cl. 1973).

[6] These transactions were completed simultaneously on November 12, 1986. On Nov. 13, 1986, the Burroughs Corporation re-incorporated under the name of "Unisys Corporation."

[7] 256 U.S. 655, 657 (1921).

[8] Of course, if a government contractor merged with another corporation which was for any reason barred from doing business with the government or, perhaps for national security reasons, could not legally perform specific contracts with the Department of Defense or another government agency, the government must and does have the right to terminate the affected contracts. In such cases, a novation agreement is, in practical terms, irrelevant. In any event, the potential for such a situation is not a justification for the government to require a novation agreement in those cases where neither the acquired nor the acquiring corporation has been debarred or is otherwise disqualified from performing the "transferred" contracts.

[9] 471 F2d 1382 (Ct.Cl. 1973).

[10] See Note 4, *supra*: "Novation Agreements and Change of Name Agreements. DAR 26-402(b) is revised to add an example to clarify the application of the policies and procedures in 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 situations." 49 FR 26925.

[11] 42-1204(c).

[12] FAR 42-1204(d)(1) to (3).

[13] As early as 1958, when the novation agreement at issue in *Sundstrand Turbo v. United States,* 389 F.2d 406, 411 (Ct.Cl. 1968) was negotiated, the following clause was included:

> " 7. The Transferor and the Transferee hereby agree that no claim for payment by or reimbursement from the government shall be made by either of them with respect to any costs, increased taxes, or other expenses arising out of or attributable to (i) said assignment, conveyance and transfer, or (ii) this Agreement, other than those which the government would have been obligated to pay or reimburse under the terms of the Contracts in effect prior to the execution of this Agreement."

The government, apparently operating on the principle that there is no point in changing what has worked so far, has varied the clause only slightly in those later novation agreements which the author has reviewed.

[14] "(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) raising capital... 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 counsellors, 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." (Emphasis supplied.)

Therefore, even the costs of measures commonly used to make a corporation—including possibly a government contractor—more capable of resisting a takeover (which would generate unallowable costs under the quoted language) are also unallowable. However, the government must at some point recognize a distinction between the costs incurred in initiating or changing the form of an organization and those costs later incurred in administering the organization in its new form. Finally, the costs of planning operations of a new company created by a merger or acquisition are probably not included in this category of unallowable costs. See *Stanwick Corp.*, ASBCA No. 18083, 76-2 BCA Para. 12,114.

[15] 822 F.2d 1573, 48 FCR 36 (CA FC 1987).

[16] *Id.* at 1574.

[17] See, *Gould Defense Systems Inc.*, ASBCA No. 24881, 83-2 BCA Para. 16,676 at 82,960 (1983) in which the board was considering the accounting changes made after the 1969 merger of Clevite Corp. with claimant Gould. The term "step-up" is also used as a noun to mean the difference between the book value of assets and the fair value.

[18] The court in *Marquardt* summarized the contracting officer's reasoning as follows:

> "... because Marquardt remained autonomous, it's [sic] assets should be depreciated on the basis of historical cost less residual value in accordance with Defense Acquisition Regulation (DAR) 15-205.9(a), and that the transaction did not meet the requirements of DAR 15-205.9 for depreciation based on price. The ACO also stated that the amount of write-up claimed was unreasonable and that the resulting cost increases were unallowable because the stock acquisition was not required for performance of a government contract. In the alternative, the ACO indicated that a novation agreement would be necessary in view of the stepped-up basis pursuant to DAR 26-402(b)(iii)," 822 F.2d at 1574. (Footnote omitted.)

[19] ASBCA No. 29888, 85-3 BCA Para. 18,245 *aff'd on reconsideration* 86-3 Para. 19,100:

> "Marquardt pointed out [to the board upon reconsideration] that relevant accounting literature, including Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 54 (SAB 54) and Internal Revenue Code Section 338 (IRC Sec. 338) require an acquired company's books to reflect the price paid for its assets when a stock acquisition occurs. Because ISC filed a consolidated tax return and elected IRS Sec. 338 treatment for Marquardt's assets... '[t]here is no rational basis to deny Marquardt the right to apply the same practice in accounting for its government contracts... " 822 F.2d at 1576.

[20] 822 F.2d at 1575 (Federal Circuit, reviewing the government's arguments before the ASBCA). According to the court, the government's further arguments before the board essentially reiterated the ACO's position.

[21] 86-3 BCA Para. 12,100 at 96-549.

[22] *Id.*

[23] The court did not identify the edition of the DCAA manual from which it quoted this provision.

[24] ASBCA No. 24881, 83-2 BCA Para. 16,676.

[25] 822 F.2d at 1580-81.

Note that, because Gould's acquisition of Clevite was completed in 1969, the applicable statement of accounting principles was Accounting Research Bulletin 48, "Business Combinations," January 1957, (ARB 48). ARB 48 significantly differs from APB 16, by which it was superseded in August 1970. Also, in 1984, Federal Acquisition Circular 84-3 amended the FAR by adding 31.205-49, which provides as follows:

> "Goodwill, an unidentifiable, intangible asset, originates under the purchase method of accounting for a business combination when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. The excess is commonly referred to as goodwill. Goodwill may arise from the acquisition of a company as a whole or a portion thereof. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable." See 49 FR 26743 (6/19/84).

[26] 822 F.2d at 1581.

[27] 389 F.2d 406 (Ct.Cl. 1968).

[28] 425 F.2d 1237 (Ct.Cl. 1970).

[29] 389 F.2d at 411.

[30] 425 F.2d at 1239.

[31] "[O]ur plaintiff not only claims the power to predict [Chance Vought's] *total* cost of performing the instant CPFF contract..., but even more questionable is its casual assumption of the prescience necessary to perform *individual* cost offset refinements... Confounding plaintiff's scheme beyond redemption... is its insistence on offsetting measurable cost increases... against uncertain cost savings as well." *Id.* at 1242. (Emphasis in original.).

[32] For example, in one executed Novation Agreement, the Transferee agreed to indemnify the government from any claim which the acquired company might have had arising out of pre-acquisition contracts and, additionally, agreed to give the government 60 days advance notice of any proposed transfer of all or any portion of the assets or divisions of the acquired company above a specified dollar value. In another Novation Agreement, the acquiring company agreed to limit the business of the subsidiary through which it had acquired a previously independent government contractor and to continue "participating" in a particular program, even committing itself to submit a response to a Request for Proposal for that program when that RFP had not yet been issued.

[33] 83-2 BCA Para. 16,676 at 82,972.

[34] 83-2 BCA at 83,973.

[35] 48 FCR 767.

fostering dependence and weakening incentives to develop managerial skills, he said.

Pendleton said he supports the provisions in HR 1807 to eliminate fraud and corruption in the 8(a) program, as well as other provisions to improve program efficiency, such as expanded funding for training and incentives for program administrators in managing 8(a) portfolios (47 FCR 530).

However, he scored the bill's numerical system for evaluating a company's competitiveness and progress. Numerical standards would be used to admit firms into the 8(a) program, to terminate participation, and to graduate them through successive stages and ultimately out of the program. However, this system also expands significantly the scope of federal assistance to 8(a) firms, most notably by doubling the maximum participation period from seven to 14 years, he said. The aid may take the form of grants, technology transfer, and antitrust exemptions. These provisions "create a complex system for micromanaging the progress of participants toward competitiveness," he maintained.

The commission chairman told the panel he had no quarrel with efforts to restructure the 8(a) program, so as to encourage growth of minority firms. However, extending the maximum 8(a) participation period "will tend to increase the dependency of these firms of federal protection," he said. Fewer firms will thus be able to enter the program, he warned, adding that SBA would have to focus more resources on a small number of companies. Rather than pumping more resources into a few existing firms, it "would be far better to shorten program participation to a maximum term of five years," Pendleton concluded, noting that this could be divided into "developmental" and "mainstreaming" stages, similar to those contemplated by HR 1807 (47 FCR 530).

"I support the intention of restricting the program to maximize its effectiveness and to limit the possibility of abuses such as minority-front companies and inappropriate use of consultants," Commission member Mary Frances Berry said.

Berry also praised the bill for its balanced approach to resolving 8(a) program administration problems, including entry and termination. The issue is not a fixed number of years in the program, but insuring eligibility of small disadvantaged firms and helping them to become competitive, she explained. A termination procedure is necessary to remove firms that, according to competitiveness criteria, seem to be losers, she conceded. "Space can therefore be made for other, better prospective owners to enter the program."

HR 1807's provisions to curb 8(a) abuses are "especially significant." according to Berry. Prohibiting SBA employees from owning stock in 8(a) firms and from participating in the management of 8(a) companies should help eliminate some of the opportunities for politicization, she observed. Requiring 8(a) firms to report use of consultants and others to obtain contracts should reduce the pattern of buying influential former and current political officials, she added. In addition, increasing the penalties for fronts to $100,000 should "cause some second thoughts" among abusers, Berry concluded.

### Fostering Minority Business

"It should be unnecessary to remind an agency of its responsibility to enforce a law as Congress initially intended it to be enforced," former House Small Business Chairman Parren Mitchell told the panel. Yet SBA has consistently proven that such legislation is needed, he commented. The agency continues to mismanage the 8(a) program, thus thwarting Congress' intent, he declared. "Our goal to create viable minority-owned businesses within a reasonable period of time was ignored."

Mitchell, who testified on behalf of the Minority Business Enterprise Legal Defense and Education Fund, praised the provisions in HR 1807 that are intended to depolicitize SBA. "They will be a deterrent to those who seek to abuse the program by establishing front companies," he said.

Rev. Jesse Jackson, also testifying at the hearing, endorsed the 8(a) set-aside as morally sound policy. The program is the most fair, most orderly way of including minority firms that have been "locked out" without doing violence to the Constitution, Jackson said.

However, the oft-controversial civil rights leader criticized the government for helping foreign nations become competitive, while telling small and disadvantaged domestic firms that they are no longer eligible for assistance. "HR 1807 provides developmental assistance at the beginning and at the transitional stage for those businesses that are about to become totally independent; this is protecting the government's investment and lessening the risk of failure," he said.

### Outlook

The subcommittee held a second hearing on HR 1807 last Thursday, with small business trade associations and former 8(a) companies testifying in support of the measure. The panel has set more hearings this week. Representatives from the General Accounting Office, SBA will testify May 20; DOD, NASA, and GSA officials will testify the following day.

HR 1807 sponsor Mavroules plans to move the bill quickly out of subcommittee, but conceded at the May 12 hearing that some changes might be made to win Republican support at the full committee level. "The bill is not perfect," he said, referring to the fact that the subcommittee's ranking minority member, Rep. Silvio Conte (R-Mass), does not support HR 1807 as drafted.

## *Allowable Costs*

## FAR COUNCILS PROPOSE RULES DISALLOWING 'GOLDEN PARACHUTES, HANDCUFFS'

The Defense Acquisition Regulatory Council and the Civilian Agency Acquisition Regulatory Council last week proposed regulations to specifically bar contractors' recovery of costs for "golden parachutes" and "golden handcuffs" — arrangements that guarantee lucrative compensation for top corporate executives in the event of a takeover.

DOD's policy has been that such costs are not allowable because they are neither reasonable nor benefit the government (47 FCR 481). The proposed rules make the costs explicitly unallowable.

The proposal would amend the FAR cost principle on compensation, 31. 205-6 to state:

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they 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."

The proposed rule also would revise Section 31.205-27, Organization costs, to disallow the costs incurred in resisting a takeover:

(a) Except as provided in paragraph (b) of this subsection, 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.

Comments on the proposed rule are due by July 13, and should be sent to General Services Administration, FAR Secretariat (VRS), 18th & F Sts., N.W., Room 4041, Washington, D.C. 20405. Cite FAR Case 87-19.

### Allowability of Trade Meeting Costs

A proposed rule narrowing the cost principle on allowability of costs incurred for trade and professional meetings also was issued May 13 by the FAR Councils. The proposal, which would revise FAR 31.205-43 on trade, business, technical and professional activity costs, is necessary due to the "proliferation" of nongovernment sponsored seminars that could result unreasonable costs being charged to government contracts, the Councils said.

The proposal would differentiate costs for attendance of contractor employees and those for noncontractor personnel, and would specifically cover the costs of organizing and sponsoring a meeting. The proposed revision of 31.205-43 (c) states:

The following types of costs are allowable:

(c) When the principal purpose of a meeting, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information, or the stimulation of production or improved productivity:

(1) Costs of organizing, setting up and sponsoring the meetings, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental and directly associated costs.

(2) Costs of attendance by contractor employees, including travel costs (see 31.205-46).

(3) Costs of attendance by noncontractor personnel provided (i) such costs are not also reimbursed to the individual by the employing company or organization, and (ii) the individual's attendance is essential to achieve the purpose of the conference, meeting, symposium, etc.

Comments on the proposed revision to the cost principle governing trade meetings also are due July 13 and should be sent to the above address. Cite FAR Case 87-18 when commenting on the allowability of trade meeting costs.

***Liability***

## SENATORS PROPOSE IG OVERSIGHT IN PLACE OF PENALTIES UNDER DOE CONTRACTS

Rather than imposing hefty civil and criminal penalties to ensure that contractors comply with safety regulations at the Department of Energy's nuclear facilities, a DOE Inspector General will be charged with oversight of contractor safety compliance, under a proposal to be offered by Sens. Bennett Johnston (D-La) and James McClure (R-Ind).

Johnston, the chairman, and and McClure, the ranking minority, of the Senate Energy and Natural Resources Committee, will offer their proposal as a substitute for provisions now included in S 748 that provide for civil penalties of up to $30 million, as well as criminal penalties, for contractors operating government-owned nuclear facilities who "knowingly and willfully" violate safety regulations.

The Johnston/McClure proposal was prompted by strong objections to the penalties from the Department of Energy and DOE contractors.

According to a committee aide, making the IG responsible for safety oversight is "an attempt to find another mechanism besides penalties" to strengthen contractor compliance with DOE safety regulations.

The proposal, expected to be offered when the committee continues consideration of S 748 this week, may also include some reduced penalties for noncompliance, the aide said.

### Price Anderson Amendments

S 748, introduced by Johnston, would reuthorize the Price Anderson Act, sections of which expire Aug. 1. The Act provides for public compensation in the event of an accident at a DOE nuclear facility, and provides for a system of government indemnity for contractors operating DOE nuclear facilities under government-owned, contractor-operated contracts.



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# *Case Management Record*

| DAR Case No. 84-18 | CAAC No. | Original | | Date 10-12-88 |
|---|---|---|---|---|
| | | Updated | ✓ | |

**Title** ACCTG FOR MERGERS AND OTHER BUSINESS COMBINATIONS

**Reference** CCP Report 10-12-88

**Synopsis**

| Priority | Submitted By A1 | Originator Code | Case Manager A. |
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| Keywords | | | |

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| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | CCP | | | |

**Recommendation** DISCUSSION 9 NOV 88

**Notes**

B

**DEPARTMENT OF THE ARMY**
**HEADQUARTERS, U. S. ARMY MATERIEL COMMAND**
**5001 EISENHOWER AVENUE, ALEXANDRIA, VA 22333-0001**

UNITED STATES CONSTITUTION BICENTENNIAL 1787 1987 DEPARTMENT OF DEFENSE

OCT. - 1988

DAR Staff
Case 84-18B

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. PROBLEM:

To review and make recommendations relative to the comments received in response to the October 28, 1987 Federal Register notice statement which expressed the Defense Acquisition Regulatory and the Civilian Agency Acquisition Councils' concern about whether the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. More specifically, whether the Government should recognize depreciation or cost of money flowing from asset write-ups that result if the "purchase method" is used to account for the business combination. For ease of reference we have enclosed at Atch 1, our previous report of February 4, 1987, and at Atch 2, the Cost Accounting Standards (CAS) Policy Group's report of July 20, 1987.

II. RECOMMENDATIONS:

A. That FAR 31.205-10, 31.205-11, 31.205-16 and 31.205-49 be revised as shown at Tab A and published as proposed rules.

B. That FAR 30.404 and 30.409 be revised as shown in Tab B and published as proposed rules simultaneously with the proposed rules in paragraph A above. This revised language is consistent with that proposed by the CAS Policy Group in their report of July 20, 1987.

C. That the DAR Council seek a legal review of the language shown in Tab C, revising FAR 31.109 and 42.12 and decide on the appropriate course of action in light of the Committee's comments in Section III.C.1.

D. That upon approval of Tabs A, B, and C the memorandum at Tab D and the related document at Tab E be forwarded to the CAAC.

III. DISCUSSION:

A. BACKGROUND.

This case began life as 84-18, Accounting for Mergers and Other Business Combinations. We had previously reviewed the pertinent issues and forwarded recommended coverage to the DAR Council by memorandum dated February 4, 1987. Since the proposed coverage included changes to the CAS the DAR Council decided to sever those cost principles that could stand alone from those that were associated with the revisions to CAS. Thus, two cases were established; 84-18A, Organization Costs and Compensation Incidental to Business Acquisitions, and 84-18B, Accounting for Mergers and Other Business Combinations. Case 84-18A addressed golden parachute and handcuff costs (FAR 31.205-6) as well as certain organization and reorganization costs (FAR 31.205-27). These changes were published as a final rule in FAC 84-35, April 1, 1988. The other case, 84-18B, was forwarded to the CAS Policy Group for their consideration of the combined cost principles and CAS changes that were impacted as a result of the Committee's proposed rule to limit the write-up of assets when the "purchase method" is used to account for mergers and other business combinations. The CAS Policy Group's recommendations have been incorporated in the proposed language except for minor editorial changes.

The proposed language pertaining to asset write-ups contained in our February 4, 1987 report (Case 84-18) to the DARC was not published as proposed rules. However, the DARC and the CAAC published a notification of their intent to develop a rule in the Federal Register of October 28, 1987.

Thirty comment letters were received in direct response to the October 28, 1987 Federal Register notice. The Committee also incorporated comments included in two discussion papers, one appearing in the Federal Contracts Report of March 7, 1988 and the other prepared by Pettit & Martin and delivered during a presentation at an American Bar Association Conference of October 1, 1987 by the ABA's Section on Public Contracts. Additionally, a meeting was held with the American Institute of Certified Public Accountants (AICPA) on June 17, 1988, as requested by them in their letter. They believed that a discussion would be more beneficial than written comments. We have referenced their verbal comments where appropriate but have not increased our total count of documents reviewed to avoid double counting. The adjusted count of 32 breaks down as follows: 15 had no comment; 4 concurred; 9 nonconcurred; and 4 indicated partial objections. A matrix which groups the comments in broad categories is included as an APPENDIX to this report. The comments are discussed below by topic and numbered as in the matrix.

B. Specific Comments.

1. Real Cost/Generally Accepted Accounting Principles (GAAP).

Davey Compressor Company, Vincent T. Noone, American Institute of Certified Public Accountants (AICPA), Emerson Electric Company, American Bar Association (ABA), Steiger and Evans, and Pettit & Martin objected to any prohibition on the allowability of asset write-ups that result from a business combination when the "purchase method" of accounting is used. They point out that the cost to the acquiring company is the purchase price paid for the acquired company. This cost determines the fair market value of the purchased assets. If the acquiring company expends more to acquire a company than the recorded (book) value of the acquired company's assets, the assets are stepped-up to their fair market value. This stepped-up amount then serves as the basis for future depreciation (future depreciation being that post-dating the acquisition). Futhermore, the "purchase method" is mandated by GAAP through Accounting Principles Board Opinion No. 16 (APB 16), except in limited circumstances which have no bearing on this particular discussion. Additionally, the Cost Accounting Standard at FAR 30.404 recognizes the "purchase method".

Committee Comments.

The Committee believes 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 revaluation resulting from business combinations, thereby recognizing altered depreciation and facilities capital cost of money amounts in accounting periods subsequent to the acquisition. Under this approach equity should be 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.

In choosing between these two broad approaches, the Committee 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.

In view of this, the Committee believes that extending the "depreciation capture" 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 overall.

Indeed, for precisely this reason, the ASPR Committee provided expressly for the abandonment of this approach, and the substitution of the 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" 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? 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 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 event will also result in no "gain" or "loss", and no attendant credit or charge for Government contract costing.

2. Competition.

Avco Research Laboratory, the Council of Defense and Space Industry Association (CODSIA), AICPA and the ABA have averred that cost and price increases will be controlled by the competitive forces of the market place and not by the suppliers' ownership. Additionally, the Government, by rejection of the purchase method of accounting, seeks to to place itself in a more favorable position than commercial customers.

Committee Comments.

The Committee was also influenced by considerations of the competitive market place, or more accurately, the lack thereof. In juxtaposition to those opinions expressed in the foregoing, the Committee perceived 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. Commercial prices are normally set by operation of the marketplace. Thus, commercial customers would not suffer an increase in price solely because of a change in ownership, and the Government would.

3. Capital Generation.

McKenna, Conner & Cuneo; the American Defense Preparedness Association; CODSIA; ABA; Steiger and Evans; and Pettit & Martin have made two major points. First, that the objective of business combinations is to generate capital. One method of acquiring capital is by stepping up asset values. The imposition of limitations on the revaluation of assets severely depresses the attractiveness of aerospace and defense oriented companies in the marketplace. Second, the additional implication is that since the proposed rule does not permit recovery of the cost of the investment in the acquired entity it will result in a disincentive to invest in defense assets and thereby shrink the defense industrial base and increase Government procurement costs.

Committee Comments.

With respect to the first point the Committee believes that the price of a target company largely reflects its future profitability. Asset valuations are only a small part of that assessment. The market value of companies, including those with defense orientation, is based partially on the cash flow they generate. To the extent that a defense company's value has been artificially inflated by anticipation of the Government paying increased depreciation expenses for assets after one firm is acquired by another, the draft coverage will return the market value of the firm to a value based on the real worth of the company and not one created by the Government peculiar cash flow. The argument concerning contractor investment in the industrial base is the more serious one; it also is an even more persuasive reason to adopt the Committee's recommended position. When a defense firm is acquired and its assets written up, the Government not only pays depreciation on an asset it may have already substantially paid for, but it is also paying depreciation on an old existing asset. No change in productivity has occurred. The net result is an increase in unit cost to the Government through higher overhead expenses and the likely resultant decrease in quantities purchased and deployed. Productivity and modernization come from firms investing in new assets, not acquiring and inflating the write-offs on old ones. In fact, money that goes to acquire existing firms at high prices is being diverted from investment in new plant and equipment which is the only real hope for increased productivity in the defense industrial base. The fact that firms are, in numerous cases acquiring actual or potential competitors and thereby shrinking the industrial base by the very act of acquisition should also be noted.

The complaint that a no-write-up rule is unfair to the acquiring contractor is in the Committee's opinion flawed. The argument seems based on the false premise that an asset write-up without a disposal credit would ever be acceptable to the Government. However, the determination of financial advantage is not so simple or clear-cut when the immediate "depreciation recapture" is taken into account. It is perfectly possible for this credit approach to be more disadvantageous to the acquiring contractor than the no-write-up rule.

4. Novation.

McKenna, Conner, and Cuneo; Vincent T. Noone; Emerson Electric Company; CODSIA; the ABA; and Steiger and Evans asserted that 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. Additionally, they support clarifying FAR 42.12 to protect the Government on existing contracts and to reduce the opportunities for the Government to secure concessions on unrelated points.

Committee Comments.

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.

Comments regarding changes to FAR 42.12 are contained in Section III.C.1., Additional Committee Comments.

5. Requests Meeting.

The AICPA posited that this subject presents significant legal, business, and economic issues which should be addressed by discussion with the Committee.

Committee Comments.

A meeting was held with the AICPA on June 17, 1988. It is the Committee's opinion that no new issues were introduced by the AICPA. The AICPA's representatives agreed that they would subsequently summarize and submit their comments. Since they have not yet done so we presume they will be received in response to the draft language.

6. Recognition of Gain Sharing.

The DoD/IG postulated that the excess of the selling price received over the stated net book value is a gain to the sellers in which the Government should share.

Committee Comments.

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 and thus there is no need, generally, for recognition of gain sharing. However, in those cases where asset revaluations are recognized, provisions have been made, as suggested by the DOD/IG for the Government to share in the gain to the extent that it represents excess depreciation.

7. Strengthen Novation.

The DoD/IG has proposed that increased costs on current contracts can be avoided through the proper use of novation agreements.

Committee Comments.

The Committee concurs with the DoD/IG comments. Reference our previous discussion under paragraph 4.

8. Appraisals.

The DoD/IG propounded the idea that 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.

Committee Comments.

The IG's suggestion called the Committee's attention to a situation that is evolving faster than the regulatory system's recent ability to respond. The DCAA Member has advised the Committee that, more and more often, her agency is encountering the capitalization of a broad range of newly-created assets on the books of acquiring concerns. The values being capitalized cover such concepts as profits yet-to-be realized on existing backlog,software programs, patents, or aggregated values of small tooling.

The tactical reasons for going this direction and their supporting arguments are easily understood. Goodwill has been unallowable for several years now. Currently, the Government has announced its intention to address the "problem" of upward asset revaluations attendant to a merger. The "jaw-boning" process that has virtually eliminated asset revaluations in large transactions and existing drafts of attempts to codify these policies have made it common knowledge that the Government intends to settle for no less than either no asset write-ups or an equitable immediate credit for the disposal gains. In these circumstances, a newly-created asset seems the perfect safe haven. If the asset did not exist on the books of the acquired company, its valuation cannot be a revaluation. If it had no prior existence as an asset, the consumption of its value was never recognized as depreciation. Therefore, the limitation on disposal gain recognition (i.e., to depreciation previously taken) is zero. The argument concludes that the Government must recognize the depreciable base for the new asset and has no right to a disposal credit, if its appraised value is reasonable.

Despite the superficial appeal of the foregoing argument, it is logically wrong. To grasp why it is wrong, the logic behind the recognition of the disposal gain must be examined. To begin with, the depreciation is intended to provide a reasonable measure of the consumption of an asset's value. When an asset is sold at a price that is greater than its depreciated book value, it can be concluded that too much depreciation was taken over the service life of that asset. The disposal credit corrects the books and recaptures the excessive depreciation.

Creation of a new asset creates a dilemma for the contractors doing so. Putting aside accounting conventions and complexities, at the instant of the combination transaction, the asset in question either does or does not have the value attributed to it in the acquiring entity's appraisals. Obviously, if it does not, the asset should not be recognized. However, if the asset is a reasonable entry on the books of the acquiring entity, then it follows that the books of the acquired company were wrong at the instant of the transaction and stand in need of correction in the form of an equivalent disposal credit. It is reasonable to assume that efforts to generate the value being newly-capitalized were expensed (i.e., instantly and completely depreciated) by the acquired entity when they were incurred. In most circumstances, Government contractors are naturally motivated to expense rather than capitalize simply to recover cost faster. Were the Government to permit a newly-created asset to be capitalized and subsequently depreciated without insisting on a comparable disposal credit, it would be sanctioning a redundant cost recovery. The Cost Principles Committee has provided new coverage for placement at 31.205-49(a)(2)(iv) that is intended to preclude such duplicate recovery.

9. <u>Case-by-Case Benefits</u>.
GAO advocated the concept that 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.

<u>Committee Comments</u>.
The Committee concurs conceptually with the GAO that asset revaluations can be allowed on a case by case basis but not necessarily for the reason cited by GAO; e.g., lower unit costs. The Committee has difficulty in subscribing to any lower cost theory put forth by a contractor since the genesis of the case was to preclude mammoth cost increases on our contracts resulting from mergers and other business combinations. Examples of the parameters under which the Committee would recognize write-ups follow.

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". 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". 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 a cost recapture 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 revaluations is automatic.

10. Marquardt and Related Cases

Several commenters addressed the Marquardt Case (ASBCA 29888 and CAFC 86-1546) in varying ways. Before dealing with the comments, the Committee notes that the case itself, although ostensibly a Government victory, carries an enormous potential for creating other problems.

The facts of the case were that Marquardt was sold by its parent, CCI Corporation, to ISC Electronics in a stock transfer with no subsequent change in the legal or management form of Marquardt. After having first obtained the cognizant ACO's concurrence that a novation agreement was not required because "...the sale involves a transfer of stock, not assets...", Marquardt subsequently presented the Government with a bill representing stepped-up asset values based upon the price paid by its new parent. The Government resisted the increased costs and the issues were drawn in a classical confrontation between legal form and transaction substance. Marquardt's case was rooted in APB 16 which requires the "purchase method" of accounting for such transactions. The Government based its case upon the reasoning behind the agreement reached earlier that no novation had been necessary; i.e., that Marquardt was the same entity before and after the transaction. The Government prevailed at both the ASBCA and the CAFC. In a disquieting dissent to the Appeals Court decision, Judge Bissell noted the narrow basis upon which the majority decision had separated itself from the Gould Case (ASBCA 24881) in which the contractor had prevailed on the allowability of the purchase price assigned in the form of both stepped-up asset values and goodwill. Judge Bissell indicated that the "purchase method" of accounting would have been available to Marquardt if only they had legally combined the corporate structures of parent and subsidiary as had Gould. The dissent went on to point out that such a rule protects the Government from virtually nothing and invites the incurrence of otherwise pointless legal costs simply to qualify the stepped-up costs for allowability under Government contracts.

The Committee believes the danger to the Government extends far beyond that envisioned by Judge Bissell. Primacy of legal form over accounting substance would invite the worst kind of legal gerrymandering aimed at producing those cost allocations which maximize a contractor's return. The Government has a long-standing policy of basing its cost calculations upon organizational reality rather than legal form. The DCAA Contract Audit Manual reflects this policy when it discusses procedures regarding the inclusion of segments in a home office allocation base at paragraph c of 6-606.5, Allocation Bases for Corporate/Home Office Expense:

> To evaluate the bases used by the contractor to distribute home office expenses, the auditor should carefully review the organizational structure and operations of the corporate office and each corporate segment, including details of the type of service and support rendered by the corporate office to each segment... the corporate/home office auditor is responsible for the necessary reviews of segments not involved in government contract work. The objective is to see that the contractor's allocations proportionally distribute home office costs to all segments of the business on the basis of the relative benefits received. Use the applicable contract cost principles (such as FAR 31.201-4, 31.202, and 31.203) as criteria to evaluate the contractor's method.

The FAR subsection and sections referenced by the audit manual are respectively captioned "Determining allocability", "Direct costs", and "Indirect costs". It is noteworthy that nowhere in any of that coverage is there the slightest hint that legal form plays any part in the determination of an appropriate structure for calculating Government contract costs. The audit manual goes on to reinforce that specific point at 6-606.5e:

> The form of the business (foreign or domestic), the extent of ownership (wholly- or partially-owned), or the accounting treatment for financial accounting purposes (consolidated or unconsolidated) are not basic criteria for determining whether a particular segment should be included in or excluded from the residual allocation base....

In the Committee's opinion, the Government would not be well advised to employ the Marquardt decision as any part of the solution of merger problems.

Four commenters referenced Marquardt and other related cases in their comments. Three of them (ABA, Pettit & Martin, and

Norman A. Steiger) were written from the legal perspective. The fourth (Mr. Vincent T. Noone) commented from an accounting and costing policy perspective.

The ABA mentioned Marquardt only as a footnote to their discussion of the Gould case which they cited as being consistent with widely accepted accounting practices and case law in general. They noted that the Government did not dispute the validity of the "purchase method" of accounting but only its application to the acquired entity and that the Court also upheld the "purchase method" and its application to the purchaser but not the acquired entity. They conclude that "In light of its longstanding acceptance and use in Government contract accounting, any change contemplated by the CAAC and DARC should not modify or eliminate the purchase method of accounting without careful study." They also object to the practice in recent years of going beyond the regulations and requiring advance agreements that the assets will not be stepped-up.

The Committee believes that the ABA has correctly described generally accepted accounting practices as well as the case law. We do not believe that these facts warrant the conclusions drawn by the ABA. They clearly do not see the problem that we do when our prices are increased because of an acquisition transaction. As to whether this case is receiving careful study, the case originated in 1984. It would be difficult to categorize any policy action finally taken as impulsive. One of the primary purposes of the proposed coverage was to codify actual practice. The Committee believes that most large and well-noticed acquisitions in recent years have resulted in agreements that the assets would not be revalued. We agree with the ABA that it would be better to have our actual practices spelled out in the regulations so that they would apply more consistently to all mergers. That is what our prior proposal tried to do.

Mr. Smith of Pettit & Martin has also set forth the particulars of the Marquardt case. He seems to conclude that Marquardt has settled the issue of asset revaluation for stock purchase acquisitions with a standard that would require novations when the acquired entity has been legally restructured as part of the acquirer's organization. When a novation is required only existing contracts would be charged depreciation at levels which have not been stepped-up. Otherwise, all new contracts may be charged depreciation representing the increased asset values. On the other hand, when a novation is not required because the acquired entity has not been legally reorganized, existing assets can never be written up. Mr. Smith described Judge Bissell's dissent in a footnote without comment.

Mr. Smith is one of the relatively few commenters who dealt at all with the topic of a disposal gain in a merger transaction.

Once again, we have no problem with Mr. Smith's description of the evolution of the relevant cost principle and CAS coverage, much of it apparently gleaned from the Committee's report on this case. However, noticeably lacking from Mr. Smith's conclusion that disposal credits resulting from merger transactions are a somewhat freewheeling matter that is to be decided on a case-by-case basis utterly lacking in guidelines or rules is the common sense linking of an asset revaluation (because something was bought) with a disposal credit (because something was sold). Nor does Mr. Smith evidence any concern with the equities of those situations in which a disposal credit falls upon a fixed-price universe.

Mr. Norman Steiger also noted Sundstrand (Ct. Cl. 1968) and LTV (Ct. Cl. 1970), which while they involved the issue of asset write-ups, did so under the more limited scope of interpretation of novation agreements and their impact upon the novated contracts. Issues involved were such things as the meaning of "any costs" and whether other cost economies resulting from the merger could be netted against depreciation increases. The Government received a favorable ruling in both of these cases. Mr. Steiger concludes "It's obvious... that the Government will not concede the right of any acquired or acquiring corporation to step up the value of the assets... on any contracts which predate that transaction." Mr. Steiger appears to take great care to not expand the discussion to the revaluation of assets for contracts entered into after the acquisition transaction. He bemoans the fact that options exercised after the transaction, but whose rights were acquired in a pre-transactional contract, are covered in the novation restriction. Under that narrow focus, he argues against the requirement for two sets of depreciation records and the asset resale value impingement. These arguments would seem more appropriate with regard to the larger avoided issue, asset revaluation on contracts which post-date the acquisition.

Mr. Vincent T. Noone, faces the real issue of this case more squarely than his legal compatriots, and recommends a policy which reflects classical accounting theory, acknowledging that asset values would be increased for depreciation to post-acquisition contracts. Notably missing from Mr. Noone's paper is any mention of the correlated topic of disposal gains. Mr. Noone concludes that existing contracts should not receive depreciation reflecting stepped-up asset values but subsequent contracts should be costed at the increased values. He buys the result but not the reasoning of Marquardt. He is particularly critical of the reasoning that regards ISC as a disjointed third party unable to allocate the cost paid for Marquardt's assets to Marquardt's assets.

Mr. Noone suggests that novation agreements be required for all business combination situations including those achieved by a stock purchase. He would have those novation agreements protect the Government from all increased costs, not just depreciation. He believes that, were it not for CAS 404.50(d), the Government would be protected from increased costs on existing contracts. Mr. Noone would eliminate CAS 404 because it is a financial accounting standard and let the matter be governed by the pronouncements of the Financial Accounting Standards Board. He would position his basic rule (i.e., write-ups and cost of money are OK for the post-acquisition contracts) in the cost principles relating to organization costs and the cost-of-money. It is not clear to us what difference that would make. What is at issue here is the fundamental rule. In our opinion, none of these commenters tie the issues or the problems together in a cohesive way.

In the Committee's opinion, the case law cited is compatible within itself but the question remains as to what a sensible policy should be. According to the case law:

1. Where novation agreements are required, the stepped-up asset values cannot be charged to pre-existing contracts.
2. Novation agreements are required when the legal form of the organization with which we are contracting has changed.
3. Novation agreements are not required when the acquired company is not subsequently legally combined with the acquirer (stock purchase transaction).
4. When a legal combination is not carried out, the assets on the books of the acquired entity may never be written up, even for subsequent contracts.

It would be reasonable to conclude that where the premium over the book value is sufficient only a fool would save the legal cost of consummating a legal combination. That is a ridiculous standard for determining whether or not assets can be written up for purposes of costing to Government contacts. Surely, whether the acquirer's cost of the assets can be recovered is a more serious question than that. Disappointingly, none of these commenters made a serious attempt to tie together the substance of an asset disposal and an asset acquisition; we refer to the simple proposition that if something was bought, something must have been sold. There are only two choices as to how to view one of these transactions for contract costing and pricing purposes. We absorb the impact of the transaction in the contract prices on both ends or we do not.

In our opinion, the case law sheds little or no light on what a reasonable policy should be. However, failing to act in this case leaves the case law to govern. Acquirers can write up the assets if their legal papers are in order and the credits for the disposal gains are, at least arguably, if not equitably, not coordinated with the acquisition transaction. The recommendations advanced by the Committee in our earlier report on this case remain the best combination of equity and flexibility regarding these transactions.

C. Additional Committee Comments.

1. The DAR Council's taskings of February 24 and April 17, 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 previously to the DAR. 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 the 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 is obliged to point out that this whole issue lies outside its primary area of expertise. Accordingly, it is recommended that the DAR Council seek legal advice on it. However, in case the Council remains interested in pursuing the approach proposed by the Army and ADPA, the Committee has included some detailed comments and suggestions on their proposed coverage at TAB C.

The Committee also adds here that, should the Council decide that new FAR coverage is necessary to encourage or require advance agreements for these kinds of business acquisitions, there are other possibilities besides placing 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 advance agreements 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 C should the DAR

Council wish to pursue this course of action.

In any case, however, the Committee believes that the new cost principles coverage it is recommending elsewhere in this report will go a long way toward protecting the Government's interest in situations in which a Government contractor is acquired regardless of the form of the combination. 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 FAR language is enacted.

2. During Committee discussions on this case, the issue of repeated sales (or "churning") of an entity was raised. Some firms, or segments, have been sold, and then sold again. The concern was that repeated sales, whether real or sham, could lead to the evasion of the no write-up rule being established by this case. The last sentence in 31.205-49(a)(1), TAB A, as follows is intended to cover both single and multiple sale situations.

> In such situations, allowable amortization, cost of money, and depreciation expenses shall be limited to the amount that would have been allowed had the combination and subsequent revaluation or creation not taken place. (emphasis added)

The amount allowed after the first sale is the net book value of the acquired firm. This becomes the base value of the covered assets of the acquiring firm. This then flows through each subsequent acquisition as the amount allowed had a combination not taken place (minus depreciation or amortization taken based on continued use of the original schedule).

3. The Committee recommends that the CAS portion of the proposed changes be issued as proposed rules rather than exposure drafts. The Committee believes that the previously published background notice served as the exposure draft required for CAS changes and thus, the revised CAS language need not, in this particular case, be formally issued as exposure drafts. Additionally, this will preserve the continuity of the case since both the CAS and the cost principle changes must be processed concurrently.

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

Tom Luedtke
Chairman
Commercial Cost Principles
Committee

Commercial Cost Principles Committee Members

DOD Members

Terrence D. Sheppard, Air Force
Donald W. Reiter, DLA
Don Sawyer, OASD(P)CPF
Fran T. Brownell, DCAA
Harry Hindman, OASD(C)

Other Members

Jeremy F. Olson, GSA
Robert W. Lynch, NASA
Dave Erdman, DOE

cf: CAAC

Attachments
APPENDIX
1. CPC Report, Feb 4, 1987
2. CASPG Report, Jul 20,1987
TAB A - Proposed Changes to FAR 31.2
TAB B - Proposed Changes to FAR 30.4
TAB C - Changes for DARC Consideration
TAB D - Proposed Transmittal Memo to CAAC
TAB E - *Federal Register* Notice

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| | |
|---|---|
| Asset Acquisition Cost | $10 |
| Depreciation Method | Straight Line |
| Useful Life | 10 years |
| Date Asset Acquired | 1 January of year 1 |
| Disposal Date | 31 December of year 10 |
| Disposal Price | $15 |

| Depreciation Inflated | | | | | Cost of Money | |
|---|---|---|---|---|---|---|
| End of Year | Depreciation | Interest Rate (i) | n | $(1+i)^n$ | Average Net Book Value (Avg NBV) | Cost of Money (Avg NBV x i) |
| 1 | 1 | .07 | 9.5 | 1.902 | 9.5 | .665 |
| 2 | 1 | .07 | 8.5 | 1.777 | 8.5 | .595 |
| 3 | 1 | .07 | 7.5 | 1.661 | 7.5 | .525 |
| 4 | 1 | .07 | 6.5 | 1.552 | 6.5 | .455 |
| 5 | 1 | .07 | 5.5 | 1.451 | 5.5 | .385 |
| 6 | 1 | .07 | 4.5 | 1.356 | 4.5 | .315 |
| 7 | 1 | .07 | 3.5 | 1.267 | 3.5 | .245 |
| 8 | 1 | .07 | 2.5 | 1.184 | 2.5 | .175 |
| 9 | 1 | .07 | 1.5 | 1.107 | 1.5 | .105 |
| 10 | 1 | .07 | .5 | 1.034 | .5 | .035 |
| | | | | 14.291 | | 3.5 |

Present Recapture Rule:

| | |
|---|---|
| Book Gain | $15 |
| Depreciation Allowed | $10 |
| Recapture Credit | $10 |

Proposed Recapture Rule

| | |
|---|---|
| Book Gain | $15 |
| Inflation Adj. Depr. | 14.291 |
| Recapture Credit | 14.291 |

Recapture based upon depreciation (in nominal dollars) allowed plus cost-of-money

| | |
|---|---|
| Book Gain | $15 |
| Depreciation (nominal dollars) | $10 |
| Cost of Money applied | 3.5 |
| Recapture Credit | 13.5 |

# *Case Management Record*

A

| DAR Case No. | ~~GAAC~~ No. | Original | | Date |
|---|---|---|---|---|
| 84-18A | FAR 87-19 | Updated | ✓ | 1/22/88 |

**Title** Golden Parachutes/Handcuffs and Organization Costs

**Reference** Cost Principles Committee report of 22 Jan 1988

**Synopsis** Early action required to comply with 120 day deadline (4/2/88) of PL 100-180

| Priority | Submitted By | Originator Code | Case Manager N |
|---|---|---|---|
| **Keywords** | | | |

| | | | | |
|---|---|---|---|---|
| **Case References** | | | | |
| **FAR Cites** | | | | |
| **DFARS Cites** | | | | |
| **Cognizant Committees** | | | | |

**Recommendation** ~~Docket 2/3/88~~
Discussion 2-10-88

**Notes**

Ack 3/3/88

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18A

22 January 1988

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Golden Parachutes/Handcuffs and Organization Costs

I. PROBLEM:

To review and make recommendations related to the comments on the proposed rule which was published in the Federal Register on 13 May 1987.

II. RECOMMENDATIONS:

A. That FAR 31.205-6 and 31.205-27 be revised as shown at TAB A and published as a final rule.

B. That the memorandum at TAB B be used to transmit the final rule, together with the TAB C recommended Federal Register notice and the TAB D FAC Preamble, to the Civilian Agency Acquisition Council.

III. DISCUSSION:

A. Background.

On 13 May 1987 the CAA and DAR Councils asked for comments on proposed changes to FAR 31.205-6, Compensation for personal services, and 31.205-27, Organization costs, in order to clarify allowability policy. The proposed changes were prompted by a belief that there has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. Since there are situations in which companies recorded cost structures are directly reflected in the price to the Government, the Government should not bear the risk of paying higher prices simply resulting from a change or resisting a change in ownership; thus the proposed changes would make certain extraordinary compensation payments, commonly referred to as "golden parachutes" and "golden handcuffs," unallowable as well as those costs resulting from resisting or planning to resist reorganization of the corporate structure or controlling interest in the ownership.

B. Comment Summary.

Twenty comment letters were received. The attached APPENDIX lists the commenters and briefly quotes those comments which recommended revisions to the proposed rules. Seventeen commenters either had no objections or comments or concurred with the changes as proposed. Two commenters disagreed with certain portions of the proposed coverages and the remaining commenter nonconcurred in all changes.

C. Discussion of Comments.

1. The American Defense Preparedness Association (ADPA) had an objection in connection with novation and change-of-name agreements. They argue that these costs, even when resulting from objectionable costs of takeovers and mergers, are ordinary administrative costs and therefore should be allowable.

The Cost Principles Committee disagrees. These costs are not at issue in this case. Existing regulations already make costs of this type unallowable and it is not the Committee's intent to make them allowable.

2. The Council of Defense and Space Industry Associations (CODSIA) had several objections, to wit:

a. The language of the proposed cost principle regarding golden handcuffs is inconsistent with the background statement and would disallow payments which are neither extraordinary nor unreasonable. They recommend that the word unreasonable be inserted at 31.205-6(l)(2) preceding the words special compensation.

The Committee does not agree. Adding the word unreasonable duplicates coverage at 31.201-3 and 31.205-6(b) and would infer that there could be a reasonable golden handcuff payment. It is the Committee's intent to not permit recovery of any special payments incurred in conjunction with mergers or business combinations. For example, an individual was performing a job normally paid and objectively worth $50,000 per year, given the nature of the job's duties and responsibilities, but for good reason (e.g., to help the company through a rough financial period) accepted and was paid $30,000 per year. If the new owners immediately raise his pay to $50,000, this would not be considered a golden handcuff, but a pay raise to normal, i.e., reasonable, levels. However if the employee's pay is increased from $30,000 to $80,000 per year, but $30,000 of this amount is contingent upon the individual remaining with the company for a 3-year period, the contingent amount is the unallowable golden handcuff cost.

In order to more explicitly define golden handcuffs, we have revised the coverage at TAB A to more closely link the handcuff

payment to the requirement to remain with the company. Accordingly, we have changed "... 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" to read:

> "... in which those employees receive special compensation which is contingent upon the employee remaining with the contractor for a specified period of time."

b. CODSIA suggests that where the merger or acquisition benefits the Government, such costs should be allowable when they are otherwise reasonable and allocable. They recommend that subparagraph (a) of section 31.205-27 be modified accordingly.

The Committee does not agree. The Government has a longstanding policy against paying costs related to all forms of capital formation, including fundamental structural reorganizations. It is a given of Government contracting that a contractor comes forth prepared to perform the contract. A contract is not a vehicle to underwrite capital formation. The costs in question here are clearly related to such activities, and are being disallowed for that reason.

c. Using the same "reasonableness" rationale, CODSIA recommends use of a separate paragraph (b) for FAR 31.205-27 addressing the cost allowability vis-a-vis resisting or planning to resist any corporate reorganization or change in controlling interest and to also state that these costs are subject to the FAR 31.201-3 reasonableness criteria.

Again CODSIA would have us believe that a portion of these costs are subject to the reasonableness criteria while others are apparently not. Otherwise, why specifically state that the costs of resisting or planning to resist a takeover are subject to 31.201-3? The Committee is not convinced that these costs need treatment in a separate paragraph or that they require a direct linkage with 31.201-3, Reasonableness.

3. The Professional Services Management Association (PSMA) recommends that FAR 31.205-27 be deleted in its entirety and that a reasonable portion of "golden parachutes" and "golden handcuff" costs should be allowable since they are a necessary cost in today's business merger atmosphere. PSMA avers that the Government benefits from these activities and therefore should pay for them.

Other than PSMA's allegation that the Government benefits from such activity no evidentiary material is presented. The Committee has previously addressed similar comments and will not further belabor the point.

D. Consideration of Section 805 of P.L. 100-180, the DoD Authorization Act of 1988.

The Committee reviewed the language as contained in Section 805 of P.L. 100-180 and found it to be substantially the same as the proposed rule regarding "golden parachutes." Thus the Committee recommends adopting its previously proposed language. However, Section 805 makes no reference whatsoever to "golden handcuffs" or other organization or business combination costs. The Committee has discussed the significance of this omission and reached the conclusion that coverage of these areas remains necessary as stated in our background statement in the Federal Register notice of May 13, 1987.

E. Other Comments.

The Committee recommends deleting from 31.205-6(l) the sentences which begin "These arrangements are commonly known as 'golden ....'" They are slang terms which become outdated after a period of time, and also can become unduly limiting. It is possible that someone could develop a tin parachute or handcuff, or they could be described as being made of linen, paper, or plastic. We prefer to avoid the use of slang terms in the FAR. We believe the definitions are sufficiently precise to protect the Government's interest and, therefore, we have deleted these two sentences.

F. Summary.

The comments received generally concurred or did not object to the proposed rule. Only relatively minor issues, discussed above, were raised. We recommend only minor adjustments to our previous language and that a final rule be promulgated immediately without further public discussion.

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

JWErmerins

J. W. ERMERINS
Chairman
Cost Principles Committee

DoD Members

Edwin Cornett, Army
Terrence D. Sheppard, Air Force
Donald W. Reiter, DLA
Charles D. Brown, OASD(C)
Frances Brownell, DCAA
Donald Sawyer, OASD(A&L)/CPF

Other Members

Robert W. Lynch, NASA
William T. Stevenson, DOE

Attachments:
APPENDIX - Comment Matrix
TAB A - Ppsd Rev. to FAR 31.205-6 and 31.205-27
TAB B - Transmittal Memo to CAAC
TAB C - Ppsd Federal Register Notice
TAB D - FAC Preamble

SUMMARY OF COMMENTS
DAR Case 84-18A, Golden Parachutes/Handcuffs and Organization Costs
FAR Case 87-19

| | | No comment/ Objection | Concur/ Support | Nonconcur | Partial Objection |
|---|---|---|---|---|---|
| 1. | Federal Communications Commission | X | | | |
| 2. | USA Railroad Retirement Board | X | | | |
| 3. | U.S. Small Business Administration | X | | | |
| 4. | American Defense Preparedness Association | | | | X |
| 5. | National Labor Relations Board | X | | | |
| 6. | Agency for International Development | | X | | |
| 7. | U.S Department of Housing and Urban Development | X | | | |
| 8. | Panama Canal Commission | X | | | |
| 9. | National Endowment for the Humanities | X | | | |
| 10. | U.S. Department of Justice | X | | | |
| 11. | Office of GSA Acquisition Policy and Regulations (GSA) | X | | | |
| 12. | DoD Inspector General | | X | | |
| 13. | U.S. Information Agency | | X | | |
| 14. | Council of Defense and Space Industry Associations (CODSIA) | | | | X |
| 15. | Professional Services Management Association | | | X | |
| 16. | Pennsylvania Avenue Development Corporation | | X | | |
| 17. | U.S. Department of Agriculture | | X | | |
| 18. | Veterans Administration | | X | | |
| 19. | Office of Federal Procurement Policy | X | | | |
| 20. | U.S. Nuclear Regulatory Commission | X | | | |
| | TOTAL | 11 | 6 | 1 | 2 |

| Objections/Issues | Commenter |
| --- | --- |
| The costs to a contractor, over and above ordinary and normal expenses, resulting from acquisitions and mergers should not be charged to the Government as an ordinary expense in performing a Government contract. On the other hand, it should be made clear that expenses incurred in connection with novation and change-of-name agreements (FAR 42.12) are allowable, even when resulting from objectionable costs of takeovers and mergers. Such agreements are ordinary administrative costs affecting performance of the Government contract and therefore should be allowable. | American Defense Preparedness Agency |
| It is the opinion of the undersigned associations that the proposed language 31.205-6 (1)(2), disallowing the cost of "golden handcuffs," is unnecessary and, moreover, is inconsistent with the policy enunciated in the background statement preceding the proposed new cost principle. While the background statement defines "golden handcuffs" as "extraordinary payments above and beyond ordinary, customary, and reasonable compensation payments to employees for services rendered," the proposed cost principle would define any compensation in excess of normal pay as "golden handcuffs," or per se unreasonable and extraordinary. CODSIA agrees that the government should not have to reimburse extraordinary and unreasonable compensation payments, and thus agrees with the statement of policy offered as background to the proposed cost principle. However, the language of the proposed cost principle is inconsistent with this policy and would disallow payments which are neither inconsistent with this policy and would disallow payments which are neither extraordinary nor unreasonable. | Council of Defense and Industry Associations |
| Since the ultimate resource of the acquired company is its employees, the success of an acquired company is usually related to its | |

| Objections/Issues | Commenter |
|---|---|

ability to retain key people, such as certain management, technical and administrative staff (e.g., tax staff personnel) for a specific period of time after the acquisition. To disallow the reasonable cost of special compensation arrangements (i.e., completion bonuses) to retain such valuable resources of an acquired company would be detrimental to the acquiring company as well as its customers--in this case, the U.S. Government.

We recommend that allowability of such arrangements continue to be handled on a case by case basis, employing the "reasonableness criteria" already provided by FAR 31.201-3 and should not, out of hand, be deemed unallowable. Therefore, it is recommended that 31.205-6(1)(2) be revised to read as follows:

> "(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 received <u>unreasonable</u> special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time."

We suggest that in the judgment of the contracting officer, where the merger or acquisition benefits the government, their costs be allowable where they are otherwise reasonable and allocable. Subparagraph (a) of section 31.205-27 should be modified accordingly.

In this connection, and applying the same reasonableness criteria as discussed above, we recommend that the proposed revision to FAR 31.205-27 addressing the allowability of expenditures incurred in resisting or planning to resist any corporate reorganization or change in controlling interest

| Objections/Issues | Commenter |
|---|---|
| of a business be addressed in a separate paragraph (b) as follows:<br><br>"(b) Costs in connection with 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 are subject to the reasonableness criteria provided in 31.201-3." | |
| These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.<br><br>In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary and reasonable cost of doing business in today's business merger atmosphere (condoned by Congress). | Professional Services Management Association |

TAB A
DAR Case 84-18A

RECOMMENDED CHANGES TO FAR 31.205-6 AND 31.205-27

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 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.

(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 which is contingent upon the employee remaining with the contractor for a specified period of time.]

(m) Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) ~~below~~ [of this subsection], 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.

[ ] - New coverage.
~~words lined out~~ - coverage deleted.

TAB B
DAR Case 84-18A

PROPOSED TRANSMITTAL MEMO TO CAAC

MEMORANDUM FOR CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: DAR Case 84-18A (FAR Case 87-19), Golden Parachutes/ Handcuffs and Organization Costs

The DAR Council has approved revisions to FAR 31.205-6, Compensation for personal services, and FAR 31.205-27, Organization costs, to provide final rules under the subject case. The analysis of the public comments and the rationale supporting the proposed rule are contained in the attached report. If the CAAC agrees with our position, please forward the case to the FAR Secretariat for further processing and inclusion in the next Federal Acquisition Circular.

DUNCAN A. HOLADAY
Director
Defense Acquisition
Regulatory Council

Attachment

TAB C
DAR Case 84-18A

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31 (Federal Acquisition Circular 84-XX)

Federal Acquisition Regulation (FAR); Golden Parachutes/Handcuffs and Organization Costs

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

ACTION: Final rule.

SUMMARY: Federal Acquisition Circular 84-XX amends the Federal Acquisition Regulation (FAR) 31.205-6, Compensation for personal services, and 31.205-27, Organization costs.

EFFECTIVE DATE: ___________.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405. Telephone (202) 523-4755.

SUPPLEMENTARY INFORMATION:

A. Public Comments.

A notice of the proposed rule was published in the Federal Register on May 13, 1987 (52 FR 18159), recommending revisions to FAR 31.205-6 and 31.205-27 to control costs and clearly state the policy of the Government regarding the allowability of these costs. Of 20 comments received, 17 either concurred or had no

objection or comment. Two commenters partially objected with the proposed rules and one commenter totally disagreed. Minor editorial changes were made to the definitions of the proscribed costs, and the slang terms, "golden parachutes" and "golden handcuffs" were deleted.

B. Regulatory Flexibility Act.

The 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 business entities are awarded on a competitive fixed-price basis and cost principles do not apply.

C. Paperwork Reduction Act.

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because the changes to FAR 31.205-6 and 31.205-27 provide clarification as to the allowability of compensation for personal services and organization costs and do not impose any reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501 et seq.

LIST OF SUBJECTS IN 48 CFR PART 31

Government Procurement.

Dated: ________, 1987

Harry S. Rosinksi,
Acting Director, Office of Federal Acquisition and Regulatory Policy.

PART 31 -- CONTRACT COST PRINCIPLES AND PROCEDURES

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).

2. Paragraphs (l) of subsection 31.205-6 and (b) 31.205-27 are revised to read as follows:

(See approved version of TAB A)

TAB D
DAR Case 84-18A

RECOMMENDED FAC PREAMBLE

Item No. _____ - Golden Parachutes/Handcuffs and Organization Costs

There has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. The Government found that the previous cost principles at FAR 31.205-6 and 31.205-27, lacked specificity regarding certain costs. FAR 31.205-6 did not address the issue of special compensation in conjunction with a planned or executed merger or business combination. FAR 31.205-27 did not prescribe the treatment to be accorded costs resulting from resistance or planned resistance to the reorganization of the corporate structure of a business or change in the controlling interest in the ownership of a business.

The revised rules clarify the policy of the Government regarding these costs and specifically describes the costs which are unallowable. The revisions do not reflect or result from a change in allowability policy.

MANAGEMENT RECORD 7/21 7

ORIGINAL
UPDATED X

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

TITLE: Accounting for Mergers & Other Business Combinations

REFERENCE:

22 JUL 1987

ORIGINATION DATE: 22 July 87

SYNOPSIS:

CAS Working Group Report on Tab A, Part 3 of the Commercial Cost Principles report on subject case.

PRIORITY: | ORIGINATOR CODE:

KEYWORDS

CASE REFERENCES

| FAR CITES | 30.404-50 | 30.409-50 | 31.205-16 | | |
|---|---|---|---|---|---|
| DFARS CITES | | | | | |

CASE MANAGER: F | SUBCOUNCIL ASSIGNMENT:

COGNIZANT COMMITTEES | CAS | CCP

RECOMMENDED ACTION:

Discussion 5 Aug 87

22 JUL 1987

| BOX RECORD | 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION:

DEPARTMENT OF THE AIR FORCE
WASHINGTON, D.C. 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

July 20, 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. PROBLEM:

To review and coordinate on Tab A, Part 3 of the Commercial Cost Principles Committee (CPC) report on the subject case, dated 4 February 1987 and amended on 12 March 1987.

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 (CAS).

II. Recommendations:

That FAR 30.404-50(a) and (d); and 30.409-50(j)(1), (2), and 3 be revised as shown in Tab A-1.

That the last sentence of FAR 31.205-16(a)(1) which appears in Tab A, Part 3, p.3, of the CPC report of 4 February 1987 (Tab A-3) be changed as shown in Tab A-2.

That FAR 31.205-16(e) remain unchanged as shown in Tab A-2.

III. Discussion:

A. Revaluation of Assets

The Cost Accounting Standards Policy Group (CASPG) approached this problem with the objective of seeking the best policy for costing Government contracts. We concur with the CPC basic "no write-up" policy as being fairest to both the Government and the contractor.

The CPC correctly saw the problem of asset revaluations as having two possible solutions. Either the asset could be written up with an equitable recognition of the disposal gain or the transaction could be ignored for Government contract costing purposes. The CPC chose "no write-up" as the primary or default rule which will apply unless both parties can reach a satisfactory arrangement regarding the disposal credit. The CASPG also believes "no write-up" to be the fairest rule for the following reasons:

(1) Basing contract prices upon cost incurred is, at best, an unavoidable surrogate for a commercial price-competive marketplace. A supplier in a price-competitive marketplace could not successfully raise the price of his products because his company had been acquired by another corporation. The acquirer's investment cost would have to be recovered through other realized efficiencies or the deal is not likely to be done. It makes no sense to have the Government, as a customer, suffer a price increase because someone acquired its supplier, whether or not it is good financial accounting on the consolidated books of the acquirer.

(2) The pass through nature of the cost of revalued assets creates the circularity argument, i.e., a prospective takeover target would become more attractive if any increase in asset values could be passed on to the customer. This would drive up the cost of the acquisition of a defense contractor which would pass through to the Government in the form of increased depreciation cost despite whatever depreciation recapture takes place under current regulations.

(3) Congress expressed its feelings in the general area of revaluation of assets in Sec. 2314 of the Deficit Reduction Act of 1984. P.L. 98-369.

That law amends the Social Security Act to require that "... in establishing an appropriate allowance for depreciation ... with respect to an asset of a hospital or skilled nursing facility which has undergone a change of ownership, such regulations shall provide that the valuation of the asset after such change of ownership shall be the lesser of the allowable acquisition cost of such asset to the owner of record as of the date of enactment of this subparagraph ... or the acquisition cost of such asset to the new owner... Such regulations shall provide for recapture of depreciation..."

So Congress placed a legislative cap on the revaluation of hospital or skilled nursing facility assets after change of ownership to the lower of the predecessor or successor cost. The resulting cost of any increase in asset valuation dealt with above would be passed on to insurance companies in a non-competitive environment in a situation similar to the cost being passed to the Government in non-competitive defense contracting.

(4) The same general approach of using predecessor cost of assets is used in business combinations of public utilities and some other industries operating in a non-competitive environment where prices are regulated. In these industries an increase in the value of the asset base would be passed through to the customer as increased prices similar to the way they would be passed through to the Government in non-competitive defense contracting.

(5) The situations in reasons (a)(1) through (a)(4) above deal with business combinations made in a non-competitive environment where the cost of revalued assets are passed directly through to the customer as increased prices. Since price competition does not constrain the price paid for the acquired company, a pass through of the costs of the revalued assets to the customer usually does not achieve equity. While the disposal credit route may provide equity in some circumstances, it can also produce results that are grossly unfair to either of the contracting parties because of the mix of Government participation and contract types, or the fact that the increase in the revalued assets far exceeds the depreciation previously paid.

B. Changes to CAS 404

The CPC recommended that 30.404-50(d) and (e) concerning the "purchase method" and "pooling of interest method" of accounting for business combinations be eliminated in their entirety. The CASPG does not agree with that recommendation because it believes that most of the coverage in the paragraphs recommended for deletion, retains some applicability. Under the rules proposed by the CPC, the purchase method may still be used when other equitable arrangements have been mutually agreed to. Our recommendations for a compatible revision to CAS 404 are set out in Part I of Tab A.

C. Exception to the No Write-Up Rule

While laying down a general policy of no write-up of assets in a business combination, the CPC recommendations leave some latitude for the exercise of judgement in making exceptions by the contracting officer faced with the specific business combination. The CASPG concurs that exceptions to the general no write-up rule are appropriate, but believes they will be utilized in a minimal number of cases.

In the case where the contracting officer does allow assets to be revalued upward, it is assumed he will obtain a credit to the Government for the gain from the acquiring company. The gain was previously limited in 31.205-16(b) and in 30.409-50(j)(1) to the amount of depreciation previously taken. The CPC recommended raising the limit specified in 31.205-16(b) by increasing the depreciation previously taken to present value using the Treasury rate. The CASPG concurs that it is equitable and logical to convert the measurement of depreciation taken to its present value. We also agree that the Treasury Rate of Interest is a practical index for this purpose. It is worthy of note that the CAS Board had considered a proposal to increase the limit on gain recognition to the sum of depreciation taken plus the cost-of-money related to the asset.

Our recommended changes to CAS 409 make the standard consistent with the CPC proposed change to the cost principles by raising the limit on a gain to the depreciation taken inflated by the Treasury rate. In addition, we have clarified CAS 409 to assure that the coverage on gains and losses on disposal of tangible assets applies to business combinations as well as disposal of individual assets of on going businesses.

D. Gains or Losses Arising from Mass or Extraordinary Dispositions

The CASPG recommends adjusting 30.409(j)(3) and 31.205-16(a)(1) as shown in Tab A and to leave 31.205-16(e) unchanged. The reasons for our recommendation are as follows:

The amount of a gain or loss on an asset disposed of is indicated in the existing cost principle (31.205-16(b)) and CAS (30.409-50(j)(1)) as the difference between "...the net amount realized ... and its undepreciated balance..." Both the existing cost principle and CAS go on to indicate the general rule that a gain or loss should be assigned to the cost accounting period in which the disposition occurs. The CAS makes an exception to gains or losses, arising from mass or extraordinary dispositions, by allowing the contracting parties to account for them in an equitable manner. The cost principles have similar coverage at 31.205-16(e).

The original CPC coverage at 31.205-16(a)(1) would have expanded the exception to apply to all individual dispositions as well as mass and extraordinary dispositions. It is believed that the change would have potentially made the gain or loss on every individual asset disposed of, subject to adjustment for amount or timing at either party's discretion or whim. The only claim necessary would have been that the application of the general rule determining amount and timing of the gain or loss did not achieve equity. The lack of consistency, thus created, would have been undesirable from both the Government and contractor's viewpoints. Consequently, the CASPG believes that limiting the exception to mass and extraordinary dispositions would be more appropriate as long as extraordinary is properly defined.

Accounting Principles Board Opinion No. 30 (APB 30) places very strict limitations on items classified as extraordinary. Both committees believed this limitation to be much too restrictive. Consequently, the recommended coverage expands the definition of extraordinary dispositions to include real property transactions and those groups of transactions which in total would result in a material inequity if assigned to the period in which disposition occurs.

We believe that this change will cover the situation in which a contractor chooses to sell all major assets individually over a short time period rather than all at once as in the usual business combination. The Chairman of the CPC and the two joint members of both committees concur with the changes to 31.205-16(a)(1) and 31.205-16(e) in the CPC report.

E. All CASPG members concur with the contents of this report.

David C. Relly

DAVID C. RELLY
Chairman, CAS Policy Group

5 Atch
1. Tab A-1 CASPG Proposed Revision to FAR 30.404 & 30.409
2. Tab A-2 CASPG Proposed Revision to FAR 31.205-16(a)(1) & 31.205-16(e)
3. Tab A-3 CPC Report, DAR Case 84-18, Tab A, Part 3
4. Tab B Proposed Transmittal Memo to CAAC
5. Tab C Proposed Federal Register Notice

CAS Policy Group Members

David P. Calder, Army (AMCPP-SC)
Ted Godlewski, Navy (MAT 0224B)
Steve Araki, DLA
Robert Lynch, NASA
Patrick Duffy, DCAA
LTC Robert Gustin, OASD (A&L)/CPF
Harry Hindman, OASD (C)
Frank Van Lierde, GSA

CAS 404 - CAPITALIZATION OF TANGIBLE ASSETS

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.404-50 Techniques for Application.

(a) Except for the limitations described in paragraph (d) of this subsection. [T] the cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(d) The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the "purchase method" when other equitable arrangements (see 31.205-49(a)) have been mutually agreed to. 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.

Key:
[bracket] = deletion
underline = new

(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.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

CAS 409 - DEPRECIATION OF TANGIBLE CAPITAL ASSETS

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-40 Fundamental Requirement.

(a) The depreciable cost of a tangible capital asset (or group of assets) shall be assigned to cost accounting periods in accordance with the following criteria:

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(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.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(b) The annual depreciation cost of a tangible capital asset (or group of assets) shall be allocated to cost objectives for which it provides service in accordance with the following criteria:

(4) The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-50 Techniques for Application.

(j) (1) Gains and losses on disposition of tangible capital assets <u>(including business combinations in which the Contracting Officer agrees to use of the "purchase method" of accounting to revalue the assets for contract costing purposes)</u> 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] <u>amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.</u>

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) <u>assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction.</u> (ii) assets are grouped and such gains and losses are processed through the

accumulated depreciation account, or [(ii)] (iii) 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.

(3) The contracting parties [may] shall account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which the disposition occurs.

(4) Gains and losses on disposition of tangible capital assets transferred in other than an arms-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

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 31.205-49) of depreciable 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 or charges resulting from mass or extraordinary dispositions shall be adjusted in accordance with subparagraph (a)(2) and (e) of this subsection when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.

" " " "

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis.

31.205-10 Cost of Money.

(a)(1) - Unchanged.

(2) <u>Allowability.</u> 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) <u>Allowability</u>[.] 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 ~~if~~[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.

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(a) and (d); 30.409-50(j)(1), (2), and (3); and 31.205-10, 31.205-11, 31.205-16, and 31.205-49; to provide clear rules on the allocability and allowability of costs flowing from asset writeups resulting from business acquisitions. 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

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: Exposure draft.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 30.404-50(a) and (d), 30.409-50(j)(1), (2), and (3), 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to set forth new or clarified rules on the allocability and 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 proposed 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 Council's 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 30.404-50(a) and (d); 30.409-50(j)(1), (2), & (3); and 31.205-10, 31.205-11, 31.205-16, and 31.205-49; to implement this decision.

B. Regulatory Flexibility Act.

The proposed changes to FAR 30.404.50(a) and (d); 30.409-50(j)(1), (2), and (3); 31.205-10, 31.205-11, 31.205-16, 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. In addition small business are exempt from cost accounting standards.

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 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 3, and 4 as approved)

CAS 404 - CAPITALIZATION OF TANGIBLE ASSETS

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30.404-50 Techniques for Application.

(a) [Except for the limitations described in paragraph (d) of this subsection,] ~~T~~ [t]he cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(d) [The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the "purchase method" when other equitable arrangements (see 31.205-49(a)) have been mutually agreed to.] 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.

Key:

- - - - - = deletion

[ ] = new

DEPARTMENT OF THE AIR FORCE
WASHINGTON, D.C. 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

July 20, 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. Problem:

To review and coordinate on Tab A, Part 3 of the Commercial Cost Principles Committee (CPC) report on the subject case, dated 4 February 1987 and amended on 12 March 1987.

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 (CAS).

II. Recommendations:

That FAR 30.404-50(a) and (d); and 30.409-50(j)(1), (2), and 3 be revised as shown in Tab A-1.

That the last sentence of FAR 31.205-16(a)(1) which appears in Tab A, Part 3, p.3, of the CPC report of 4 February 1987 (Tab A-3) be changed as shown in Tab A-2.

That FAR 31.205-16(e) remain unchanged as shown in Tab A-2.

III. Discussion:

A. Revaluation of Assets

The Cost Accounting Standards Policy Group (CASPG) approached this problem with the objective of seeking the best policy for costing Government contracts. We concur with the CPC basic "no write-up" policy as being fairest to both the Government and the contractor.

The CPC correctly saw the problem of asset revaluations as having two possible solutions. Either the asset could be written up with an equitable recognition of the disposal gain or the transaction could be ignored for Government contract costing purposes. The CPC chose "no write-up" as the primary or default rule which will apply unless both parties can reach a satisfactory arrangement regarding the disposal credit. The CASPG also believes "no write-up" to be the fairest rule for the following reasons:

(4) The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-50 Techniques for Application.

(j) (1) Gains and losses on disposition of tangible capital assets [(including business combinations in which the Contracting Officer agrees to use of the "purchase method" of accounting to revalue the assets for contract costing purposes)] 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~~ [amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.]

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) [assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction.] (ii) assets are grouped and such gains and losses are processed through the

accumulated depreciation account, or (ii) [(iii)] 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.

(3) The contracting parties ~~may~~ [shall] account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. [Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which the disposition occurs.]

(4) Gains and losses on disposition of tangible capital assets transferred in other than an arms-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

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 31.205-49) of depreciable 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 or charges resulting from mass or extraordinary dispositions shall be adjusted in accordance with subparagraph a(2) and (e) of this subsection when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis.

Tab A, Part 3
of Cost Principles
Committee Report,
DAR Case 84-18

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;

Key:
[bracket] = new
~~line-through~~ = deletion

| | |
|---|---|
| Asset Acquisition Cost | $10 |
| Depreciation Method | Straight Line |
| Useful Life | 10 years |
| Date Asset Acquired | 1 January of year 1 |
| Disposal Date | 31 December of year 10 |
| Disposal Price | $15 |

| | | Depreciation Inflated | | | Cost of Money | |
|---|---|---|---|---|---|---|
| End of Year | Depreciation | Interest Rate (i) | n | $(1+i)^n$ | Average Net Book Value (Avg NBV) | Cost of Money (Avg NBV x i) |
| 1 | 1 | .07 | 9.5 | 1.902 | 9.5 | .665 |
| 2 | 1 | .07 | 8.5 | 1.777 | 8.5 | .595 |
| 3 | 1 | .07 | 7.5 | 1.661 | 7.5 | .525 |
| 4 | 1 | .07 | 6.5 | 1.552 | 6.5 | .455 |
| 5 | 1 | .07 | 5.5 | 1.451 | 5.5 | .385 |
| 6 | 1 | .07 | 4.5 | 1.356 | 4.5 | .315 |
| 7 | 1 | .07 | 3.5 | 1.267 | 3.5 | .245 |
| 8 | 1 | .07 | 2.5 | 1.184 | 2.5 | .175 |
| 9 | 1 | .07 | 1.5 | 1.107 | 1.5 | .105 |
| 10 | 1 | .07 | .5 | 1.034 | .5 | .035 |
| | | | | 14.291 | | 3.5 |

Present Recapture Rule:

| | |
|---|---|
| Book Gain | $15 |
| Depreciation Allowed | $10 |
| Recapture Credit | $10 |

Proposed Recapture Rule

| | |
|---|---|
| Book Gain | $15 |
| Inflation Adj. Depr. | 14.291 |
| Recapture Credit | 14.291 |

Recapture based upon depreciation (in nominal dollars) allowed plus cost-of-money

| | |
|---|---|
| Book Gain | $15 |
| Depreciation (nominal dollars) | $10 |
| Cost of Money applied | 3.5 |
| Recapture Credit | 13.5 |

31.205-10 Cost of money.

(a)(1) - Unchanged.

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

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with 30.414;

(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. (i) Whether or not the contract 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--

Key:

[ ] = Bracketed words are additions to FAR.

~~Lined-through~~ words are deletions from FAR.

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with 30.417;

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

(C) The cost of money for tangible capital assets is 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.

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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) Except for limitations elsewhere in this subsection,] ~~G~~[g]ains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall 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)~~.

[(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. [The timing (or the amount, if necessary) of the recognition of such gains and losses resulting from mass or extraordinary dispositions shall be adjusted when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include any transactions in which the acquirer employs the purchase method of accounting for subsequent valuation of the property, real property transactions, and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

(f) - Unchanged.

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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 allowed 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.

(iv) Assets which did not exist on the books of the acquired entity may be capitalized and recognized on the books of the acquiring entity only if the Government agrees to accept an equivalent credit to achieve equity on Government contracts.

(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 -40 - Unchanged.

-50(a) [Except for the limitations described in paragraph (d) of this subsection,] ~~T~~[t]he cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

-50(a)(1) through (c) - Unchanged.

-50(d)[The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the purchase method when other equitable arrangements have been mutually agreed to (see 31.205-49(a)(2)).] 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 the 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 the capital assets shall be reduced by a proportionate part of the excess.

-50(e) through -60(b)(2) - Unchanged.

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30.409 - Cost accounting standard-depreciation of tangible capital assets.

30.409-10 through -50(i) - Unchanged.

(j)(1) Gains and losses on disposition of tangible capital assets [(including business combinations in which the Contracting Officer agrees to use of the purchase method of accounting to revalue the assets for contract costing purposes)] 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~~[amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.]

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where:

(i) [Assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction, (ii)] assets are grouped and such gains and losses are processed through the accumulated depreciation account, or, ~~(ii)~~ [(iii)] 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.

(3) The contracting parties ~~may~~ [shall] account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. [Mass and extraordinary dispositions include any transactions in which the acquirer employs the purchase method of accounting for subsequent valuation of the property, real property transactions, and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

-50(j)(4) through (l) - Unchanged.

31.109 Advance agreements.

(a) through (h)(17) - Unchanged

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

**************************************************

42.1200

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 (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, whether or not there is a 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.

Tab D
DAR Case 84-18B

PROPOSED TRANSMITTAL MEMO TO CAAC

MEMORANDUM FOR CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

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

The DAR Council has approved proposed revisions to FAR 30.404, 30.409, 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to provide clear rules on the allowability of costs flowing from asset write-ups resulting from business acquisitions and on the allowability of certain other costs incidental to such combinations. The rationale for these decisions is contained in attachments 1 and 2. If the CAAC agrees with the positions as set forth, please forward the case to the FAR Secretariat for further processing as proposed rules.

DUNCAN A. HOLADAY
Director
Defense Acquisition
Regulatory Council

Attachments

TAB E
DAR Case 84-18B

<u>FEDERAL REGISTER</u> 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 Rules.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 30.404, 30.409, 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to set forth new or clarified rules on the allowability of costs stemming from business combinations.

DATE: 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 final rules. Please cite FAR Case 87-43 and DAR Case 84-18B in all correspondence related to this issue.

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

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

SUPPLEMENTARY INFORMATION:

A. <u>Background</u>.

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. Comments on these matters were previously solicited by a <u>Federal</u>

Register notice dated October 28, 1987 and have been considered in drafting these proposed rules. This review has been occasioned by the increased pace and size of such events in recent years and 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 the cost of money expense flowing from asset write-ups 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 the price, the Government should be at risk of paying higher prices simply because of ownership changes at its suppliers. Accordingly, the Councils are proposing changes to FAR 30.404, 30.409, and corollary changes to 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to implement this decision.

B. Regulatory Flexibility Act.

The proposed changes are not expected to have 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. Additionally, small businesses are exempt from the cost accounting standards. An initial Regulatory Flexibilty analysis has therefore not been performed. Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected FAR subpart will also be considered in accordance with section 610 of the Act. Such comments must be submitted separately and must cite FAR Case 89-610 in correspondence.

C. Paperwork Reduction Act.

The Paperwork Reduction Act does not apply because the proposed rule does not change 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:_______________

Harry S. Rosinski
Acting Director, Office of Federal Acquisition and Regulatory Policy

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).

Parts 30 and 31 - (Amended)

(See TABs A and B as approved)

CASE MANAGEMENT RECORD

ORIGINAL
UPDATED ✓

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

TITLE: Accounting for Mergers and Business Combinations

REFERENCE: Cost Principles Committee supplemental report of 12 March 87

ORIGINATION DATE:

SYNOPSIS:
The Treasury Rate of interest should be used to adjust the limit on depreciation recapture following disposition of assets at a gain.

PRIORITY: | ORIGINATOR CODE:

KEYWORDS

CASE REFERENCES

FAR CITES

DFARS CITES

CASE MANAGER: N | SUBCOUNCIL ASSIGNMENT:

COGNIZANT COMMITTEES

RECOMMENDED ACTION:

Discussion 3-25-87

| BOX RECORD | 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION:

PROPOSED RULE: | INTERIM RULE: | FINAL RULE:

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18

12 March 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

Subject: DAR Case 84-18, Accounting for Mergers and Business Combinations--SUPPLEMENTAL REPORT

I. PROBLEM:

The 4 February 1987 report of the Commercial Cost Principles Committee could be misinterpreted as it relates to the Committee's description of the relationship of the cost accounting standards and the proposed cost principles coverage.

The inflation adjustment of the limit on previously recognized depreciation expense which is recouped as a gain upon a contractor's disposition of depreciable assets should be changed to require use of the facilities capital cost of money (i.e, Treasury) rate.

II. RECOMMENDATION:

That the Committee's previously recommended coverage for FAR 31.205-16(b) be changed to read as indicated below.

III. DISCUSSION:

A. Background.

In its 4 February 1987 report, the Commercial Cost Principles Committee, aware of a frequent criticism of times past, discussed the relationship of the cost accounting standards (CAS) and the cost principles, and accusations of "impermissible conflict" between the two bodies of regulations within the FAR. At the meeting of 27 February 1987 of the DAR Council, the Cost Principles Committee was requested to clarify its earlier comments.

Also at the same DAR Council meeting, the Committee was requested to revise its proposed coverage at FAR 31.205-16, "Gains and losses on disposition of depreciable property or other capital assets," by deleting reference to "inflation adjusted" in paragraph (b) and instead use the Treasury rate as the adjustment index.

B. Committee Comments.

1. CAS/Cost Principles Relationship.

In the 27 February 1987 meeting of the DAR Council, certain members expressed concern that one of the the Committee's comments in the report could be taken out of context. The comment in question (p. 23) recommended deletion of certain sections of CAS "to eliminate the inconsistency between the standard ... and the new cost principles coverage..." The Committee went on to say that it believed that, even without the CAS deletions, there would probably not be an "impermissible conflict" of the sort found by the courts in the Boeing SERP case but that there was no reason to run whatever litigative risk was inherent in leaving the CAS unchanged. The Committee believes that, read in light of this further comment, the meaning of the sentence in question is clear and defensible. It remains the Committee's opinion on this matter. The Committee would reemphasize that the litigative risk here is real, particularly since it seems virtually impossible to assess the precise degree of such risk before one reaches court. After all, the Government was so confident of victory in the Boeing SERP case that it requested a summary judgment--and then lost the case.

2. Adjusted Limit for Depreciation Recapture.

At the 27 February meeting, the DAR Council tentatively concurred with the concept that the limit for depreciation recapture on asset disposition should be increased beyond the absolute amount of depreciation previously taken to reflect the time value of money. However, the Council requested that the Committee develop coverage that more precisely implemented this concept in lieu of the vague reference to "inflation-adjusted" depreciation previously taken as recommended in the Committee report of 4 February. The new coverage for 31.205-16(b) developed by the Committee in compliance with this request reads as follows:

> The gain recognized for contract costing purposes shall be limited to the amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken (except see subdivision (c)(1)(i) or (ii) below).

J. W. Ermerins

J. W. ERMERINS
Chairman
Cost Principles Committee

# Case Management Record

8 JUN 1989

| DAR Case No. | CAAC No. | Original | | Date |
|---|---|---|---|---|
| -84-18 | | Updated | ✓ | 6/6/89 |

Title
Mergers & Acquisitions

Reference
A long time ago, Di said she'd get copies of the JCACC handbook on mergers + acquisitions.

Synopsis Here it is. It was passed out at 19 May JCACC mtg. Principals are supposed to be reviewing.

| Priority | Submitted By Di | Originator Code | Case Manager |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

Recommendation
File &/or read.

Notes

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100

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IN REPLY REFER TO DLA-G

MEMORANDUM FOR THE JOINT CONTRACT ADMINISTRATION COORDINATING COUNCIL

SUBJECT: Mergers, Acquisitions, and Divestitures Working Group Report

In its 5 May 1988 meeting, the Joint Contract Administration Coordinating Council (JCACC) established a working group to address problems arising from corporate reorganizations. DLA was to chair the working group and the direction provided by the JCACC was for the group to develop a booklet similar to that developed for warranties and that the group (a) establish guidance for assigning agency responsibility in novations involving contractors with more than one ACO/CACO; (b) provide highlights from recent novations; and (c) provide a list of items of which to be alert during corporate reorganizations.

DLA convened the first meeting of the working group on 14 June 1988, with representatives from the Army, Navy, Air Force, DLA, DCAA, and OSD. At later meetings, representatives from the Defense Investigative Service and the Office of Industrial Base Assessment were included in the group. The group met monthly and drafted a booklet of guidance on what to do when a contractor reorganizes. The draft booklet is presented to you for your review, comment, or coordination.

The booklet was intentionally drafted to be as brief as possible without losing the substance of the subject matter, and is written in as informal and nontechnical manner as possible. The group wants ~~to~~ THE booklet to be both useful and readable by the intended audience, contracting and quality assurance personnel and their support groups, such as price analysts and auditors.

The booklet addresses the areas which the group was instructed to address and will hopefully provide adequate information to the contracting team members to enable them to question costs in reorganizations and to provide at least a minimal structure in which to begin their search for answers. There are, however, areas that the group did not address, either because the booklet was not the place in which to address some matters or because the group did not feel it was in their mandate to address particular areas. The group wants to bring these specific areas to the attention of the JCACC, with explanations of why the group elected not to address the matters. Where the group was able to recommend a solution to a problem, the group recommendation is noted.

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## Problem Area I: Reorganizations involving Stock Sales

The booklet, intended to be a "how to" handbook for contracting personnel in the field, acknowledges that there is no FAR or DFARS guidance on stock sales that are tantamount to the sale of a business. The booklet recommends that each transaction be evaluated to determine if there was an asset transfer; if there was, a novation agreement would be required. If the transaction does not involve an asset transfer, the booklet recommends that advance agreements be entered.

The group discussed recommending a DAR case to include stock sales in the group of transactions that require novation agreements. The group noted that shortly before the FAR was adopted, a DAR change had been made to include sales of substantial amounts stock as an event that would trigger the need for a novation. For some reason that nobody has been able to explain, that DAR provision was not included in the FAR when it was issued. There is a significant group that believes the stock provisions were dropped from the FAR by simple administrative error and that they should be put back in the FAR immediately. The working group was divided on this issue; some members took the view that stock sales were inadvertently omitted and that a case should be initiated to correct the administrative error. Others took the view that sale of stock does not change the legal corporate identity of the party to the Government contract. Unless and until that legal identity changes, there is no basis for demanding a novation agreement. Yet another group argued that there was a need for a stock sale provision in the novation coverage, but could not agree on the amount necessary for a novation to be required. Because of this dichotomy of views, the lack of clear guidance from other sources, and the need to get information out to the field personnel who are currently operating in the dark, the group decided to follow current FAR guidance and not require novation agreements <u>per se</u> in stock sale situations but to urge the negotiation of advance agreements. The group also determined it inappropriate to advance DAR cases on this issue. Because reorganizations accomplished through stock sales are such a troublesome area, however, the group did want to raise it to the JCACC's attention.

## Problem Area II: Asset Revaluation

The group discussed at length the problem of asset revaluation following a corporate reorganization. The group decided to approach this problem by urging the Government personnel to negotiate as part of the novation or advance agreement a "no step-up provision," as used by the Navy and DLA. Such a provision would freeze a contractor's ability to revalue its assets for a set period of time. There are several problems with this approach:

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a. Assuming the transaction is one in which a novation agreement is required, our privity of contract is with the original contractor and its successor in interest. If the successor sells the original contractor, which is frequently the case, the Government has no recourse if the ultimate purchaser were to revalue the assets. Even if an indemnification clause is included in the original novation agreement, under the terms of which the original and successor contractors agree to indemnify the Government should there be a set-up of assets by either party, the original contractor and first purchaser are usually dissolved by the time the ultimate purchaser revalues the assets. Thus, the Government would have a legally sufficient remedy and no company against which to enforce its remedy.

b. Enforcement of the "no step-up" provisions is very difficult; many such provisions are binding for as long as fifteen years from the date the novation is executed, requiring Government personnel to watch the assets values for that entire period.

c. Industry will argue that the "no step-up provision" is an improper intrusion into the generally accepted manner of accounting for costs in the business community. Asset revaluation is perfectly acceptable under Generally Accepted Accounting Principles, the Cost Accounting Standards, and the cost principles. The Government would be requiring industry to do something for it that industry does not do for any other entity, which will of course be costly to the Government.

The Cost Principles Committee of the DAR Council has recently sent a case to the Council that would preclude contractors from ever writing up their assets for any reason. If this case is passed, the guidance in the pamphlet will be outdated. The proposed DAR case, however, brings with it its own unique set of problems, which will presumably be the subject of discussion at the DAR Council table. Because of the controversial nature of the proposed case and the countervailing need to get guidance to the field, the group elected to retain the recommendations to negotiate "no step-up provisions" rather than wait for the result of the DAR case.

**Problem III: Pension Fund Modifications**

The group took the position that when a pension fund to which the Government contributed is terminated, the Government is entitled to a refund of its contribution as well as its allocable share of any overfunding due to appreciation. This position has been consistently argued in all the recent major novation negotiations. Contractors have consistently denied that the Government is entitled to any portion of the overfunding due to appreciation. Absent specific legislation allocating ownership of the overfunding, industry and the Government will continue to battle on this important issue.

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**Problem IV: Advance Notice of Reorganizations**

The group considered initiating a DAR case to create contractual provisions requiring contractors to give the Contracting Officer advance notice of corporate reorganizations. The group concluded, however, after lengthy discussion, that not only would such a provision be unacceptable to industry, but DoD would probably be unwilling to accept the responsibility and risk that would accompany such advance information. The group did investigate other sources of similar advance information that already exist in the Government. It appears that some such information is available from other DoD agencies, as well as some of the civilian agencies, and that the information may be available in some limited fashion to DoD personnel working on novations. Because there is a potential for obtaining information from other sources, the group decided not to pursue DFARS coverage requiring advance notification.

**Problem V: Providing Highlights of Recent Novations**

The group, in attempting to address the guidance given by the JCACC, discussed whether copies of actual novation agreements should be included in the booklet. The group decided not to include the agreements, but to refer generally to provisions included in the agreements in the appropriate sections of the booklet. The group was concerned that if the agreements were included in the pamphlet, contracting officers would use the agreements verbatim and not seek the assistance of their attorneys; while the executed agreements were considered at the time of execution to be the best negotiated protection for the Government in that particular situation, that does not mean that the same agreement is the best protection for the Government in every situation now and in the future. Thus, the agreements were consciously left out of the draft booklet.

The attached draft booklet is, in the opinion of the working group, a useful tool for the contracting community. Notwithstanding the limitations and problems described above, the group believes that contracting officers, quality assurance personnel, cost/price analysts, auditors, and many other personnel who deal with contractors and contract costs will benefit from the timely distribution of this booklet. The group stands ready to discuss this project with you.

Encl

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## I. Your Role in Corporate Reorganizations

This guide is provided to you as a member of the Government's contracting team, a group of procurement professionals including procuring contracting officers (PCO), administrative contracting officers (ACO), price/cost analysts, quality assurance representatives (QAR), auditors, or any other procurement professionals involved in contract performance. This guide is intended to help you and your team members deal with the difficult questions arising from the corporate reorganizations that are occurring so frequently among Government contractors.

You may have asked yourself, "What is a corporate reorganization? How does it affect Government contracts under my cognizance? What can I do about any adverse effects?" Although this guide may not answer all of these questions, it is an excellent starting point and will give you a basic understanding of how and why corporate reorganizations occur, what the ultimate effect could be on any Government contracts involved in the reorganization, and the actions you should consider taking to protect the Government from those effects. This guide provides practical information how existing FAR coverage, particularly FAR Subpart 42.12 novation and change-of-name agreements, can be used to address a number of issues arising from the reorganizations, such as revaluation of assets, taxes, worker's compensation, idle facilities, pension plans, cost accounting changes, and access to records.

You may decide, with the assistance of your advisors, that you don't need to take any of the suggested courses of action in your particular circumstances, or you may decide that you need to take actions not discussed in this guide. The important thing is that you are asking the right questions in your efforts to protect the Government's contract interests affected by the reorganization.

## II. What is a "business combination" or a "corporate reorganization?"

Corporation - legally created entity under state law which is legally recognized as a "person," capable of engaging in contracts, of suing, and of being sued in its corporate name.

Business combination -- Two or more businesses, generally corporations, joining to form one business. This joining can be done through a merger (one company absorbing a second company into itself) or through a consolidation (two or more companies joining together to form a new, combined company, each of the original companies then ceasing to exist).

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Corporate Reorganization -- Includes business combinations. Also includes any change to the internal structure of a corporation or a group of corporations that does not affect the legal identity of any of the corporations, such as restructuring operating divisions within a corporation.

A thorough and easy-to-read discussion of business combinations and corporate reorganizations is provided at Appendix II.

## III. The Business Combination Blues: To novate or not to novate?

Under existing FAR and DFARS coverage, if a contractor sells all of the assets involved in the performance of a Government contract, the Government may choose to treat the purchaser as the "successor in interest" to the contract. If the Government decides to recognize the new company, a novation agreement is signed by the Government, the original contractor, and the "successor in interest," under the terms of which the "successor in interest" is liable for the entire contract performance and the original contractor guarantees the performance of the "successor in interest."

There is no specific guidance in the FAR or DFARS addressing reorganizations accomplished strictly by the sale of stock, and that is the nature of most of the current reorganizations. If the reorganization will be a business combination, however, you should be able to find a point in the transaction at which assets are being transferred from the Target corporation into the Acquiring corporation. Once that asset transfer has been identified, you can invoke the requirements of FAR 42.12. The Air Force and the Defense Logistics Agency evaluated the sale of Singer to the Bilzerian Group in this manner. At the point at which the assets were moved out of Singer and into the Bilzerian Group's corporate shell structure, a novation agreement was demanded and executed.

There may be reorganizations which do not include a business combination and asset transfer, instead structured simply as stock transactions. In this type of reorganization, the company purchasing all or a controlling interest of stock in the selling company maintains the selling corporation as a separate corporate entity, never moving the assets out of the selling corporation. Even in these situations, the contractors may attempt to pass on to the Government increased costs generated by the stock purchase. Absent an identifiable asset transfer, the Government is in a more difficult position to demand a novation agreement. In these situations, there are two alternatives:

(1) You may choose to do nothing, relying on the basic fact that there is no change in the corporation and there should, therefore, be no change in the contractor's costs. This position was successfully argued in <u>The Marquardt Company</u>, ASBCA 29888, July 18, 1985, 85-3 BCA ¶ 18,245, sustained on motion for reconsideration, June 2, 1986, 86- BCA ¶ ____, aff'd on appeal, 822

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F.2d 1573 (Fed. Cir. 1987). Before deciding to take this approach, consult with your legal advisors; the factual circumstances in Marquardt were an important element in the outcome of the case and your circumstances may not lend themselves to this approach.

(2) You can negotiate an advance agreement on costs with the contractor, using as your justification for the agreement the significance of the change in the corporation and the Government need for and entitlement to reassurance that the corporate change will not have an effect on the costs charged to the Government. Your leverage in this situation will increase if the corporation suddenly changes its corporate name after the stock sale, which sometimes occurs. If there is such a name change, the contractor will have to request a change-of-name agreement under FAR 42.12, at which time you, the Government procurement representative, can express the concern of the Government that the proper party be paid and that the Government be assured that the costs are all proper. You can then include in the change-of-name agreement all the necessary provisions from the novation agreement.

It is very important to note an often-overlooked provision in the FAR, FAR 42.1204(e), which contains the standard novation agreement. One of the introductory sentences that preceed the standard novation agreement states, "This format [for the standard novation agreement] may be adapted to fit specific cases and may be used as a guide in preparing similar agreements for other situations." The novation agreement and the regulatory coverage that provides the agreement are both dynamic, allowing the Government and a reorganized contractor to agree on things that are not included in the standard novation agreement. There are indeed elements that should be included in novation agreements in today's corporate environment that did not exist when the novation coverage in the FAR was drafted. The FAR has provided the flexibility to address those new elements.

Listed below are some nonstandard provisions you should include in your agreements as appropriate:

1. Make the entire novation, or particularly critical parts of the the novation, encompass all existing contracts and subcontracts as well as future contracts. This will require that "future contracts" be defined and distinguished from "contracts," as used in the standard novation coverage. The Navy has successfully negotiated application of provisions in the Sperry/Unisys novation agreement to future contracts for periods as long as 15 years commencing on the date of execution of the agreement.

2. Regarding potential asset revaluation by the acquiring contractor, either:

(a) Government receives allocable credit of any gains resulting from asset writeups (FAR 31.205-16, 31.201-5);

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OR

(b) Prohibit stepping-up the value of assets. This has been successfully negotiated by the Services and DLA in several recent novations. Precluding step-up is the approach being taken in the majority of DoD novations. As a practical matter, it is far easier not to permit the contractor to charge the Government more money, as in step-up prohibition, than it is to permit the step-up and try to get a credit for a portion of the increased costs, as in the credit provisions.

3. Costs of goodwill, whether stated expressly or included in other cost elements, are unallowable (FAR 31.205-49).

(a) Costs of money resulting from including goodwill in the facilities capital employed base are unallowable (FAR 31.205-10(a)(5)).

(b) Be on the lookout for high dollar values attributed to intangible assets such as computer software, patents, etc., particularly if the original contractor did not have high dollar values assigned to such assets. This may be goodwill in disguise.

4. The Government shall not pay or reimburse any costs for:

(a) Organization and reorganization costs incurred in planning or executing the acquisition/merger and reorganization (FAR 31.205-27(a)).

(b) The assessment or allocation of any costs for interim entities.

(c) Costs of resisting reorganization of a business (FAR 31.205-27(a)).

(d) Costs of raising capital (FAR 31.205-27(a)).

(e) Special employee compensation packages, to include:

i. "Golden parachutes" -- excessive severance payments (FAR 31.205-6(l)(1)).

ii. "Golden handcuffs" -- special compensation to employees who agree to remain with contractor for a specified period of time (FAR 31.205-6(l)(2)).

(f) State and local taxes on current contracts. A business combination can easily cause a change to the

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allocation method used to distribute state/local taxes to operating segments. For example, a company allocates from corporate office directly to each segment using a common allocation base. After merger, taxes are first collected by taxing jurisdiction and then allocated to segments within that taxing jurisdiction.

(g) Insurance or workers' compensation increases for a specified period of time. The Navy has determined that for most reorganizations, 2 years is an adequate period of time for the work force to recover from the reorganization.

(h) Idle facilities and capacity on current contracts.

5. Those costs described above that are not expressly unallowable will be treated as "mutually agreed to be unallowable" under CAS 405.

6. Net increases in costs to the Government (other than those in paragraphs 2(a) through (h)) shall be determined separately for each Group/Division in accordance with guidance provided in Cost Accounting Standards (CAS) Working Group Study 76-8 (i.e., offsets are permitted vertically within Group/Division).

7. Cost accounting changes will be treated as CAS voluntary changes. See FAR 52.230-3.

8. IR&D/B&P costs will be allocated pursuant to CAS 420 and the ceilings imposed by the Standards and the FAR.

9. Transferor/transferee will provide the Government with advance notification in writing on any changes that have a material cost impact on Government contract(s), such as pension fund terminations, environmental issues, etc.

10. Pension plans in existence at the time of the reorganization should be carefully reviewed. In particular, the Government is concerned that acquiring entities will terminate an overfunded pension plan or will substitute a less expensive and less effective plan for the one in existence at the time of the reorganization, allowing the acquiring company to take assets from the plan and use them for purposes other than that for which they were intended.

(a) Government receives credit for its allocable share of any excess terminated pension plan assets (FAR 31.201-5).

(b) Pension plan mergers are subject to CAS 413.

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11. The contractor will identify and provide, within an agreed period of time, an accounting of costs unallowable under the terms of the agreement. Fifteen months from the date of the agreement is a good rule of thumb and one that the Navy routinely uses in its agreements.

12. If data rights were obtained from the original contractor, the successor agrees to license or sublicense data rights to the Government under terms substantially the same as those with the original contractor, particularly if the entity holding the data rights is later sold.

13. The successor will provide Government with access to records to verify implementation of the Agreement. Without this access provision in the agreement with the contractor, the Government has no way of knowing whether the contractor is complying with the terms of the agreement.

Additional provisions for treatment of specific costs may be included if needed.

## IV. INDICATORS OF A CORPORATE REORGANIZATION

Before companies actually undergo a corporate reorganization and change their identities, there are usually signals that something out of the ordinary is about to happen. The Government contracting teams must be on the lookout for the warning signs of a corporate reorganization so that protections for the Government contracts can be negotiated as soon as possible. The following list describes some of the things that would indicate a reorganization is about to occur.

a. The contractor may run financial statements on a more frequent basis than usual.

b. The contractor may start making long-needed capital improvements, such as fixing broken equipment, painting, replacing carpet, landscaping, or other things that would make the facility more attractive to a potential purchaser.

c. Special audits or out-of-cycle audits, by either the company's outside auditors or by other audit teams, are being performed with little explanation.

d. High level company executives start announcing that they are leaving the company, or other unusual personnel changes in the company management are announced.

e. Significant changes to 5 year plan are publicly announced or identified in normal contract administration reviews.

f. There is a sudden spike in the company's overhead rate, indicating extraordinary costs, potentially legal or

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accounting costs, or a reduction in the allocation base, indicating that a reorganization had already occurred.

g. Rumors are heard or evidence uncovered of special studies planned or conducted regarding:

- pension and/or insurance plan
- operating efficiency
- staffing
- stock options

h. Information contained in the Board of Directors' meeting minutes or in other available corporate publications indicates a corporate change is under consideration. Information can also be gathered from publically available sources, such as newspapers, business journals, and industry publications.

i. Unusual amount of legal and other consulting costs are being charged.

j. Rumors are overheard that special financing packages being considered by the contractor, such as:

- new stock or bond issue
- stock buy-back in process or proposed
- loan package

If you as a member of the Government contracting team see any of the above activity or any other activity that you believe indicates that a major change is to be made in the identity of a Government contractor, you need to assure that those changes do not adversely affect the ongoing Government contracts. Notify your assigned Contract Administration Office (CAO) of the activity at the contractor facility and to keep the CAO informed of new developments. If you are at the CAO, notify your legal advisors of your suspicion that ther may be a corporate reorganization and provide them with your evidence; novation agreements or advance agreements may be required to protect the Government's interests and much of the Government's leverage in negotiations arises from early involvement in the cost issues.

## V. SPECIAL CONSIDERATIONS

### A. Reorganizations involving cleared facilities.

Possible reorganizations or restructurings of contractors possessing facilities clearances and performing on Government classified contracts pose unique reporting and monitoring problems. You already have guidance from the Defense Investigative Service on the procedures you should follow when a cleared contractor is bought or sold. These procedures are provided at Appendix III for your convenience. In view of the sensitivity of the Government's interests in proposed corporate reorganizations in general, and in

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classified contracts in particular, you should report potential sales of cleared contractors to the Defense Investigative Service as soon as possible after identifying the unusual happenings.

B. Reorganization involving foreign purchasers.

If you are aware that a corporation with Government contracts is about to be acquired, whether by stock or asset purchase, by a foreign entity, that fact should be highlighted to the CAO when you notify the CAO of the potential reorganization. Provide the potential purchaser's nationality to the CAO, along with the other information about the potential reorganization.

## APPENDIX I

REFERENCES THAT SHOULD BE CONSIDERED WHEN A MAJOR CHANGE OF A CONTRACTOR'S ORGANIZATION STRUCTURE TAKES PLACE

a. Access to Records - CAM 1-504

b. Accounting Principles Board Opinion No. 16 (Business Combinations) (Financial Accounting only)

c. Accounting Principles Board Opinion No. 17 (Intangible Assets) (Financial Accounting only)

d. Advance Agreements - FAR 31.109

e. Capital Investment - CAM 5-602

f. CAS Disclosure Statement - FAR 30.2

g. Cash Disbursements - CAM 14-306.2.d

h. CAS Impact Statement - FAR 30.3

i. Compensation - FAR 31.205-6

j. Consultants - FAR 31.205-33 & 37.203

k. Depreciation - FAR 31.205-11

l. Economic Planning - FAR 31.205-12

m. Gains and Losses on Assets - FAR 31.205-16

n. Goodwill - FAR 31.205-49

o. Insurance - FAR 31.205-19; CAS 416

p. Labor Relations Costs - FAR 31.205-21

q. Novation and Change of Name Agreements - FAR 42.12 and DFARS 42.12

r. Pensions - FAR 31.205.6(j); CAS 412 & 413

s. Plant Rearrangement - CAM 9-703.9

t. Records Destroyed - CAM 1-505

u. Sale and Leaseback - DCAA Contract Audit Manual (CAM) 9-703.11

v. SEC Current Report - CAM 5-1S1 (Form 8k)

w. Taxes - FAR 31.205-41

## Business Combinations

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

There are two basic approaches to obtaining control over assets owned and used by other firms. The acquiring firm may buy the desired assets and thereby obtain title to their use directly, or it may obtain an ownership interest in the common stock of another company enabling it to exercise indirect control over the other firm's assets. These two basic approaches can be adopted in various forms, as follows:

a. Acquisition of assets: the purchase and sale of a major amount of operating assets.

b. Acquisition of stock: the purchase of the voting common stock of the investee.

c. Statutory merger: one or more corporations give up their separate legal identities to another constituent corporation which maintains its identity.

d. Statutory Consolidation: results in the formation of a new corporation and the liquidation of the constituent corporations.

## Purchase and Pooling of Interests Methods of Accounting for Business Combinations

There are two generally accepted methods of accounting for a business combination: the pooling of interests method and the purchase method. Although equally acceptable, the methods cannot be used alternatively. That is, a business combination must meet certain requirements to qualify as a pooling of interests; if it does not meet the requirements it must be treated as a purchase.

The pooling of interests method reflects the union of ownership between the entities involved. The pooling is accomplished primarily through the issuance of common stock of the acquiring company. Goodwill is never recorded in a pooling of interests because the assets and liabilities of the companies involved are carried forward at their recorded amounts. In short, they are viewed as always having been one entity.

The purchase method reflects the acquisition of one company by another. The excess, if any, between the fair value of the identifiable assets purchased and the amount paid is recorded as goodwill.

## Asset Valuation and Reevaluation Under the Purchase Method of Accounting for Business Combinations

In a business combination that is accounted for as a purchase, a write-up (or write-down) of the asset values can occur when the purchase price paid for the assets or the capital stock is more (or less) than the book value of the assets. The amount of the write-up is limited to the lower of the purchase price or the fair market value of the acquired assets.

Asset write-ups (or write-downs) may occur through either the direct purchase of assets or through the purchase of stock when the acquired company is liquidated.

### Write-ups Resulting From the Direct Purchase of Assets

If a business combination results from the direct purchase of assets: (1) Generally Accepted Accounting Principles (GAAP) obligates the acquiring firm to record the assets at amounts which reflect the actual price paid for the assets; (2) the adjusted asset amounts are reflected on the books of the acquired company (assuming it continues as a separate operation); and (3) the government recognizes the adjusted amounts for contract cost accounting purposes.

### Write-ups (or Write-downs) Resulting From the Purchase of Stock and Liquidation of the Acquired Company

If the business combination of two corporations is achieved through the purchase of stock, no writeup of assets is permissible on the acquired corporation's accounting records unless the acquiring corporation elects to liquidate the acquired corporation. This is an important distinction from the direct purchase of assets. It is based on how the courts view the corporate entity and the ownership of assets. That is, in a stock purchase without liquidation of the acquired corporation, the courts have determined that (1) the assets held by the acquired company after the stock purchase, are the same assets as those held before the stock purchase, and (2) it is the acquiring corporation, not the acquired corporation, which has incurred the costs to purchase the stock and assets of the acquiring corporation.

Consistent with the position above, in a stock purchase without liquidation, the difference between the book value and purchase price of the acquired company's assets is reflected on the books of the acquiring company, not the acquired company.

## Credits Due the Government When Assets Are Written-Up Under the Purchase Method of Accounting for Business Combinations

It is DCAA's position that an adjustment for the depreciation costs charged to government contracts is required whenever (1) one company with government contracts is acquired by another through either a direct purchase, or stock purchase with liquidation; (2) the purchase price of the assets is materially more or less than the book value of the assets; and (3) there is no advance agreement between the involved parties and the government that would preclude such an adjustment. This position is based on the related provisions of CAS 409(j)(3) and FAR 31.205-16(e) which deal with gains and losses arising from the mass or extraordinary sale of assets. The adjustment itself represents the difference between the net book value of the acquired assets (at the time of liquidation/merger) and the appraised "market" value of the assets (at the time of purchase by the acquiring company). It is similar in theory to the depreciation that is "recaptured" under Sections 1245 and 1250 of the Internal Revenue Code.

CAS 409(j)(3) and FAR 31.205-16(e) further stipulate that the contracting parties account for gains and losses on the mass sale or disposition of assets in a manner that results in equitable treatment to all parties. Parties seeking equity on the "mass" sale or disposition of assets on the basis of these provisions, are not then compelled to comply with the other provisions of CAS 409 and FAR 31.205-16 governing the routine sale or disposition of one or more tangible capital assets.

When an adjustment to the costs of government contracts is warranted due to the mass sale and write-up (or write-down) of assets, it should be pursued first through the contracts of the selling company (i.e., the company which experienced the gain or loss on the sale of the assets for tax purposes). If the adjustment was not considered by the selling company, and the buying company acquired the contracts of the selling company (as well as the assets), then the adjustment should be viewed (and pursued) as an obligation of the buying company. The reason for this is that the buying company becomes the proper "successor" company for contractual performance, and as such, it assumes all of the contractual rights, duties, and obligations of the selling company.

## Novation Agreements

A successor in interest to a government contract usually evolves from a change in the ownership of a contractor organization. The successor in interest is recognized by a novation agreement executed by (1) the contractor (transferor), (2) the successor in interest (transferee), and (3) the government. By the novation agreement, among other things, the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the government recognizes the transfer of the contract and related assets (FAR 42.1201). Novation agreements are entered into for all executory contracts transferred to a successor in interest.

The transfer of a government contract is prohibited by law (41 U.S.C. 15). FAR 42.1204(a) states: "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 (1) all the contractor's assets or (2) the entire portion of the assets involved in performing the contract." Examples include, but are not limited to:

(1) Sale of the assets with a provision for assuming liabilities.

(2) Transfer of the assets pursuant to merger or consolidation of a corporation.

(3) Incorporation of a proprietorship or partnership or formation of a partnership.

When it is in the government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the government, and the contract may be terminated for reasons of default, should the original contractor not perform (see FAR 42.1204(b)).

When a contractor requests the government to recognize a successor in interest, the contractor is required to submit a signed novation agreement. The form of the novation agreement and the conditions for its use are prescribed in FAR 42.12.

The authorized agreement provides in part, that "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 the Government in the absence of this transfer or Agreement would have been obligated to pay or reimburse under the terms of the contracts" (see FAR 42.1204(e)). The cited provision is not limited to professional services, taxes, and corporate expenses directly connected with the change in ownership. For novated contracts, it bars any increase in contract costs that would otherwise not have occurred. This applies not only to total cost of performance but to any element of cost. The Armed Services Board of Contract Appeals barred an increase in depreciation resulting from a revaluation of assets by the new owners (LTV Aerospace Corporation, ASBCA No. 11161, 67-2 BCA para. 6406). In that case, the Board also rejected a contention that the claim was proper as an offset for "savings" resulting from decreases in other cost categories such as reduced state income taxes resulting from increased depreciation. The "savings" were not costs under the contract because they were never incurred by the contractor.

### 4.4-1 References

a. FAR 4.4, Safeguarding Classified Information Within Industry.

b. FAR 53.204-1, Safeguarding Classified Information Within Industry (DD Form 254, DD Form 441).

c. DoD 5220.22-R, Industrial Security Regulation.

d. DoD 5220.22-M, Industrial Security Manual for Safeguarding Classified Information.

e. DAR 16-811, Contract Security Classification Specification, DD Forms 254, Contract Security Classification Specification.

### 4.4-2 General

a. The guidance in this section covers the industrial security requirements as they involve the ACO and the cognizant security office and/or PCO during the performance of a classified contract and subcontract. The Defense Investigative Service (DIS) has the authority and responsibility for administration of the Defense Industrial Security Program (DISP). Within the DIS Regions the Directors of Industrial Security are designated as the cognizant security offices for all contractor facilities within their jurisdiction and are responsible for ensuring that classified material in the hands of industry is properly safeguarded.

b. The administration of classified contracts necessitates a close and continuing relationship between the ACO and the DIS cognizant security office. The DIS cognizant security office can assist and advise the ACO, particularly in the areas of postaward orientation action concerning classified contracts and in obtaining, interpreting and clarifying security classification guidance as it appears in DD Forms 254. Each DIS cognizant security office has a Classification Management (CM) Specialist who can be contracted for assistance and who can act as a catalyst between the government and the contractor. ACO's are encouraged to contact the CM Specialist for any assistance needed.

### 4.4-3 Procedures

a. The responsibility for providing a prime contractor with appropriate security classification guidance for the performance of a classified contract rests with the procuring activity. This guidance is provided to the prime contractor by use of the DD Form 254. The DD Form 254 is a contractual document and is required for all classified contracts. A classified contract is any contract that requires or will require access to classified information by the contractor or his/her employees in the performance of the contract. (A contract may be classified contract even though the cont document itself is not classified.) The procur activity also has the responsibility to provide prime contractor with any changes necess during contract performance (a revised DD Fo 254 is issued) and to review the classification gu ance at least once every 2 years. After this revi the procuring activity advises the contractor writing) that no change resulted from the revie or issues a revised DD Form 254 with the appr priate changes. The procuring activity also has t responsibility to issue a Final DD Form 254 upc completion of a classified contract if the contractc requests and is granted, authority to retain an classified material under the prime contract.

b. The DIS cognizant security office has the re sponsibility for initiating action with the procur ing activity if the biennial review is not accom plished as required or if the classification guidance provided is not adequate for the performance of the contract.

### 4.4-4 ACO Responsibilities.

During the performance stages of an assigned classified contract, the ACO is responsible for various security matters as listed in appendix C of DoD 5220.22-R. In discharging his overall responsibility for the administration of classified contracts, the ACO will be assisted by the Industrial Security Staff Specialist of the cognizant security office (DIS) assigned classification management duties. In instances where delegation of authority is not clearly defined, the matter should be coordinated with the PCO prior to the initiation of the action. Outlined below are some of the more significant functions and associated references which provide the necessary detailed guidance and instruction to perform these functions:

a. Reviews, approves, and signs DD Form 254 for classified subcontracts (DoD 5220.22-R, paragraph 7-102, and paragraph 4.4-5 below).

b. Issues notices of reclassification for subcontracts, when required by DoD 5220.22-R, paragraphs 7-102, 7-104, and 7-105.

c. Obtains resolution for any problem relating to classification of the prime and subcontract (see DoD 5220.22-R, paragraphs 7-102 and 7-105).

d. Indicates on the DD Form 254, the routing of subcontractor's requests for public release of information pertaining to classified contracts (DoD 5220.22-M, appendix I, paragraph F).

e. Furnishes justification for interim facility security clearance of prospective subcontractors (DoD 5220.22-R, paragraphs 1-241 and 2-102).

f. Authorizes release of classified information by contractor at seminars, meetings, and symposia, when authority is required (Do 220.22-R, paragraphs 1-113 and 1-400 through 1-409).

g. Reviews and furnishes written authorization for publication and distribution of classified sales literature (DoD 5220.22-M, paragraph 5p).

h. Provides a copy of final DD Form 254 for classified subcontracts to the cognizant security office (DIS). DTIC will be advised of terminations on classified contracts under which DTIC services are provided. Any extensions of classified contracts will be reported to DTIC only when ACOs have been duly authorized by PCOs to sign DD Forms 1540 in accordance with DLAR 4185.10, Certification and Registration for Access to DoD Scientific and Technical Information, DLAM 4185.3. Extensions of classified contracts need not be reported to the cognizant security office (DIS).

i. Advises contractor and subcontractor(s) under his cognizance of approved method of shipment of classified material, after coordination with Transportation functional element. Prime contract ACOs must identify subcontractor(s) involved in shipments of classified materials and promptly process requests for supporting administration in accordance with part 42.204, in order to avoid delays in providing the necessary shipping instructions. ACOs performing supporting administration must coordinate with their Transportation functional element in sufficient time to provide subcontractors with the approved method of shipment well before shipments are ready to be released to carriers. (DoD 5220.22-R, paragraph 1-602; DoD 5220.22-M, paragraph 17).

j. Authorizes classified visits, both outgoing and incoming (DoD 5220.22-R, section III).

k. Approves expenditures of funds for security requirements, i.e., area controls, storage equipment, protection alarm systems (DoD 5220.22-R, paragraph 1-109 and DoD 5220.22-M, paragraph 34c).

l. Reviews reports of security violations and recommends appropriate action (DoD 5220.22-R, paragraph 5-102d(1)).

m. Recommends to PCO use of secure electrical transmission system (DoD 5220.22-R, paragraphs 1-502 and 1-602).

n. Recommends to PCO need for COMSEC material for Research and Development, Production, Installation, and Maintenance (DoD 5220.22-R, paragraphs 1-502 and 1-602).

o. Appoints contractor couriers for COMSEC material after contractor identifies employees for this purpose (DoD 5220.22-R, paragraph 1-506).

p. Advises con :or of the ACO representatives' authorized access to controlled areas containing cryptographic material (DoD 5220.22-R, paragraph 3-101c).

q. Furnishes written approval to contractor to grant physical custody of TOP SECRET information to prospective subcontractors, vendors, and suppliers (DoD 5220.22-R, paragraph 1-602).

**4.4-5 DD Form 254, Contract Security Classification Specification.** The DD Form 254 for prime contracts is prepared by the program, project, or systems manager or similar official, and issued by the PCO. The ACO's determination, with respect to the classification specifications for subcontracts is based upon the classification specifications furnished by the PCO in connection with the prime contract. The actual preparation of these forms for subcontracts will normally be accomplished by the prime contractor. However, they will be approved and signed by the ACO. The Industrial Security Staff Specialist located at DIS will provide technical guidance and assistance to the ACO upon his request. With the agreement of the ACO, the prime contractor may accomplish the required distribution of the classification guidance. Where the DD Form 254 is required under lower tier subcontracts, the ACO cognizant of the contractor issuing the initial subcontract will be responsible for signing the form for the initial and lower tier subcontracts. (This does not apply to service and graphic arts contracts, pursuant to DoD 5220.22-R, paragraph 7-102d(4)(b).)

**4.4-6 Foreign Influence Over DoD Contractors.** The ACO will notify the cognizant security office (DIS) whenever he becomes aware of any of the following situations:

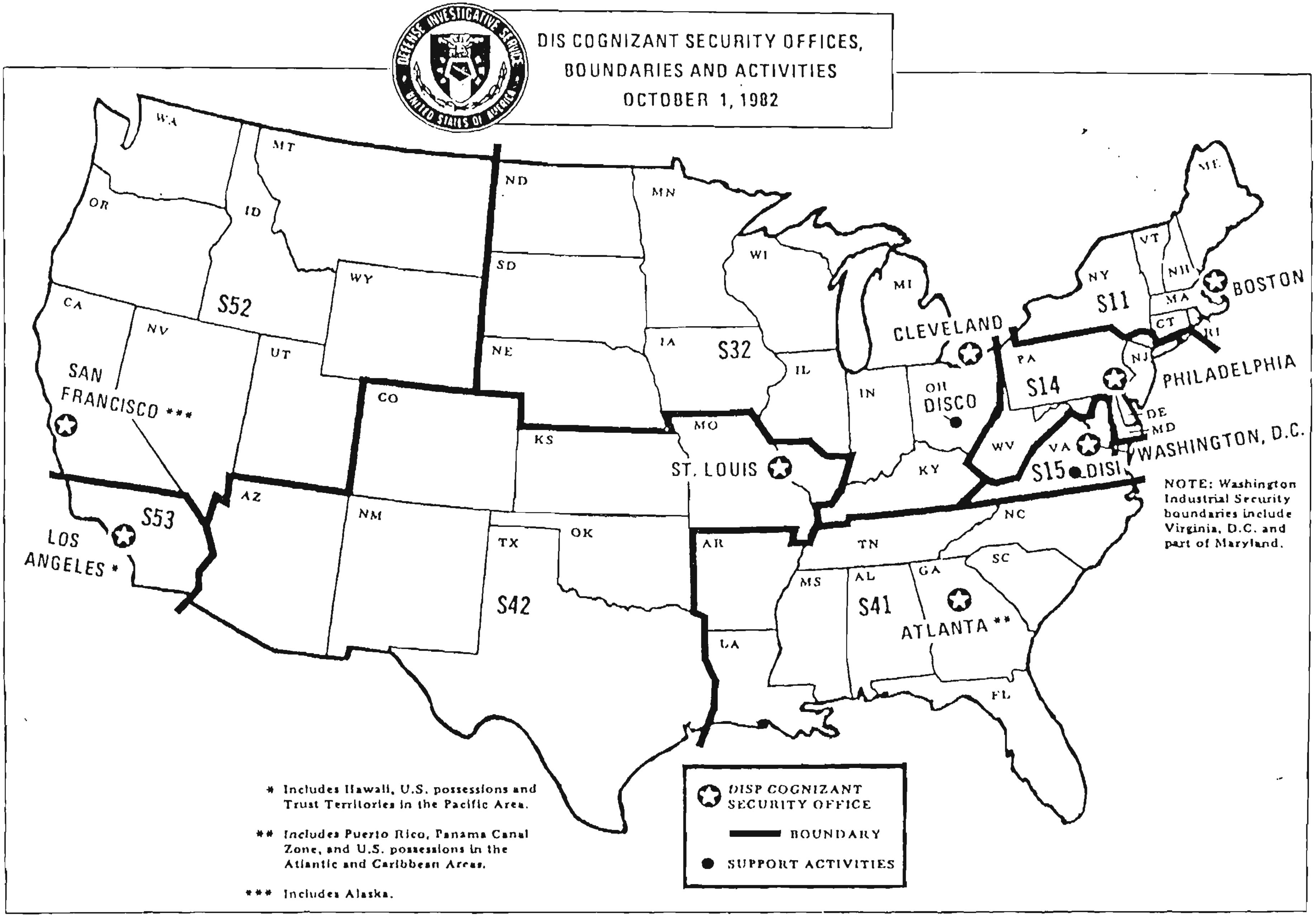
a. Foreigners have or plan to purchase stock in a corporation.

b. Foreigners plan to buy out a partner or privately owned contractor.

c. A foreign-controlled trust is established to purchase a contractor's assets.

d. A contractor becomes obligated to foreign interests through loans to the contractor or joint ventures.

e. Interlocking directorates with foreign interests have been or will be established. The cognizant security office (DIS) will then take action necessary to determine the extent of foreign ownership control or influence in accordance with DoD 5220.22-R section II, part 2.


DEFENSE INVESTIGATIVE SERVICE
UNITED STATES OF AMERICA
DIS COGNIZANT SECURITY OFFICES, BOUNDARIES AND ACTIVITIES
OCTOBER 1, 1982
S52
S53
S42
S32
S41
S11
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SAN FRANCISCO ***
LOS ANGELES *
ST. LOUIS
CLEVELAND
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NC
VA
WV
PA
NY
VT
NH
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MA
CT
RI
NJ
DE
MD
NOTE: Washington Industrial Security boundaries include Virginia, D.C. and part of Maryland.
* Includes Hawaii, U.S. possessions and Trust Territories in the Pacific Area.
** Includes Puerto Rico, Panama Canal Zone, and U.S. possessions in the Atlantic and Caribbean Areas.
*** Includes Alaska.
DISP COGNIZANT SECURITY OFFICE
BOUNDARY
SUPPORT ACTIVITIES

C e Management Record

| DAR Case No. 88-146 | CAAC No. | Original X / Updated | Date 12-7-88 |
|---|---|---|---|

Title REVALUATION OF ASSETS

Reference IDS MTG 12-6-88

Synopsis REPORT DUE 1/13/89

| Priority 1 | Submitted By A1 | Originator Code O | Case Manager A |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | 84-18 | | | |
| FAR Cites | 31.205 | | | |
| DFARS Cites | | | | |
| Cognizant Committees | CCP | | | |

Recommendation UPDATE CAM — COUNCIL AGREED TO ACCEPT NEW CASE 12-7-88

Notes

Committee to develop proposal that makes unallowable depreciation & FCCM resulting from up-ward revaluation of assets which results from merger or acquisition.

Committee proposal to be as consistent as possible with CAS.

84-18 closed into 88-146

INFO

DEPT OF THE ARMY
OASA(RDA)/SARD-PP

0 9 DEC 1988

MEMORANDUM FOR CHAIRMAN, COMMERCIAL COST PRINCIPLES COMMITTEE

SUBJECT: Asset Revaluation, Case 88-146

1. At its meeting of 7 December 1988, the DAR Council established a new case, subject as above, and assigned it to your Committee for action. Case 84-18B, Accounting for Mergers and Other Business Combinations is closed to the new case.

2. Your task is to develop a proposed FAR rule which would make unallowable any increase in costs due to the upward revaluation of assets resulting from mergers or other business combinations, while at the same time making the new rule as consistent as practicable with Cost Accounting Standards.

3. Your report is due to me no later than 13 January 1989.

Curtis N. Stevenson

CURTIS N. STEVENSON
Army Policy Member
DAR Council

OFFICAL MASTER CASE RECORD

B

DATE: 12/7

DAR CASE: 84-18

DISCUSSION:

CAM POSTED

YES

NO

DARC

DARSC

① CLOSE CASE

② open NEW CASE (88-?) ON "REVALUATION OF ASSETS". ASSIGN TO CCP; priority 1 ~~CCP~~ CCP TO write COST principle to make costs associated with write-up of assets unallowable. A1 to TASK CCP.

# Case Management Record

INFO

| DAR Case No. | CAAC No. | Original | | Date |
|---|---|---|---|---|
| 84-18B | | Updated | X | 12-8-88 |

**Title** ACCOUNTING FOR MERGERS + OTHER BUSINESS COMBINATIONS

**Reference**

**Synopsis** 84-18B IS CLOSED TO CASE 88-146, ASSET REVALUATION

| Priority | Submitted By A1 | Originator Code | Case Manager A |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | CCP | | | |

**Recommendation** UPDATE CAM

**Notes**

B

OFFICAL MASTER CASE RECORD

DATE: 11/30 | CAM POSTED | DARC
DAR CASE: 84-18 | YES | DARSC
DISCUSSION: | NO |

- ACQ & Mergers case can't proceed as is: Requires change to both CAS and COST PRIN. Only CAS Board (and OFPP) can make change to CAS - OFPP Administrator statutorily directed to ensure nothing done that would conflict w/CAS

- Novation coverage might be strengthened? Open a new case to do so??

---

CLOSE 84-18

[O1 TO DISCUSS WITH DASD(P)]

D1 RD 12/7 ON NOVATION - THEN CLOSE CASE

Leave in present Prog (69)

11-30-88

DARC has Time Chk on case

O1 to discuss with DASD(P) issue of CAS STD & COST. Prin. D1 rept due on Novation issue by

12-7-88

[illegible] 1 Rpt due.

OFFICAL MASTER CASE RECORD

B

| | | |
|---|---|---|
| DATE: 9 NOV 88 | CAM POSTED | DARC |
| DAR CASE: 84-018 | YES | DARSC |
| DISCUSSION: | NO | |

Time Certain Nov 30 1300 hrs
Tom Ludke will attend

9.22

84-18B

ELEANOR -

FYI. Grey wasn't in such a hurry when the NAVY chaired the committee.

Dun

DARS - Duncan -
thank you -
El

☆ U.S.G.P.O.: 1984-454-378/18736

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

B

PRODUCTION AND
LOGISTICS
P/DARS

22 SEP 1988

In reply refer to
DAR Case: 84-18B

MEMORANDUM FOR THE DIRECTOR, CONTRACTS AND BUSINESS MANAGEMENT

SUBJECT: Accounting for Mergers and Other Business Combinations

You recently wrote concerning the status of this case. I've checked with the new Cost Principles Committee chairman, and he has advised that the case should clear the committee this month. The Council will then give it a high priority consideration. However, this is a very complex and controversial matter and I do not expect a particularly rapid resolution of the issues involved, particularly as we deal with the CAAC and move through the public comment process on the proposed rule.

If you have any questions regarding this or any other DAR case please give me a call.

Duncan Holaday
Director, Defense Acquisition
Regulatory System

DISCUSSION

84-18

L 'ARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

AUG 25 1988

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (PROCUREMENT)

Subj: DAR CASE 84-18B ACCOUNTING FOR MERGERS AND OTHER BUSINESS COMBINATIONS

It is my understanding that the Cost Principles Committee will soon be forwarding its recommendation on the subject case to the DAR Council. I am particularly interested in moving this case along because of the difficulties we are experiencing in the Navy Department with asset revaluations after business combinations, and I understand the other services are having similar problems.

In the past couple of years, I have been involved in negotiating several asset revaluation agreements including Sperry/Burroughs, GE/RCA, and Bath Iron Works. In one case I am reviewing right now, the acquiring company has written up the assets by over $200 million, and of this amount, 95% represents intangibles (other than goodwill) which never appeared on the selling company's books. The opportunity for "gaming" under the existing FAR coverage is real. The absence of a cost principle which clearly defines the government's rights in this area weakens our negotiating position, prolongs the novation process, and results in a lack of uniformity in the treatment of these costs among the services. The subject DAR case has been on the books since 1984, and I would encourage you to expedite the handling of this case when it reaches your office for approval.

I was pleased to learn that the "Termination of Defined Benefit Pension Plan" case has been forwarded to the Contract ? Administration Advisory Council (CAAC) for approval. As you know, this is another case that has been of particular interest to me, and I will be monitoring its progress at the CAAC.

ERNEST G. CAMMACK
Director
Contracts and Business Management

Curt to give me info - end of month

Also 84-97

DISCUSSION
84-18
B

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

AUG 25 1988

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (PROCUREMENT)

Subj: DAR CASE 84-18B ACCOUNTING FOR MERGERS AND OTHER BUSINESS COMBINATIONS

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?

ERNEST G. CAMMACK
Director
Contracts and Business Management

A

COST PRINCIPLES COMMITTEE
DAR Case Report Due Dates
as of 11 March 1988

| DAR Case | Subject | Rept Date |
|---|---|---|
| 85-257 | Value Engineering Cost Principle | 11 Apr 88* |
| 84-018 | Accounting for Mergers and Business Combinations | 22 Apr 88* |
| 88-013 | Relocation Costs | 29 Apr 88* |
| 86-029 | Leasing | 13 May 88* |
| 86-027 | Litigation Costs | 31 May 88* |

*New report date, based on present status and priorities.

# *Case Management Record*

A

| DAR Case No. | CAAC No. | Original | | Date |
|---|---|---|---|---|
| 84-18 | | Updated | X | 22 Feb 1988 |

**Title**
Accounting for Mergers and Business Combinations

**Reference** Navy Policy memo dtd 22 Feb 1988 to the Commercial Cost Principles Committee

**Synopsis**
Additional public comments tasked to CCP Committee for review.

| Priority | Submitted By N1 | Originator Code | Case Manager N |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

**Recommendation**

**Notes**

# Case Management Record

Ø A

| DAR Case No. | CAAC No. | Original | | Date |
|---|---|---|---|---|
| 84-18 | | Updated | X | 9 Feb 1988 |

**Title** Accounting for Mergers and Business Combinations

**Reference**
Navy Policy tasking memo dtd 9 Feb 1988 to the Cost Principles Committee

**Synopsis**
CCP Committee tasked to review public comments.
Report due 11 April 1988

| Priority | Submitted By N1 | Originator Code | Case Manager N |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

## Recommendation

## Notes

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18 9 February 1988

MEMORANDUM FOR MR. JAMES W. ERMERINS, CHAIRMAN, COMMERCIAL COST PRINCIPLES COMMITTEE

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

Encl: (1) FAR Secretariat letter (undated) forwarding public comments
(2) Federal Register article dated 28 October 1987 providing Proposed Rule

Enclosure (1) contains public comments which have been received on the enclosure (2) proposed rule.

It is requested that your Committee review these comments and submit your recommendations to the DAR Council by 11 April 1988.

If I can be of any assistance, please let me know.

Linda E. Greene
LINDA E. GREENE
Navy Policy Representative
Defense Acquisition Regulatory Council

Copy to:
CCP Committee Members
DAR Council Members, w/o encls

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18 22 February 1988

MEMORANDUM FOR MR. JAMES W. ERMERINS, CHAIRMAN, COMMERCIAL COST PRINCIPLES COMMITTEE

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

Ref: (a) Navy Policy tasking memo dated 9 February 1988

Encl: (1) FAR Secretariat letter dated 1 February 1988 forwarding additional public comments

By reference (a), the Cost Principles Committee was requested to review public comments which had been received on the subject case. The additional public comments contained in enclosure (1) are forwarded for consideration along with the reference (a) tasking.

Linda E. Greene
LINDA E. GREENE
Navy Policy Representative
Defense Acquisition Regulatory Council

Copy to:
CCP Committee Members
DAR Council, w/o encl

82.7.4

8 A

MAR 3 1988

MEMORANDUM FOR FAR SECRETARIAT

FROM: Signed HARRY S. ROSINSKI
ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 87-19/CAAC Case 87-24/DAR Case 84-18A, Golden Parachutes/Handcuffs and Organization Costs

This memorandum provides the subject case for publication as a final rule. This case was approved by the DARC on February 9, 1988, and by the CAAC on March 2, 1988.

The following are enclosed for your information:

1. FAR revisions approved by both councils.

2. The collateral requirements.

Enclosures

cc: Director, DARC

2-58

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

# FAST TRACK

PRODUCTION AND LOGISTICS
(P/DARS)

09 FEB 1988

In reply refer to
DAR Case: 84-18A

MEMORANDUM FOR MR. HARRY S. ROSINSKI, ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: DAR Case 84-18A (FAR Case 87-19), Golden Parachutes/Handcuffs and Organization Costs

The DAR Council has approved revisions to FAR 31.205-6, Compensation for Personal Services, and FAR 31.205-27, Organization Costs, to provide final rules under the subject case. The analysis of the public comments and the rationale supporting the proposed rule are contained in the attached report. If the CAAC agrees with our position, please forward the case to the FAR Secretariat for further processing and inclusion in the next Federal Acquisition Circular you are requested to expedite action in this regard since Section 805 of Pub. L. 100-180 mandates that the "golden parachutes" portion of subject case be effective for all DoD contracts entered into on or after April 1, 1988. Please have the FAR Secretariat keep us advised in this regard.

for Michael Sullivan

Duncan Holaday
Director, Defense Acquisition
Regulatory Council

Attachment

Enclosure 1

# *Case Management Record*

| DAR Case No. | ~~GAAC~~ No. | Original | | Date |
|---|---|---|---|---|
| 84-18A | FAR 87-19 | Updated | ✓ | 1/22/88 |

| | |
|---|---|
| Title | Golden Parachutes/Handcuffs and Organization Costs |
| Reference | Cost Principles Committee report of 22 Jan 1988 |
| Synopsis | Early action required to comply with 120 day deadline (4/2/88) of PL 100-180 |

| Priority | Submitted By | Originator Code | Case Manager N |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

**Recommendation** Docket 2/3/88

**Notes**

DEPARTMENT OF DEFENSE

GENERAL SERVICES ADMINISTRATION

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31

## Federal Acquisition Regulation (FAR); Trade, Business, Technical and Professional Activity Costs

**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 changes to FAR 31.205-43, Trade, business, technical and professional activity costs, that are intended to clarify allowability policy.

**DATE:** Comments should be submitted to the FAR Secretariat at the address shown below on or before July 13, 1987, 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 NW., Room 4041, Washington, DC 20405.

Please cite FAR Case 87-18 in all correspondence related to this issue.

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

**SUPPLEMENTARY INFORMATION:**

A. Background

There has been a proliferation of non-Federal Government sponsored symposia resulting in possibly unreasonable costs being charged against Government contracts. In addition, Government contracting officers and auditors have found that the present cost principle does not address the attendance of company employees at such activities, it does not describe the circumstances in which the cost of attendance by noncontractor employees' costs might be allowable, and it does not distinguish between setting up or sponsoring meetings, conferences, symposia, and seminars and attending those events. This proposed rule was necessitated by a need to control costs, to clearly state the policy of the Government with respect to these costs, and to describe more specifically the nature of costs which are allowable. The proposed changes do not reflect or result from a change in allowability policy.

B. Regulatory Flexibility Act

The proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of 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 cost principles do not apply. An initial Regulatory Flexibility Analysis has therefore not been performed. Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected FAR Subpart will also be considered in accordance with Section 610 of the Act. Such comments must be submitted separately and cite FAR Case 87-610 in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because this proposed change to FAR 31.205-43 provides clarifications as to the allowability of trade, business, technical and professional business activity costs, and does not impose any additional reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

List of Subjects in 48 CFR Part 31

Government procurement.

Dated: May 1, 1987.

**Lawrence J. Rizzi,**

*Director, Office of Federal Acquisition and Regulatory Policy.*

Therefore, it is proposed that 48 CFR Part 31 be amended as set forth below:

PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

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

**Authority:** 40 U.S.C. 486(c); 10 U.S.C. Ch. 137; and 42 U.S.C. 2473(c).

2. Section 31.205-43 is amended by revising paragraph (c) and the introductory text is republished to read as follows:

**31.205-43 Trade, business, technical and professional activity costs.**

The following types of costs are allowable:

* * * * *

(c) When the principal purpose of a meeting, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information, or the stimulation of production or improved productivity:

(1) Costs of organizing, setting up and sponsoring the meetings, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental and directly associated costs.

(2) Costs of attendance by contractor employees, including travel costs (see 31.205-46).

(3) Costs of attendance by noncontractor personnel provided (i) such costs are not also reimbursed to the individual by the employing company or organization, and (ii) the individual's attendance is essential to achieve the purpose of the conference, meeting, symposium, etc.

[FR Doc. 87-10842 Filed 5-12-87; 8:45 am]

BILLING CODE 6820-61-M

48 CFR Part 31

## Federal Acquisition Regulation (FAR); Extraordinary Compensation and Certain Organization Costs in Connection With Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs)

**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.

**DATE:** Comments should be submitted to the FAR Secretariat at the address shown below on or before July 13, 1987, 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 NW., Room 4041, Washington, DC 20405.

Please cite FAR Case 87-19 in all correspondence related to this issue.

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

**SUPPLEMENTARY INFORMATION:**

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

Enclosure 2

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., *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 (Pub. L. 96-511) does not apply because the proposed rule does not impose any additional recordkeeping or information collection requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

**List of Subjects in 48 CFR Part 31**

Government procurement.

Dated: May 4, 1987.

**Lawrence J. Rizzi,**

*Director, Office of Federal Acquisition and Regulatory Policy.*

Therefore, it is proposed that 48 CFR Part 31 be amended as set forth below:

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

**Authority:** 40 U.S.C. 486(c); 10 U.S.C. Ch. 137; and 42 U.S.C. 2473(c).

## PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

2. Section 31.205-6 is amended by adding paragraph (l) to read as follows:

**31.205-6 Compensation for personal services.**

* * * * *

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they 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~~ which is contingent upon emp. remain with the contractor for a specified period of time. ~~These arrangements are commonly known as "golden handcuffs."~~

* * * * *

2. Section 31.205-27 is amended by revising paragraph (a) to read as follows:

**31.205-27 Organization costs.**

(a) Except as provided in paragraph (b) of this subsection, 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.

* * * * *

[FR Doc. 87-10841 Filed 5-12-87; 8:45 am]
BILLING CODE 6820-61-M

Info
84-18

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18A

29 January 1988

MEMORANDUM FOR THE CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Golden Parachutes/Handcuffs and Organization Costs (FAR Case 87-19)

In accordance with the Memorandum of Agreement Establishing Federal Acquisition Regulation Committees of 15 July 1987, transmitted herewith is a copy of the Cost Principles Committee report of 22 January 1988, subject as above, for advance review.

J. W. ERMERINS
Chairman
Cost Principles Committee

Copy to:
Mrs. Spector, DoD, DASD(P), w/o encl
Mr. Evans, NASA, Asst Admin for Proc, w/o encl
Director, DAR Council, w/o encl

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

FEB 22 1988

MEMORANDUM FOR CAAC MEMBERS

FROM: HARRY S. ROSINSKI
ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 87-19/CAAC Case 87-24/DAR Case 84-18A, Golden Parachutes/Handcuffs and Organization Costs

Transmitted herewith is the DARC's analysis and recommendations (Enclosure 1) with respect to public comments received under the subject case which was published as a proposed rule in the Federal Register on May 13, 1987. (Enclosure 2)

Twenty comments were received of which 17 either offered no objections or concurred with the proposed changes. The remaining comments have been satisfactorily addressed by the Cost Principles Committee. (Enclosure 1)

The FAR Staff recommends that the CAAC approve this case with the minor changes proposed by the DARC.

Questions regarding this case may be referred to Edward Loeb on 523-3781.

Enclosures

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18A

22 January 1988

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Golden Parachutes/Handcuffs and Organization Costs

I. PROBLEM:

To review and make recommendations related to the comments on the proposed rule which was published in the Federal Register on 13 May 1987.

II. RECOMMENDATIONS:

A. That FAR 31.205-6 and 31.205-27 be revised as shown at TAB A and published as a final rule.

B. That the memorandum at TAB B be used to transmit the final rule, together with the TAB C recommended Federal Register notice and the TAB D FAC Preamble, to the Civilian Agency Acquisition Council.

III. DISCUSSION:

A. Background.

On 13 May 1987 the CAA and DAR Councils asked for comments on proposed changes to FAR 31.205-6, Compensation for personal services, and 31.205-27, Organization costs, in order to clarify allowability policy. The proposed changes were prompted by a belief that there has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. Since there are situations in which companies recorded cost structures are directly reflected in the price to the Government, the Government should not bear the risk of paying higher prices simply resulting from a change or resisting a change in ownership; thus the proposed changes would make certain extraordinary compensation payments, commonly referred to as "golden parachutes" and "golden handcuffs," unallowable as well as those costs resulting from resisting or planning to resist reorganization of the corporate structure or controlling interest in the ownership.

B. Comment Summary.

Twenty comment letters were received. The attached APPENDIX lists the commenters and briefly quotes those comments which recommended revisions to the proposed rules. Seventeen commenters either had no objections or comments or concurred with the changes as proposed. Two commenters disagreed with certain portions of the proposed coverages and the remaining commenter nonconcurred in all changes.

C. Discussion of Comments.

1. The American Defense Preparedness Association (ADPA) had an objection in connection with novation and change-of-name agreements. They argue that these costs, even when resulting from objectionable costs of takeovers and mergers, are ordinary administrative costs and therefore should be allowable.

The Cost Principles Committee disagrees. These costs are not at issue in this case. Existing regulations already make costs of this type unallowable and it is not the Committee's intent to make them allowable.

2. The Council of Defense and Space Industry Associations (CODSIA) had several objections, to wit:

a. The language of the proposed cost principle regarding golden handcuffs is inconsistent with the background statement and would disallow payments which are neither extraordinary nor unreasonable. They recommend that the word unreasonable be inserted at 31.205-6(l)(2) preceding the words special compensation.

The Committee does not agree. Adding the word unreasonable duplicates coverage at 31.201-3 and 31.205-6(b) and would infer that there could be a reasonable golden handcuff payment. It is the Committee's intent to not permit recovery of any special payments incurred in conjunction with mergers or business combinations. For example, an individual was performing a job normally paid and objectively worth $50,000 per year, given the nature of the job's duties and responsibilities, but for good reason (e.g., to help the company through a rough financial period) accepted and was paid $30,000 per year. If the new owners immediately raise his pay to $50,000, this would not be considered a golden handcuff, but a pay raise to normal, i.e., reasonable, levels. However if the employee's pay is increased from $30,000 to $80,000 per year, but $30,000 of this amount is contingent upon the individual remaining with the company for a 3-year period, the contingent amount is the unallowable golden handcuff cost.

In order to more explicitly define golden handcuffs, we have revised the coverage at TAB A to more closely link the handcuff

D. Consideration of Section 805 of P.L. 100-180, the DoD Authorization Act of 1988.

The Committee reviewed the language as contained in Section 805 of P.L. 100-180 and found it to be substantially the same as the proposed rule regarding "golden parachutes." Thus the Committee recommends adopting its previously proposed language. However, Section 805 makes no reference whatsoever to "golden handcuffs" or other organization or business combination costs. The Committee has discussed the significance of this omission and reached the conclusion that coverage of these areas remains necessary as stated in our background statement in the Federal Register notice of May 13, 1987.

E. Other Comments.

The Committee recommends deleting from 31.205-6(l) the sentences which begin "These arrangements are commonly known as 'golden ....'" They are slang terms which become outdated after a period of time, and also can become unduly limiting. It is possible that someone could develop a tin parachute or handcuff, or they could be described as being made of linen, paper, or plastic. We prefer to avoid the use of slang terms in the FAR. We believe the definitions are sufficiently precise to protect the Government's interest and, therefore, we have deleted these two sentences.

F. Summary.

The comments received generally concurred or did not object to the proposed rule. Only relatively minor issues, discussed above, were raised. We recommend only minor adjustments to our previous language and that a final rule be promulgated immediately without further public discussion.

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

J. W. Ermerins

J. W. ERMERINS
Chairman
Cost Principles Committee

DoD Members

Edwin Cornett, Army
Terrence D. Sheppard, Air Force
Donald W. Reiter, DLA
Charles D. Brown, OASD(C)
Frances Brownell, DCAA
Donald Sawyer, OASD(A&L)/CPF

Other Members

Robert W. Lynch, NASA
William T. Stevenson, DOE

payment to the requirement to remain with the company. Accordingly, we have changed "... 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" to read:

> "... in which those employees receive special compensation which is contingent upon the employee remaining with the contractor for a specified period of time."

b. CODSIA suggests that where the merger or acquisition benefits the Government, such costs should be allowable when they are otherwise reasonable and allocable. They recommend that subparagraph (a) of section 31.205-27 be modified accordingly.

The Committee does not agree. The Government has a longstanding policy against paying costs related to all forms of capital formation, including fundamental structural reorganizations. It is a given of Government contracting that a contractor comes forth prepared to perform the contract. A contract is not a vehicle to underwrite capital formation. The costs in question here are clearly related to such activities, and are being disallowed for that reason.

c. Using the same "reasonableness" rationale, CODSIA recommends use of a separate paragraph (b) for FAR 31.205-27 addressing the cost allowability vis-a-vis resisting or planning to resist any corporate reorganization or change in controlling interest and to also state that these costs are subject to the FAR 31.201-3 reasonableness criteria.

Again CODSIA would have us believe that a portion of these costs are subject to the reasonableness criteria while others are apparently not. Otherwise, why specifically state that the costs of resisting or planning to resist a takeover are subject to 31.201-3? The Committee is not convinced that these costs need treatment in a separate paragraph or that they require a direct linkage with 31.201-3, Reasonableness.

3. The Professional Services Management Association (PSMA) recommends that FAR 31.205-27 be deleted in its entirety and that a reasonable portion of "golden parachutes" and "golden handcuff" costs should be allowable since they are a necessary cost in today's business merger atmosphere. PSMA avers that the Government benefits from these activities and therefore should pay for them.

Other than PSMA's allegation that the Government benefits from such activity no evidentiary material is presented. The Committee has previously addressed similar comments and will not further belabor the point.

Attachments:
APPENDIX - Comment Matrix
TAB A - Ppsd Rev. to FAR 31.205-6 and 31.205-27
TAB B - Transmittal Memo to CAAC
TAB C - Ppsd <u>Federal Register</u> Notice
TAB D - FAC Preamble

SUMMARY OF COMMENTS
DAR Case 84-18A, Golden Parachutes/Handcuffs and Organization Costs
FAR Case 87-19

| | | No comment/ Objection | Concur/ Support | Nonconcur | Partial Objection |
|---|---|---|---|---|---|
| 1. | Federal Communications Commission | X | | | |
| 2. | USA Railroad Retirement Board | X | | | |
| 3. | U.S. Small Business Administration | X | | | |
| 4. | American Defense Preparedness Association | | | | X |
| 5. | National Labor Relations Board | X | | | |
| 6. | Agency for International Development | | X | | |
| 7. | U.S Department of Housing and Urban Development | X | | | |
| 8. | Panama Canal Commission | X | | | |
| 9. | National Endowment for the Humanities | X | | | |
| 10. | U.S. Department of Justice | X | | | |
| 11. | Office of GSA Acquisition Policy and Regulations (GSA) | X | | | |
| 12. | DoD Inspector General | | X | | |
| 13. | U.S. Information Agency | | X | | |
| 14. | Council of Defense and Space Industry Associations (CODSIA) | | | | X |
| 15. | Professional Services Management Association | | | X | |
| 16. | Pennsylvania Avenue Development Corporation | | X | | |
| 17. | U.S. Department of Agriculture | | X | | |
| 18. | Veterans Administration | | X | | |
| 19. | Office of Federal Procurement Policy | X | | | |
| 20. | U.S. Nuclear Regulatory Commission | X | | | |
| | TOTAL | 11 | 6 | 1 | 2 |

| Objections/Issues | Commenter |
|---|---|
| The costs to a contractor, over and above ordinary and normal expenses, resulting from acquisitions and mergers should not be charged to the Government as an ordinary expense in performing a Government contract. On the other hand, it should be made clear that expenses incurred in connection with novation and change-of-name agreements (FAR 42.12) are allowable, even when resulting from objectionable costs of takeovers and mergers. Such agreements are ordinary administrative costs affecting performance of the Government contract and therefore should be allowable. | American Defense Preparedness Agency |
| It is the opinion of the undersigned associations that the proposed language 31.205-6 (1)(2), disallowing the cost of "golden handcuffs," is unnecessary and, moreover, is inconsistent with the policy enunciated in the background statement preceding the proposed new cost principle. While the background statement defines "golden handcuffs" as "extraordinary payments above and beyond ordinary, customary, and reasonable compensation payments to employees for services rendered," the proposed cost principle would define <u>any</u> compensation in excess of normal pay as "golden handcuffs," or <u>per se</u> unreasonable and extraordinary. CODSIA agrees that the government should not have to reimburse extraordinary and unreasonable compensation payments, and thus agrees with the statement of policy offered as background to the proposed cost principle. However, the language of the proposed cost principle is inconsistent with this policy and would disallow payments which are neither inconsistent with this policy and would disallow payments which are neither extraordinary nor unreasonable. | Council of Defense and Industry Associations |
| Since the ultimate resource of the acquired company is its employees, the success of an acquired company is usually related to its | |

Objections/Issues | Commenter

ability to retain key people, such as certain management, technical and administrative staff (e.g., tax staff personnel) for a specific period of time after the acquisition. To disallow the reasonable cost of special compensation arrangements (i.e., completion bonuses) to retain such valuable resources of an acquired company would be detrimental to the acquiring company as well as its customers--in this case, the U.S. Government.

We recommend that allowability of such arrangements continue to be handled on a case by case basis, employing the "reasonableness criteria" already provided by FAR 31.201-3 and should not, out of hand, be deemed unallowable. Therefore, it is recommended that 31.205-6(l)(2) be revised to read as follows:

> "(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 received unreasonable special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time."

We suggest that in the judgment of the contracting officer, where the merger or acquisition benefits the government, their costs be allowable where they are otherwise reasonable and allocable. Subparagraph (a) of section 31.205-27 should be modified accordingly.

In this connection, and applying the same reasonableness criteria as discussed above, we recommend that the proposed revision to FAR 31.205-27 addressing the allowability of expenditures incurred in resisting or planning to resist any corporate reorganization or change in controlling interest

| Objections/Issues | Commenter |
|---|---|
| of a business be addressed in a separate paragraph (b) as follows:<br><br>"(b) Costs in connection with 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 are subject to the reasonableness criteria provided in 31.201-3." | |
| These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.<br><br>In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary and reasonable cost of doing business in today's business merger atmosphere (condoned by Congress). | Professional Services Management Association |

TAB A
DAR Case 84-18A

RECOMMENDED CHANGES TO FAR 31.205-6 AND 31.205-27

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 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.

(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 which is contingent upon the employee remaining with the contractor for a specified period of time.]

(m) Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) ~~below~~ [of this subsection], 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.

[ ] - New coverage.
~~words lined out~~ - coverage deleted.

TAB C
DAR Case 84-18A

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31 (Federal Acquisition Circular 84-XX)

Federal Acquisition Regulation (FAR); Golden Parachutes/Handcuffs and Organization Costs

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

ACTION: Final rule.

SUMMARY: Federal Acquisition Circular 84-XX amends the Federal Acquisition Regulation (FAR) 31.205-6, Compensation for personal services, and 31.205-27, Organization costs.

EFFECTIVE DATE: ___________.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405. Telephone (202) 523-4755.

SUPPLEMENTARY INFORMATION:

A. Public Comments.

A notice of the proposed rule was published in the Federal Register on May 13, 1987 (52 FR 18159), recommending revisions to FAR 31.205-6 and 31.205-27 to control costs and clearly state the policy of the Government regarding the allowability of these costs. Of 20 comments received, 17 either concurred or had no

objection or comment. Two commenters partially objected with the proposed rules and one commenter totally disagreed. Minor editorial changes were made to the definitions of the proscribed costs, and the slang terms, "golden parachutes" and "golden handcuffs" were deleted.

B. Regulatory Flexibility Act.

The 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 business entities are awarded on a competitive fixed-price basis and cost principles do not apply.

C. Paperwork Reduction Act.

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because the changes to FAR 31.205-6 and 31.205-27 provide clarification as to the allowability of compensation for personal services and organization costs and do not impose any reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501 et seq.

LIST OF SUBJECTS IN 48 CFR PART 31

Government Procurement.

Dated: ________, 1987

Harry S. Rosinksi,
Acting Director, Office of Federal Acquisition and Regulatory Policy.

PART 31 -- CONTRACT COST PRINCIPLES AND PROCEDURES

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).

2. Paragraphs (l) of subsection 31.205-6 and (b) 31.205-27 are revised to read as follows:

(See approved version of TAB A)

TAB D
DAR Case 84-18A

RECOMMENDED FAC PREAMBLE

Item No. _____ - Golden Parachutes/Handcuffs and Organization Costs

There has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. The Government found that the previous cost principles at FAR 31.205-6 and 31.205-27, lacked specificity regarding certain costs. FAR 31.205-6 did not address the issue of special compensation in conjunction with a planned or executed merger or business combination. FAR 31.205-27 did not prescribe the treatment to be accorded costs resulting from resistance or planned resistance to the reorganization of the corporate structure of a business or change in the controlling interest in the ownership of a business.

The revised rules clarify the policy of the Government regarding these costs and specifically describes the costs which are unallowable. The revisions do not reflect or result from a change in allowability policy.

[illegible]

**DATE:** 2/5/88

**DAR CASE:** 84-18

**DISCUSSION:**

CAM POSTED

YES

NO

DARC
DARSC

A

Approved committee's 1-22-88 report. DAR staff to do. Letter to CAAC must note that GP is statutory i.e. "fast track"

Give to $O_3$

To typing 2-8-88
"FAST TRACK"

A

**COST PRINCIPLES COMMITTEE**
**DAR Case Report Due Dates**
**as of 21 December 1987**

| DAR Case | Subject | Rept Date |
|---|---|---|
| 87-310 | Aerospace Exports | 06 Jan 88 |
| 84-18 | Accounting for Mergers and Business Combinations--cmts | 13 Jan 88* |
| 87-301 | Golden Parachute Payments, Unallowable | 13 Jan 88* |
| 87-303 | Technical Data (Section 808, 1988 DoD Authorization Act) | 15 Jan 88 |
| 86-027 | Litigation Costs | 31 Jan 88* |
| 85-257 | Value Engineering Cost Principle | 15 Feb 88* |
| 87-118 | Travel Costs | 15 Feb 88* |
| 86-029 | Leasing | 29 Feb 88* |

*New report date, based on present status and priorities.

DAR 84-18

FAR 87-43

DARC (O. Green)

Info B

OCT 22 1987

Mr. John E. Byrne
Director
Office of the Federal Register
National Archives and Records
Administration
Washington, DC 20408

Dear Mr. Byrne:

Enclosed is a notice of intent to develop a proposed rule on proposed changes to Federal Acquisition Regulation (FAR) Parts 30, and 31, concerning Mergers and Other Business Combinations. The FAR is codified in 48 CFR Chapter 1.

We request that the enclosed material be published in the Federal Register according to the regular publication schedule, and as requested in the special handling instructions. Please advise us of the date of publication, the Part number, and the comment due date.

If further information is required, please call me at 523-4755.

Sincerely,

(signed) Margaret A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosure

cc: Official file - VRS (FAR Case 87-43), Reading File - VRS, VR(VL), V(2), DARC,
VRS: MWillis:lf:523-4755:10/19/87 (Byrne/87-43intent)

Concurrences: VRR(Van Lierde)_____ Date_______________

VR_______________ Date_______________

VR Date

CASE MANAGEMENT RECORD

EXEC SEC

27 Oct. 87

ORIGINAL

UPDATED X

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

TITLE: Mergers AND Other Business Combinations

REFERENCE:

ORIGINATION DATE:

SYNOPSIS: Attached is Federal Register Notice (Intent to ___ Proposed rule) ON "Mergers" - Golden Parachutes / handcuffs.

PRIORITY: | ORIGINATOR CODE:

KEYWORDS

CASE REFERENCES

FAR CITES

DFARS CITES

CASE MANAGER: | SUBCOUNCIL ASSIGNMENT:

COGNIZANT COMMITTEES

RECOMMENDED ACTION: Council ___

| BOX RECORD | 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION:

PROPOSED RULE: | INTERIM RULE: | FINAL RULE:

DaRC

OCT 15 1987

MEMORANDUM FOR FAR SECRETARIAT

FROM: for Frank Van Lierde
HARRY S. ROSINSKI
ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 87-43, Mergers and Other Business Combinations (DAR Case 84-18/CAAC Case 87-24)

Please arrange for publication of the enclosed notice in the Federal Register. The notice was approved by the DARC on October 9, 1987, and by the CAAC on October 14, 1987.

This case is the final part of the subject DAR and CAAC cases. A proposed rule was previously published under these cases dealing with "Golden Parachutes" and Golden Handcuffs". That proposed rule was identified as FAR Case 87-19. It was considered appropriate to establish a separate FAR case for the current notice to facilitate the segregation of public comments on the separate issues.

Please contact Frank Van Lierde if you have any questions. Revisions noted on the enclosure were coordinated with Charley Lloyd of the DARC on October 14, 1987.

Enclosure

cc: Director, DARC

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

OCT 13 1987

MEMORANDUM FOR CAAC MEMBERS

Rogemuschwoof

FROM: for HARRY S. ROSINSKI
ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: CAAC Case 87-24/DAR Case 84-18/FAR Case 87-19, Mergers and Other Business Combinations

DARC letter of October 9, 1987, subject as above, is forwarded herewith for CAAC consideration.

Questions related to this case may be referred to Frank Van Lierde on 523-3781.

Enclosure

MFR: 10/14/87
Approved by CAAC today w/revisions indicated.

Changes were coordinated with Charley Lloyd on 10/14/87.

DAR 84-18
FAR 87-~~19~~ 43

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

PRODUCTION AND LOGISTICS
(P/DARS)

B

Mailed 09 OCT 1987

Coordinated - Reg
Willis - 7AMP
13 Oct. 1987

MEMORANDUM FOR MR. HARRY S. ROSINSKI, ACTING CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Federal Register Notice: Mergers and Other Business Combinations (FAR Case 87-19)

Attached for CAA Council review is a proposed Federal Register notice announcing an intent to develop a proposed rule on cost stemming from business mergers.

The DAR Council believes it will be to our mutual advantage to solicit predeliberational comments on this sensitive issue. We request that the CAA Council review the attached notice at its earliest convenience. If the Council concurs, please refer the notice to the FAR Secretariat for publication in Federal Register.

Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council

Attachment

10/14/87
Frank Van Riede +
Me → two minor changes
should be in Fed Reg
next week (by 21 Oct.)
new FAR case #87-43
assigned →

10/19

10/22

(Billing Code 6620-61-M)

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:** Notice of intent to develop a proposed rule. ~~pertaining to the allocability and allowability of costs stemming from mergers and other business combinations.~~ OK

**SUMMARY:** The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council invite public comment concerning the development of changes to FAR Parts 30 and 31 on the allowability of costs incident to 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 date of publication), to be considered in the formulation of a proposed rule. Please reference FAR Case 87-~~49~~ -43 in all correspondence relating to this issue. OK

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

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

**SUPPLEMENTARY INFORMATION:**

**A. Background**

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing the subject of business combinations, and particularly the allowability of costs resulting from such combinations. This review has been occasioned by the Councils' concern that existing regulations on certain aspects of this subject may not be adequate as evidenced by recent litigation. Specifically, the Councils are considering whether, in circumstances where a Government contractor is acquired, the Government should recognize depreciation or cost of money flowing from asset write-ups that result if the "purchase" method is used to account for the business combination. Government representatives have expressed concern whether, in the circumstances when a contract price will be negotiated based upon the contractor's cost, the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. Accordingly, the Councils will consider comments from interested parties regarding approaches the Councils might employ in dealing with this issue.

HARRY ROSINSKI
Acting Director, Office of Federal
Acquisition and Regulatory Policy

[illegible] CASE RECORD

**DATE:** 9-11-87 | **CAM POSTED** | DARC
---|---|---
**DAR CASE:** 84-18 | YES | DARSC
**DISCUSSION:** | NO |

O1 to schedule briefing for DASD(P) to determine whether political considerations preclude issuance of proposed draft. Kelly says if you need case CAS version is way to go. [illegible] agrees. Could view case as "not recovering" cost of money previously paid.

**APPROVAL DATE:** Return to O1

**(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 |
| M1 | M1 | M1 |
| O1 | O1 | O1 |

**STATUS**

| ORIGINAL | |
|---|---|
| UPDATED | X |

| CASE NUMBER: | DAR: See below | CAAC: | FAR: |
|---|---|---|---|

A

TITLE: Numerous

REFERENCE: DAR Cases 84-18; 85-139; 86-8; 86-36; 86-37; 86-38; 86-39; 86-40; 86-129

16 SEP 1987

ORIGINATION DATE:

SYNOPSIS:

Attached is the projected Case Schedule for the Cost Accounting Standards Policy Group

| PRIORITY: | ORIGINATOR CODE: F |
|---|---|

| KEYWORDS | | | | |
|---|---|---|---|---|

| CASE REFERENCES | | | | | |
|---|---|---|---|---|---|

| FAR CITES | | | | | |
|---|---|---|---|---|---|
| DFARS CITES | | | | | |

| CASE MANAGER: | SUBCOUNCIL ASSIGNMENT: |
|---|---|

| COGNIZANT COMMITTEES | | | |
|---|---|---|---|

RECOMMENDED ACTION:

Info

16 SEP 1987

| BOX RECORD | 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION: |

| PROPOSED RULE: | INTERIM RULE: | FINAL RULE: |
|---|---|---|

26 JUL 1985

PROJECTED CASE SCHEDULE

9 Sep 1987

| CASE | Committee Report Due | DARC Consideration | CAAC Review & Reconciliation | Public Comment Process | Resolution of Public Comments |
|---|---|---|---|---|---|
| SECTION I | | | | | |
| Original CASPG Report Being Reported | | | | | |
| 86-8 - Pay-As-You-Go Pension Plans | 10/31/87 | 11/30/87 | 1/31/87 | 7/31/87 | 09/30/87 |
| 86-37 - Insurance, CAS 416 Revision | 11/30/87 | 12/31/87 | 2/29/88 | 8/31/88 | 10/31/88 |
| 86-729- Operating Rules for CASPG | 8/31/87 | | | | |
| SECTION II | | | | | |
| CASPG Report Already Submitted<br>Case Being Processed | | | | | |
| 85-139 - CAS Incorporation Into FAR | Submitted<br>1/22/86 | Completed<br>3/24/86 | Completed<br>6/3/86 | Completed<br>8/29/86 | 12/15/86 |
| 86-36 - Insurance, Discount Factors | Submitted<br>3/21/86 | Completed<br>5/5/86 | Completed<br>7/8/86 | Completed<br>10/7/86 | 12/31/86 |
| 86-40 - Capitalization Thresholds | Submitted<br>3/28/86 | Completed<br>5/15/86 | Completed<br>7/8/86 | 10/7/86 | 12/31/86 |
| 86-38 - Pension Plan Terminations | Submitted<br>3/24/87<br>5/19/87<br>9/8/87 | | | | |
| 86-39 - Pension Plan Overfunding | Submitted<br>3/24/87<br>5/19/87 | | | | |
| 84-18 - Accounting for Mergers | Submitted<br>7/20/87 | | | | |

Projected Case Schedule - 9 Sep 87 - cont'd

| CASE | Committee Report Due | DARC Consideration | CAAC Review & Reconcilation | Public Comment Process | Resolution of Public Comments |
|---|---|---|---|---|---|
| SECTION III | | | | | |
| CASPG Report Already Submitted - Case Closed | | | | | |
| 85-71 - Overhead Cost Allocation | Submitted 12/20/85 | Closed 1/ 1/22/86 | | | |
| 85-127 - CAS Policy Group Procedures | Submitted 6/19/85 | Closed 2/ 12/13/85 | | | |
| 85-213 - CAS Applicability | Submitted 1/9/86 | Closed 3/ 1/29/86 | | | |
| 86-58 - Cost, Pension-CAS 412 and FASB87 | Submitted 4/25/86 | Completed 5/20/86 | Completed 8/14/86 4/ | 7/ | N/A |
| 85-95- Direct Charging of Sole-Source Follow-On Proposals | Submitted 12/2/85 | Completed 11/3/86 5/ | 6/ N/A | N/A | N/A |

1/ The CASPG recommended that CAS should continue to be limited to equitable allocation of cost to the contract level and that no changes in this area should be made.

2/ The DARC determined that the CASPG is a DARC committee and should operate under the rules established in the DAR Operating Guide, rather than under a separate set of procedures.

3/ The CASPG recommended that CAS rules, concerning contracts awarded on the basis of adequte price competition, not be changed.

4/ FAC 84-20 advised contractors, who are required to discontinue using spread gain actuarials cost methods as a result of FAS 87, the approach the Government will follow in negotiating contracts with them.

5/ The Deputy Secretary of Defense directed that additional information be obtained from the Services, DIA, and DCAA, which should provide for a more informed decision in the charging of sole-source follow-on proposal costs.

6/ Applies only to DOD.

7/ Public comments are not required.

TAB B

4/PROJECTED1

OFFICIAL MASTER CASE RECORD

**DATE:** 8-14-87   **CAM POSTED**   **DARC**   A.

**DAR CASE:** 84-18   **YES** 8/18   **DARSC**

**DISCUSSION:**   **NO**

F, to get scoop on present value computation from Kelly along with a side by side to CP's report so we can see the whole nine pieces. Report due 8-26-87

**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:**   **STATUS**

| YES | NO | ABSTAINED |
|---|---|---|
| A1 | A1 | A1 |
| F1 | F1 | F1 |
| S1 | S1 | S1 |
| D1 | D1 | D1 |
| M1 | M1 | M1 |
| O1 | O1 | O1 |

B

# DEPARTMENT OF THE NAVY

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

DAR Staff
Case 84-18

17 August 1987

MEMORANDUM FOR MR. JAMES W. ERMERINS, CHAIRMAN, COMMERCIAL COST PRINCIPLES COMMITTEE

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

Encl: (1) FAR Secretariat letter dated 4 August 1987 forwarding public comments
(2) Federal Register article dated 13 May 1987 providing proposed rule

Enclosure (1) contains public comments which have been received on the enclosure (2) proposed rule.

It is requested that your Committee review these comments and submit your recommendations to the DAR Council by 30 September 1987.

If I can be of any assistance, please let me know.

Linda E. Greene
LINDA E. GREENE
Acting Navy Policy Representative
Defense Acquisition Regulatory
Council

Copy to:
CCP Committee Members
✓DAR Council Members, w/o encl

19 AUG 1987

OFFICIAL MASTER CASE RECORD

TE: 8-5-87 CAM POSTED DARC DARSC

R CASE: 84-18 YES

SCUSSION: NO

Move to dismission 8-12-87 pending D, 's return.

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

84-18

MAY 1 - 1987

MEMORANDUM FOR FAR SECRETARIAT

FROM: LAWRENCE J. RIZZI (signed) Lawrence J. Rizzi
CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 87-19, Golden Parachutes and Golden Handcuffs (extract from Mergers and Other Business Combinations case) CAAC Case 87-24/DAR Case 84-18

Please arrange for publication of the attached case as a proposed rule. It was approved by the DARC sometime before April 8, 1987 (their letter to the CAAC was undated). It was approved by the CAAC on April 29, 1987. CAAC editorial revisions annotated on the enclosure were coordinated with Owen Green on April 29, 1987.

Please contact Frank Van Lierde if you have any questions.

Enclosure

cc: Director, DARC

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

APR 14 1987

MEMORANDUM FOR CAAC MEMBERS

FROM: LAWRENCE J. RIZZI
CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: CAAC Case 87-24, Golden Parachutes and Golden Handcuffs (extract from Mergers and Other Business Combinations case), DAR Case 84-18

The purpose of this memorandum is to request your consideration of the attached case from the DARC. The DARC decided to expedite the proposed FAR coverage on "golden parachutes", "golden handcuffs", and costs of resisting mergers and acquisitions. It has therefore extracted these items from the larger case relating to Mergers and Other Business Combinations (DAR Case 84-18), and is proposing that a separate proposed rule dealing with them be published immediately. Congressional interest in the issues prompted DOD to expedite this portion of the case.

The FAR Staff has no objection to the proposed coverage on "golden parachutes", "golden handcuffs", etc. (see paragraph III B of the Committee report).

Please note that the enclosure includes the entire committee report on mergers and other business combinations. It should be retained for future reference when the remainder of the case is considered. (Proposed coverage on mergers for the cost principles is presently being coordinated with the CAS Policy Group.)

Please contact Frank Van Lierde if you have any questions on this case. It will be discussed at a forthcoming CAAC meeting.

Enclosure

MFR: 4/29/87
Coordinated revisions
w/ Owen Green.

MFR: 4/22/87
Discussed today -
decision next week

MFR: 4/29/87
Approved by CAAC
as revised.

4-25
CAAC Case 87-2

THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-8000

ACQUISITION AND LOGISTICS
P/DARS

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

DEPARTMENT OF THE AIR FORCE
WASHINGTON, D.C. 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

July 1, 1987

MEMORANDUM FOR COL. FRED M. HALBERSTADT, AIR FORCE POLICY MEMBER,
DAR COUNCIL

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

Reference memorandum of 31 March 1987, which tasked the CAS Policy Group to review and coordinate on Tab A, Part 3 of the subject Cost Principles Committee Report.

The CAS Policy Group has not finished it's work on the referenced tasking. Request the due date for our report be changed to 15 July 1987.

David C. Relly

DAVID C. RELLY
Chairman, CAS Policy Group

**DEPARTMENT OF THE AIR FORCE**
**WASHINGTON, D.C. 20330-1000**

OFFICE OF THE ASSISTANT SECRETARY

May 22, 1987

MEMORANDUM FOR COL. FRED M. HALBERSTADT, AIR FORCE POLICY MEMBER, DAR COUNCIL

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

Reference memorandum of 31 March 1987, which tasked the CAS Policy Group to review and coordinate on Tab A, Part 3 of the subject Cost Principles Committee Report.

The CAS Policy Group has not finished it's work on the referenced tasking. Request the due date for our report be changed to 5 June 1987.

David C. Relly

David C. Relly
Chairman, CAS Policy Group

# *Case Management Record*

| DAR Case No. 84-18 | CAAC No. | Original / Updated ✓ | Date 10-12-88 |
|---|---|---|---|

**Title** ACCTG FOR MERGERS AND OTHER BUSINESS COMBINATIONS

**Reference** CCP Report 10-12-88

**Synopsis**

| Priority | Submitted By A1 | Originator Code | Case Manager A. |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | CCP | | | |

**Recommendation** DISCUSSION 9 NOV 88

**Notes**

B

**DEPARTMENT OF THE ARMY**
**HEADQUARTERS, U. S. ARMY MATERIEL COMMAND**
**5001 EISENHOWER AVENUE, ALEXANDRIA, VA 22333-0001**

OCT. - 1988

DAR Staff
Case 84-18B

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. PROBLEM:

To review and make recommendations relative to the comments received in response to the October 28, 1987 Federal Register notice statement which expressed the Defense Acquisition Regulatory and the Civilian Agency Acquisition Councils' concern about whether the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. More specifically, whether the Government should recognize depreciation or cost of money flowing from asset write-ups that result if the "purchase method" is used to account for the business combination. For ease of reference we have enclosed at Atch 1, our previous report of February 4, 1987, and at Atch 2, the Cost Accounting Standards (CAS) Policy Group's report of July 20, 1987.

II. RECOMMENDATIONS:

A. That FAR 31.205-10, 31.205-11, 31.205-16 and 31.205-49 be revised as shown at Tab A and published as proposed rules.

B. That FAR 30.404 and 30.409 be revised as shown in Tab B and published as proposed rules simultaneously with the proposed rules in paragraph A above. This revised language is consistent with that proposed by the CAS Policy Group in their report of July 20, 1987.

C. That the DAR Council seek a legal review of the language shown in Tab C, revising FAR 31.109 and 42.12 and decide on the appropriate course of action in light of the Committee's comments in Section III.C.1.

D. That upon approval of Tabs A, B, and C the memorandum at Tab D and the related document at Tab E be forwarded to the CAAC.

III. DISCUSSION:

A. BACKGROUND.

This case began life as 84-18, Accounting for Mergers and Other Business Combinations. We had previously reviewed the pertinent issues and forwarded recommended coverage to the DAR Council by memorandum dated February 4, 1987. Since the proposed coverage included changes to the CAS the DAR Council decided to sever those cost principles that could stand alone from those that were associated with the revisions to CAS. Thus, two cases were established; 84-18A, Organization Costs and Compensation Incidental to Business Acquisitions, and 84-18B, Accounting for Mergers and Other Business Combinations. Case 84-18A addressed golden parachute and handcuff costs (FAR 31.205-6) as well as certain organization and reorganization costs (FAR 31.205-27). These changes were published as a final rule in FAC 84-35, April 1, 1988. The other case, 84-18B, was forwarded to the CAS Policy Group for their consideration of the combined cost principles and CAS changes that were impacted as a result of the Committee's proposed rule to limit the write-up of assets when the "purchase method" is used to account for mergers and other business combinations. The CAS Policy Group's recommendations have been incorporated in the proposed language except for minor editorial changes.

The proposed language pertaining to asset write-ups contained in our February 4, 1987 report (Case 84-18) to the DARC was not published as proposed rules. However, the DARC and the CAAC published a notification of their intent to develop a rule in the Federal Register of October 28, 1987.

Thirty comment letters were received in direct response to the October 28, 1987 Federal Register notice. The Committee also incorporated comments included in two discussion papers, one appearing in the Federal Contracts Report of March 7, 1988 and the other prepared by Pettit & Martin and delivered during a presentation at an American Bar Association Conference of October 1, 1987 by the ABA's Section on Public Contracts. Additionally, a meeting was held with the American Institute of Certified Public Accountants (AICPA) on June 17, 1988, as requested by them in their letter. They believed that a discussion would be more beneficial than written comments. We have referenced their verbal comments where appropriate but have not increased our total count of documents reviewed to avoid double counting. The adjusted count of 32 breaks down as follows: 15 had no comment; 4 concurred; 9 nonconcurred; and 4 indicated partial objections. A matrix which groups the comments in broad categories is included as an APPENDIX to this report. The comments are discussed below by topic and numbered as in the matrix.

B. Specific Comments.

1. Real Cost/Generally Accepted Accounting Principles (GAAP).

Davey Compressor Company, Vincent T. Noone, American Institute of Certified Public Accountants (AICPA), Emerson Electric Company, American Bar Association (ABA), Steiger and Evans, and Pettit & Martin objected to any prohibition on the allowability of asset write-ups that result from a business combination when the "purchase method" of accounting is used. They point out that the cost to the acquiring company is the purchase price paid for the acquired company. This cost determines the fair market value of the purchased assets. If the acquiring company expends more to acquire a company than the recorded (book) value of the acquired company's assets, the assets are stepped-up to their fair market value. This stepped-up amount then serves as the basis for future depreciation (future depreciation being that post-dating the acquisition). Futhermore, the "purchase method" is mandated by GAAP through Accounting Principles Board Opinion No. 16 (APB 16), except in limited circumstances which have no bearing on this particular discussion. Additionally, the Cost Accounting Standard at FAR 30.404 recognizes the "purchase method".

Committee Comments.

The Committee believes 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 revaluation resulting from business combinations, thereby recognizing altered depreciation and facilities capital cost of money amounts in accounting periods subsequent to the acquisition. Under this approach equity should be 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.

In choosing between these two broad approaches, the Committee 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.

In view of this, the Committee believes that extending the "depreciation capture" 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 overall.

Indeed, for precisely this reason, the ASPR Committee provided expressly for the abandonment of this approach, and the substitution of the 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" 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? 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 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 event will also result in no "gain" or "loss", and no attendant credit or charge for Government contract costing.

2. Competition.

Avco Research Laboratory, the Council of Defense and Space Industry Association (CODSIA), AICPA and the ABA have averred that cost and price increases will be controlled by the competitive forces of the market place and not by the suppliers' ownership. Additionally, the Government, by rejection of the purchase method of accounting, seeks to to place itself in a more favorable position than commercial customers.

Committee Comments.

The Committee was also influenced by considerations of the competitive market place, or more accurately, the lack thereof. In juxtaposition to those opinions expressed in the foregoing, the Committee perceived 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. Commercial prices are normally set by operation of the marketplace. Thus, commercial customers would not suffer an increase in price solely because of a change in ownership, and the Government would.

3. Capital Generation.

McKenna, Conner & Cuneo; the American Defense Preparedness Association; CODSIA; ABA; Steiger and Evans; and Pettit & Martin have made two major points. First, that the objective of business combinations is to generate capital. One method of acquiring capital is by stepping up asset values. The imposition of limitations on the revaluation of assets severely depresses the attractiveness of aerospace and defense oriented companies in the marketplace. Second, the additional implication is that since the proposed rule does not permit recovery of the cost of the investment in the acquired entity it will result in a disincentive to invest in defense assets and thereby shrink the defense industrial base and increase Government procurement costs.

Committee Comments.

With respect to the first point the Committee believes that the price of a target company largely reflects its future profitability. Asset valuations are only a small part of that assessment. The market value of companies, including those with defense orientation, is based partially on the cash flow they generate. To the extent that a defense company's value has been artificially inflated by anticipation of the Government paying increased depreciation expenses for assets after one firm is acquired by another, the draft coverage will return the market value of the firm to a value based on the real worth of the company and not one created by the Government peculiar cash flow. The argument concerning contractor investment in the industrial base is the more serious one; it also is an even more persuasive reason to adopt the Committee's recommended position. When a defense firm is acquired and its assets written up, the Government not only pays depreciation on an asset it may have already substantially paid for, but it is also paying depreciation on an old existing asset. No change in productivity has occurred. The net result is an increase in unit cost to the Government through higher overhead expenses and the likely resultant decrease in quantities purchased and deployed. Productivity and modernization come from firms investing in new assets, not acquiring and inflating the write-offs on old ones. In fact, money that goes to acquire existing firms at high prices is being diverted from investment in new plant and equipment which is the only real hope for increased productivity in the defense industrial base. The fact that firms are, in numerous cases acquiring actual or potential competitors and thereby shrinking the industrial base by the very act of acquisition should also be noted.

The complaint that a no-write-up rule is unfair to the acquiring contractor is in the Committee's opinion flawed. The argument seems based on the false premise that an asset write-up without a disposal credit would ever be acceptable to the Government. However, the determination of financial advantage is not so simple or clear-cut when the immediate "depreciation recapture" is taken into account. It is perfectly possible for this credit approach to be more disadvantageous to the acquiring contractor than the no-write-up rule.

4. Novation.

McKenna, Conner, and Cuneo; Vincent T. Noone; Emerson Electric Company; CODSIA; the ABA; and Steiger and Evans asserted that 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. Additionally, they support clarifying FAR 42.12 to protect the Government on existing contracts and to reduce the opportunities for the Government to secure concessions on unrelated points.

Committee Comments.

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.

Comments regarding changes to FAR 42.12 are contained in Section III.C.1., Additional Committee Comments.

5. Requests Meeting.

The AICPA posited that this subject presents significant legal, business, and economic issues which should be addressed by discussion with the Committee.

Committee Comments.

A meeting was held with the AICPA on June 17, 1988. It is the Committee's opinion that no new issues were introduced by the AICPA. The AICPA's representatives agreed that they would subsequently summarize and submit their comments. Since they have not yet done so we presume they will be received in response to the draft language.

6. Recognition of Gain Sharing.

The DoD/IG postulated that the excess of the selling price received over the stated net book value is a gain to the sellers in which the Government should share.

Committee Comments.

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 and thus there is no need, generally, for recognition of gain sharing. However, in those cases where asset revaluations are recognized, provisions have been made, as suggested by the DOD/IG for the Government to share in the gain to the extent that it represents excess depreciation.

7. Strengthen Novation.

The DoD/IG has proposed that increased costs on current contracts can be avoided through the proper use of novation agreements.

Committee Comments.

The Committee concurs with the DoD/IG comments. Reference our previous discussion under paragraph 4.

8. Appraisals.

The DoD/IG propounded the idea that 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.

Committee Comments.

The IG's suggestion called the Committee's attention to a situation that is evolving faster than the regulatory system's recent ability to respond. The DCAA Member has advised the Committee that, more and more often, her agency is encountering the capitalization of a broad range of newly-created assets on the books of acquiring concerns. The values being capitalized cover such concepts as profits yet-to-be realized on existing backlog,software programs, patents, or aggregated values of small tooling.

The tactical reasons for going this direction and their supporting arguments are easily understood. Goodwill has been unallowable for several years now. Currently, the Government has announced its intention to address the "problem" of upward asset revaluations attendant to a merger. The "jaw-boning" process that has virtually eliminated asset revaluations in large transactions and existing drafts of attempts to codify these policies have made it common knowledge that the Government intends to settle for no less than either no asset write-ups or an equitable immediate credit for the disposal gains. In these circumstances, a newly-created asset seems the perfect safe haven. If the asset did not exist on the books of the acquired company, its valuation cannot be a revaluation. If it had no prior existence as an asset, the consumption of its value was never recognized as depreciation. Therefore, the limitation on disposal gain recognition (i.e., to depreciation previously taken) is zero. The argument concludes that the Government must recognize the depreciable base for the new asset and has no right to a disposal credit, if its appraised value is reasonable.

Despite the superficial appeal of the foregoing argument, it is logically wrong. To grasp why it is wrong, the logic behind the recognition of the disposal gain must be examined. To begin with, the depreciation is intended to provide a reasonable measure of the consumption of an asset's value. When an asset is sold at a price that is greater than its depreciated book value, it can be concluded that too much depreciation was taken over the service life of that asset. The disposal credit corrects the books and recaptures the excessive depreciation.

Creation of a new asset creates a dilemma for the contractors doing so. Putting aside accounting conventions and complexities, at the instant of the combination transaction, the asset in question either does or does not have the value attributed to it in the acquiring entity's appraisals. Obviously, if it does not, the asset should not be recognized. However, if the asset is a reasonable entry on the books of the acquiring entity, then it follows that the books of the acquired company were wrong at the instant of the transaction and stand in need of correction in the form of an equivalent disposal credit. It is reasonable to assume that efforts to generate the value being newly-capitalized were expensed (i.e., instantly and completely depreciated) by the acquired entity when they were incurred. In most circumstances, Government contractors are naturally motivated to expense rather than capitalize simply to recover cost faster. Were the Government to permit a newly-created asset to be capitalized and subsequently depreciated without insisting on a comparable disposal credit, it would be sanctioning a redundant cost recovery. The Cost Principles Committee has provided new coverage for placement at 31.205-49(a)(2)(iv) that is intended to preclude such duplicate recovery.

9. Case-by-Case Benefits.
GAO advocated the concept that 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.

Committee Comments.
The Committee concurs conceptually with the GAO that asset revaluations can be allowed on a case by case basis but not necessarily for the reason cited by GAO; e.g., lower unit costs. The Committee has difficulty in subscribing to any lower cost theory put forth by a contractor since the genesis of the case was to preclude mammoth cost increases on our contracts resulting from mergers and other business combinations. Examples of the parameters under which the Committee would recognize write-ups follow.

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". 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". 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 a cost recapture 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 revaluations is automatic.

10. Marquardt and Related Cases

Several commenters addressed the Marquardt Case (ASBCA 29888 and CAFC 86-1546) in varying ways. Before dealing with the comments, the Committee notes that the case itself, although ostensibly a Government victory, carries an enormous potential for creating other problems.

The facts of the case were that Marquardt was sold by its parent, CCI Corporation, to ISC Electronics in a stock transfer with no subsequent change in the legal or management form of Marquardt. After having first obtained the cognizant ACO's concurrence that a novation agreement was not required because "...the sale involves a transfer of stock, not assets...", Marquardt subsequently presented the Government with a bill representing stepped-up asset values based upon the price paid by its new parent. The Government resisted the increased costs and the issues were drawn in a classical confrontation between legal form and transaction substance. Marquardt's case was rooted in APB 16 which requires the "purchase method" of accounting for such transactions. The Government based its case upon the reasoning behind the agreement reached earlier that no novation had been necessary; i.e., that Marquardt was the same entity before and after the transaction. The Government prevailed at both the ASBCA and the CAFC. In a disquieting dissent to the Appeals Court decision, Judge Bissell noted the narrow basis upon which the majority decision had separated itself from the Gould Case (ASBCA 24881) in which the contractor had prevailed on the allowability of the purchase price assigned in the form of both stepped-up asset values and goodwill. Judge Bissell indicated that the "purchase method" of accounting would have been available to Marquardt if only they had legally combined the corporate structures of parent and subsidiary as had Gould. The dissent went on to point out that such a rule protects the Government from virtually nothing and invites the incurrence of otherwise pointless legal costs simply to qualify the stepped-up costs for allowability under Government contracts.

The Committee believes the danger to the Government extends far beyond that envisioned by Judge Bissell. Primacy of legal form over accounting substance would invite the worst kind of legal gerrymandering aimed at producing those cost allocations which maximize a contractor's return. The Government has a long-standing policy of basing its cost calculations upon organizational reality rather than legal form. The DCAA Contract Audit Manual reflects this policy when it discusses procedures regarding the inclusion of segments in a home office allocation base at paragraph c of 6-606.5, Allocation Bases for Corporate/Home Office Expense:

> To evaluate the bases used by the contractor to distribute home office expenses, the auditor should carefully review the organizational structure and operations of the corporate office and each corporate segment, including details of the type of service and support rendered by the corporate office to each segment... the corporate/home office auditor is responsible for the necessary reviews of segments not involved in government contract work. The objective is to see that the contractor's allocations proportionally distribute home office costs to all segments of the business on the basis of the relative benefits received. Use the applicable contract cost principles (such as FAR 31.201-4, 31.202, and 31.203) as criteria to evaluate the contractor's method.

The FAR subsection and sections referenced by the audit manual are respectively captioned "Determining allocability", "Direct costs", and "Indirect costs". It is noteworthy that nowhere in any of that coverage is there the slightest hint that legal form plays any part in the determination of an appropriate structure for calculating Government contract costs. The audit manual goes on to reinforce that specific point at 6-606.5e:

> The form of the business (foreign or domestic), the extent of ownership (wholly- or partially-owned), or the accounting treatment for financial accounting purposes (consolidated or unconsolidated) are not basic criteria for determining whether a particular segment should be included in or excluded from the residual allocation base....

In the Committee's opinion, the Government would not be well advised to employ the Marquardt decision as any part of the solution of merger problems.

Four commenters referenced Marquardt and other related cases in their comments. Three of them (ABA, Pettit & Martin, and

Norman A. Steiger) were written from the legal perspective. The fourth (Mr. Vincent T. Noone) commented from an accounting and costing policy perspective.

The ABA mentioned Marquardt only as a footnote to their discussion of the Gould case which they cited as being consistent with widely accepted accounting practices and case law in general. They noted that the Government did not dispute the validity of the "purchase method" of accounting but only its application to the acquired entity and that the Court also upheld the "purchase method" and its application to the purchaser but not the acquired entity. They conclude that "In light of its longstanding acceptance and use in Government contract accounting, any change contemplated by the CAAC and DARC should not modify or eliminate the purchase method of accounting without careful study." They also object to the practice in recent years of going beyond the regulations and requiring advance agreements that the assets will not be stepped-up.

The Committee believes that the ABA has correctly described generally accepted accounting practices as well as the case law. We do not believe that these facts warrant the conclusions drawn by the ABA. They clearly do not see the problem that we do when our prices are increased because of an acquisition transaction. As to whether this case is receiving careful study, the case originated in 1984. It would be difficult to categorize any policy action finally taken as impulsive. One of the primary purposes of the proposed coverage was to codify actual practice. The Committee believes that most large and well-noticed acquisitions in recent years have resulted in agreements that the assets would not be revalued. We agree with the ABA that it would be better to have our actual practices spelled out in the regulations so that they would apply more consistently to all mergers. That is what our prior proposal tried to do.

Mr. Smith of Pettit & Martin has also set forth the particulars of the Marquardt case. He seems to conclude that Marquardt has settled the issue of asset revaluation for stock purchase acquisitions with a standard that would require novations when the acquired entity has been legally restructured as part of the acquirer's organization. When a novation is required only existing contracts would be charged depreciation at levels which have not been stepped-up. Otherwise, all new contracts may be charged depreciation representing the increased asset values. On the other hand, when a novation is not required because the acquired entity has not been legally reorganized, existing assets can never be written up. Mr. Smith described Judge Bissell's dissent in a footnote without comment.

Mr. Smith is one of the relatively few commenters who dealt at all with the topic of a disposal gain in a merger transaction.

Once again, we have no problem with Mr. Smith's description of the evolution of the relevant cost principle and CAS coverage, much of it apparently gleaned from the Committee's report on this case. However, noticeably lacking from Mr. Smith's conclusion that disposal credits resulting from merger transactions are a somewhat freewheeling matter that is to be decided on a case-by-case basis utterly lacking in guidelines or rules is the common sense linking of an asset revaluation (because something was bought) with a disposal credit (because something was sold). Nor does Mr. Smith evidence any concern with the equities of those situations in which a disposal credit falls upon a fixed-price universe.

Mr. Norman Steiger also noted Sundstrand (Ct. Cl. 1968) and LTV (Ct. Cl. 1970), which while they involved the issue of asset write-ups, did so under the more limited scope of interpretation of novation agreements and their impact upon the novated contracts. Issues involved were such things as the meaning of "any costs" and whether other cost economies resulting from the merger could be netted against depreciation increases. The Government received a favorable ruling in both of these cases. Mr. Steiger concludes "It's obvious... that the Government will not concede the right of any acquired or acquiring corporation to step up the value of the assets... on any contracts which predate that transaction." Mr. Steiger appears to take great care to not expand the discussion to the revaluation of assets for contracts entered into after the acquisition transaction. He bemoans the fact that options exercised after the transaction, but whose rights were acquired in a pre-transactional contract, are covered in the novation restriction. Under that narrow focus, he argues against the requirement for two sets of depreciation records and the asset resale value impingement. These arguments would seem more appropriate with regard to the larger avoided issue, asset revaluation on contracts which post-date the acquisition.

Mr. Vincent T. Noone, faces the real issue of this case more squarely than his legal compatriots, and recommends a policy which reflects classical accounting theory, acknowledging that asset values would be increased for depreciation to post-acquisition contracts. Notably missing from Mr. Noone's paper is any mention of the correlated topic of disposal gains. Mr. Noone concludes that existing contracts should not receive depreciation reflecting stepped-up asset values but subsequent contracts should be costed at the increased values. He buys the result but not the reasoning of Marquardt. He is particularly critical of the reasoning that regards ISC as a disjointed third party unable to allocate the cost paid for Marquardt's assets to Marquardt's assets.

Mr. Noone suggests that novation agreements be required for all business combination situations including those achieved by a stock purchase. He would have those novation agreements protect the Government from all increased costs, not just depreciation. He believes that, were it not for CAS 404.50(d), the Government would be protected from increased costs on existing contracts. Mr. Noone would eliminate CAS 404 because it is a financial accounting standard and let the matter be governed by the pronouncements of the Financial Accounting Standards Board. He would position his basic rule (i.e., write-ups and cost of money are OK for the post-acquisition contracts) in the cost principles relating to organization costs and the cost-of-money. It is not clear to us what difference that would make. What is at issue here is the fundamental rule. In our opinion, none of these commenters tie the issues or the problems together in a cohesive way.

In the Committee's opinion, the case law cited is compatible within itself but the question remains as to what a sensible policy should be. According to the case law:

1. Where novation agreements are required, the stepped-up asset values cannot be charged to pre-existing contracts.
2. Novation agreements are required when the legal form of the organization with which we are contracting has changed.
3. Novation agreements are not required when the acquired company is not subsequently legally combined with the acquirer (stock purchase transaction).
4. When a legal combination is not carried out, the assets on the books of the acquired entity may never be written up, even for subsequent contracts.

It would be reasonable to conclude that where the premium over the book value is sufficient only a fool would save the legal cost of consummating a legal combination. That is a ridiculous standard for determining whether or not assets can be written up for purposes of costing to Government contacts. Surely, whether the acquirer's cost of the assets can be recovered is a more serious question than that. Disappointingly, none of these commenters made a serious attempt to tie together the substance of an asset disposal and an asset acquisition; we refer to the simple proposition that if something was bought, something must have been sold. There are only two choices as to how to view one of these transactions for contract costing and pricing purposes. We absorb the impact of the transaction in the contract prices on both ends or we do not.

In our opinion, the case law sheds little or no light on what a reasonable policy should be. However, failing to act in this case leaves the case law to govern. Acquirers can write up the assets if their legal papers are in order and the credits for the disposal gains are, at least arguably, if not equitably, not coordinated with the acquisition transaction. The recommendations advanced by the Committee in our earlier report on this case remain the best combination of equity and flexibility regarding these transactions.

C. Additional Committee Comments.

1. The DAR Council's taskings of February 24 and April 17, 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 previously to the DAR. 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 the 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 is obliged to point out that this whole issue lies outside its primary area of expertise. Accordingly, it is recommended that the DAR Council seek legal advice on it. However, in case the Council remains interested in pursuing the approach proposed by the Army and ADPA, the Committee has included some detailed comments and suggestions on their proposed coverage at TAB C.

The Committee also adds here that, should the Council decide that new FAR coverage is necessary to encourage or require advance agreements for these kinds of business acquisitions, there are other possibilities besides placing 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 advance agreements 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 C should the DAR

Council wish to pursue this course of action.

In any case, however, the Committee believes that the new cost principles coverage it is recommending elsewhere in this report will go a long way toward protecting the Government's interest in situations in which a Government contractor is acquired regardless of the form of the combination. 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 FAR language is enacted.

2. During Committee discussions on this case, the issue of repeated sales (or "churning") of an entity was raised. Some firms, or segments, have been sold, and then sold again. The concern was that repeated sales, whether real or sham, could lead to the evasion of the no write-up rule being established by this case. The last sentence in 31.205-49(a)(1), TAB A, as follows is intended to cover both single and multiple sale situations.

> In such situations, allowable amortization, cost of money, and depreciation expenses shall be limited to the amount that would have been allowed <u>had the combination and subsequent revaluation or creation not taken place</u>. (emphasis added)

The amount allowed after the first sale is the net book value of the acquired firm. This becomes the base value of the covered assets of the acquiring firm. This then flows through each subsequent acquisition as the amount allowed had a combination not taken place (minus depreciation or amortization taken based on continued use of the original schedule).

3. The Committee recommends that the CAS portion of the proposed changes be issued as proposed rules rather than exposure drafts. The Committee believes that the previously published background notice served as the exposure draft required for CAS changes and thus, the revised CAS language need not, in this particular case, be formally issued as exposure drafts. Additionally, this will preserve the continuity of the case since both the CAS and the cost principle changes must be processed concurrently.

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

Tom Luedtke
Chairman
Commercial Cost Principles
Committee

Commercial Cost Principles Committee Members

| DOD Members | Other Members |
| --- | --- |
| Terrence D. Sheppard, Air Force | Jeremy F. Olson, GSA |
| Donald W. Reiter, DLA | Robert W. Lynch, NASA |
| Don Sawyer, OASD(P)CPF | Dave Erdman, DOE |
| Fran T. Brownell, DCAA | |
| Harry Hindman, OASD(C) | |

cf: CAAC

Attachments
APPENDIX
1. CPC Report, Feb 4, 1987
2. CASPG Report, Jul 20,1987

TAB A - Proposed Changes to FAR 31.2
TAB B - Proposed Changes to FAR 30.4
TAB C - Changes for DARC Consideration
TAB D - Proposed Transmittal Memo to CAAC
TAB E - Federal Register Notice

84-18 (9)

DAR Case 84-18

| | |
|---|---|
| Asset Acquisition Cost | $10 |
| Depreciation Method | Straight Line |
| Useful Life | 10 years |
| Date Asset Acquired | 1 January of year 1 |
| Disposal Date | 31 December of year 10 |
| Disposal Price | $15 |

| Depreciation Inflated | | | | | Cost of Money | |
|---|---|---|---|---|---|---|
| End of Year | Depreciation | Interest Rate (i) | n | $(1+i)^n$ | Average Net Book Value (Avg NBV) | Cost of Money (Avg NBV x i) |
| 1 | 1 | .07 | 9.5 | 1.902 | 9.5 | .665 |
| 2 | 1 | .07 | 8.5 | 1.777 | 8.5 | .595 |
| 3 | 1 | .07 | 7.5 | 1.661 | 7.5 | .525 |
| 4 | 1 | .07 | 6.5 | 1.552 | 6.5 | .455 |
| 5 | 1 | .07 | 5.5 | 1.451 | 5.5 | .385 |
| 6 | 1 | .07 | 4.5 | 1.356 | 4.5 | .315 |
| 7 | 1 | .07 | 3.5 | 1.267 | 3.5 | .245 |
| 8 | 1 | .07 | 2.5 | 1.184 | 2.5 | .175 |
| 9 | 1 | .07 | 1.5 | 1.107 | 1.5 | .105 |
| 10 | 1 | .07 | .5 | 1.034 | .5 | .035 |
| | | | | 14.291 | | 3.5 |

Present Recapture Rule:

| | |
|---|---|
| Book Gain | $15 |
| Depreciation Allowed | $10 |
| Recapture Credit | $10 |

Proposed Recapture Rule

| | |
|---|---|
| Book Gain | $15 |
| Inflation Adj. Depr. | 14.291 |
| Recapture Credit | 14.291 |

Recapture based upon depreciation (in nominal dollars) allowed plus cost-of-money

| | |
|---|---|
| Book Gain | $15 |
| Depreciation (nominal dollars) | $10 |
| Cost of Money applied | 3.5 |
| Recapture Credit | 13.5 |

# *Case Management Record*

A

| DAR Case No. | ~~GAAC~~ No. | Original | | Date |
|---|---|---|---|---|
| 84-18A | FAR 87-19 | Updated | ✓ | 1/22/88 |

**Title** Golden Parachutes/Handcuffs and Organization Costs

**Reference** Cost Principles Committee report of 22 Jan 1988

**Synopsis** Early action required to comply with 120 day deadline (4/2/88) of PL 100-180

| Priority | Submitted By | Originator Code | Case Manager N |
|---|---|---|---|
| **Keywords** | | | |

| | | | | |
|---|---|---|---|---|
| **Case References** | | | | |
| **FAR Cites** | | | | |
| **DFARS Cites** | | | | |
| **Cognizant Committees** | | | | |

**Recommendation** ~~Docket 2/3/88~~
Discussion 2-10-88

**Notes**

acc 3/3/88

**DEPARTMENT OF THE NAVY**
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18A

22 January 1988

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Golden Parachutes/Handcuffs and Organization Costs

I. PROBLEM:

To review and make recommendations related to the comments on the proposed rule which was published in the <u>Federal Register</u> on 13 May 1987.

II. RECOMMENDATIONS:

A. That FAR 31.205-6 and 31.205-27 be revised as shown at TAB A and published as a final rule.

B. That the memorandum at TAB B be used to transmit the final rule, together with the TAB C recommended <u>Federal Register</u> notice and the TAB D FAC Preamble, to the Civilian Agency Acquisition Council.

III. DISCUSSION:

A. <u>Background</u>.

On 13 May 1987 the CAA and DAR Councils asked for comments on proposed changes to FAR 31.205-6, Compensation for personal services, and 31.205-27, Organization costs, in order to clarify allowability policy. The proposed changes were prompted by a belief that there has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. Since there are situations in which companies recorded cost structures are directly reflected in the price to the Government, the Government should not bear the risk of paying higher prices simply resulting from a change or resisting a change in ownership; thus the proposed changes would make certain extraordinary compensation payments, commonly referred to as "golden parachutes" and "golden handcuffs," unallowable as well as those costs resulting from resisting or planning to resist reorganization of the corporate structure or controlling interest in the ownership.

B. Comment Summary.

Twenty comment letters were received. The attached APPENDIX lists the commenters and briefly quotes those comments which recommended revisions to the proposed rules. Seventeen commenters either had no objections or comments or concurred with the changes as proposed. Two commenters disagreed with certain portions of the proposed coverages and the remaining commenter nonconcurred in all changes.

C. Discussion of Comments.

1. The American Defense Preparedness Association (ADPA) had an objection in connection with novation and change-of-name agreements. They argue that these costs, even when resulting from objectionable costs of takeovers and mergers, are ordinary administrative costs and therefore should be allowable.

The Cost Principles Committee disagrees. These costs are not at issue in this case. Existing regulations already make costs of this type unallowable and it is not the Committee's intent to make them allowable.

2. The Council of Defense and Space Industry Associations (CODSIA) had several objections, to wit:

a. The language of the proposed cost principle regarding golden handcuffs is inconsistent with the background statement and would disallow payments which are neither extraordinary nor unreasonable. They recommend that the word unreasonable be inserted at 31.205-6(l)(2) preceding the words special compensation.

The Committee does not agree. Adding the word unreasonable duplicates coverage at 31.201-3 and 31.205-6(b) and would infer that there could be a reasonable golden handcuff payment. It is the Committee's intent to not permit recovery of any special payments incurred in conjunction with mergers or business combinations. For example, an individual was performing a job normally paid and objectively worth $50,000 per year, given the nature of the job's duties and responsibilities, but for good reason (e.g., to help the company through a rough financial period) accepted and was paid $30,000 per year. If the new owners immediately raise his pay to $50,000, this would not be considered a golden handcuff, but a pay raise to normal, i.e., reasonable, levels. However if the employee's pay is increased from $30,000 to $80,000 per year, but $30,000 of this amount is contingent upon the individual remaining with the company for a 3-year period, the contingent amount is the unallowable golden handcuff cost.

In order to more explicitly define golden handcuffs, we have revised the coverage at TAB A to more closely link the handcuff

payment to the requirement to remain with the company. Accordingly, we have changed "... 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" to read:

> "... in which those employees receive special compensation which is contingent upon the employee remaining with the contractor for a specified period of time."

b. CODSIA suggests that where the merger or acquisition benefits the Government, such costs should be allowable when they are otherwise reasonable and allocable. They recommend that subparagraph (a) of section 31.205-27 be modified accordingly.

The Committee does not agree. The Government has a longstanding policy against paying costs related to all forms of capital formation, including fundamental structural reorganizations. It is a given of Government contracting that a contractor comes forth prepared to perform the contract. A contract is not a vehicle to underwrite capital formation. The costs in question here are clearly related to such activities, and are being disallowed for that reason.

c. Using the same "reasonableness" rationale, CODSIA recommends use of a separate paragraph (b) for FAR 31.205-27 addressing the cost allowability vis-a-vis resisting or planning to resist any corporate reorganization or change in controlling interest and to also state that these costs are subject to the FAR 31.201-3 reasonableness criteria.

Again CODSIA would have us believe that a portion of these costs are subject to the reasonableness criteria while others are apparently not. Otherwise, why specifically state that the costs of resisting or planning to resist a takeover are subject to 31.201-3? The Committee is not convinced that these costs need treatment in a separate paragraph or that they require a direct linkage with 31.201-3, Reasonableness.

3. The Professional Services Management Association (PSMA) recommends that FAR 31.205-27 be deleted in its entirety and that a reasonable portion of "golden parachutes" and "golden handcuff" costs should be allowable since they are a necessary cost in today's business merger atmosphere. PSMA avers that the Government benefits from these activities and therefore should pay for them.

Other than PSMA's allegation that the Government benefits from such activity no evidentiary material is presented. The Committee has previously addressed similar comments and will not further belabor the point.

D. Consideration of Section 805 of P.L. 100-180, the DoD Authorization Act of 1988.

The Committee reviewed the language as contained in Section 805 of P.L. 100-180 and found it to be substantially the same as the proposed rule regarding "golden parachutes." Thus the Committee recommends adopting its previously proposed language. However, Section 805 makes no reference whatsoever to "golden handcuffs" or other organization or business combination costs. The Committee has discussed the significance of this omission and reached the conclusion that coverage of these areas remains necessary as stated in our background statement in the Federal Register notice of May 13, 1987.

E. Other Comments.

The Committee recommends deleting from 31.205-6(l) the sentences which begin "These arrangements are commonly known as 'golden ....'" They are slang terms which become outdated after a period of time, and also can become unduly limiting. It is possible that someone could develop a tin parachute or handcuff, or they could be described as being made of linen, paper, or plastic. We prefer to avoid the use of slang terms in the FAR. We believe the definitions are sufficiently precise to protect the Government's interest and, therefore, we have deleted these two sentences.

F. Summary.

The comments received generally concurred or did not object to the proposed rule. Only relatively minor issues, discussed above, were raised. We recommend only minor adjustments to our previous language and that a final rule be promulgated immediately without further public discussion.

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

JWErmerins

J. W. ERMERINS
Chairman
Cost Principles Committee

DoD Members

Edwin Cornett, Army
Terrence D. Sheppard, Air Force
Donald W. Reiter, DLA
Charles D. Brown, OASD(C)
Frances Brownell, DCAA
Donald Sawyer, OASD(A&L)/CPF

Other Members

Robert W. Lynch, NASA
William T. Stevenson, DOE

Attachments:
APPENDIX - Comment Matrix
TAB A - Ppsd Rev. to FAR 31.205-6 and 31.205-27
TAB B - Transmittal Memo to CAAC
TAB C - Ppsd *Federal Register* Notice
TAB D - FAC Preamble

SUMMARY OF COMMENTS
DAR Case 84-18A, Golden Parachutes/Handcuffs and Organization Costs
FAR Case 87-19

| | | No comment/ Objection | Concur/ Support | Nonconcur | Partial Objection |
|---|---|---|---|---|---|
| 1. | Federal Communications Commission | X | | | |
| 2. | USA Railroad Retirement Board | X | | | |
| 3. | U.S. Small Business Administration | X | | | |
| 4. | American Defense Preparedness Association | | | | X |
| 5. | National Labor Relations Board | X | | | |
| 6. | Agency for International Development | | X | | |
| 7. | U.S Department of Housing and Urban Development | X | | | |
| 8. | Panama Canal Commission | X | | | |
| 9. | National Endowment for the Humanities | X | | | |
| 10. | U.S. Department of Justice | X | | | |
| 11. | Office of GSA Acquisition Policy and Regulations (GSA) | X | | | |
| 12. | DoD Inspector General | | X | | |
| 13. | U.S. Information Agency | | X | | |
| 14. | Council of Defense and Space Industry Associations (CODSIA) | | | | X |
| 15. | Professional Services Management Association | | | X | |
| 16. | Pennsylvania Avenue Development Corporation | | X | | |
| 17. | U.S. Department of Agriculture | | X | | |
| 18. | Veterans Administration | | X | | |
| 19. | Office of Federal Procurement Policy | X | | | |
| 20. | U.S. Nuclear Regulatory Commission | X | | | |
| | TOTAL | 11 | 6 | 1 | 2 |

| Objections/Issues | Commenter |
| --- | --- |
| The costs to a contractor, over and above ordinary and normal expenses, resulting from acquisitions and mergers should not be charged to the Government as an ordinary expense in performing a Government contract. On the other hand, it should be made clear that expenses incurred in connection with novation and change-of-name agreements (FAR 42.12) are allowable, even when resulting from objectionable costs of takeovers and mergers. Such agreements are ordinary administrative costs affecting performance of the Government contract and therefore should be allowable. | American Defense Preparedness Agency |
| It is the opinion of the undersigned associations that the proposed language 31.205-6 (1)(2), disallowing the cost of "golden handcuffs," is unnecessary and, moreover, is inconsistent with the policy enunciated in the background statement preceding the proposed new cost principle. While the background statement defines "golden handcuffs" as "extraordinary payments above and beyond ordinary, customary, and reasonable compensation payments to employees for services rendered," the proposed cost principle would define <u>any</u> compensation in excess of normal pay as "golden handcuffs," or <u>per se</u> unreasonable and extraordinary. CODSIA agrees that the government should not have to reimburse extraordinary and unreasonable compensation payments, and thus agrees with the statement of policy offered as background to the proposed cost principle. However, the language of the proposed cost principle is inconsistent with this policy and would disallow payments which are neither inconsistent with this policy and would disallow payments which are neither extraordinary nor unreasonable.<br><br>Since the ultimate resource of the acquired company is its employees, the success of an acquired company is usually related to its | Council of Defense and Industry Associations |

| Objections/Issues | Commenter |
|---|---|

ability to retain key people, such as certain management, technical and administrative staff (e.g., tax staff personnel) for a specific period of time after the acquisition. To disallow the reasonable cost of special compensation arrangements (i.e., completion bonuses) to retain such valuable resources of an acquired company would be detrimental to the acquiring company as well as its customers--in this case, the U.S. Government.

We recommend that allowability of such arrangements continue to be handled on a case by case basis, employing the "reasonableness criteria" already provided by FAR 31.201-3 and should not, out of hand, be deemed unallowable. Therefore, it is recommended that 31.205-6(1)(2) be revised to read as follows:

> "(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 received <u>unreasonable</u> special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time."

We suggest that in the judgment of the contracting officer, where the merger or acquisition benefits the government, their costs be allowable where they are otherwise reasonable and allocable. Subparagraph (a) of section 31.205-27 should be modified accordingly.

In this connection, and applying the same reasonableness criteria as discussed above, we recommend that the proposed revision to FAR 31.205-27 addressing the allowability of expenditures incurred in resisting or planning to resist any corporate reorganization or change in controlling interest

| Objections/Issues | Commenter |
|---|---|
| of a business be addressed in a separate paragraph (b) as follows:<br><br>"(b) Costs in connection with 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 are subject to the reasonableness criteria provided in 31.201-3." | |
| These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.<br><br>In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary and reasonable cost of doing business in today's business merger atmosphere (condoned by Congress). | Professional Services Management Association |

TAB A
DAR Case 84-18A

RECOMMENDED CHANGES TO FAR 31.205-6 AND 31.205-27

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 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.

(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 which is contingent upon the employee remaining with the contractor for a specified period of time.]

(m) Unchanged.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) ~~below~~ [of this subsection], 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.

[ ] - New coverage.
~~words lined out~~ - coverage deleted.

TAB B
DAR Case 84-18A

PROPOSED TRANSMITTAL MEMO TO CAAC

MEMORANDUM FOR CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: DAR Case 84-18A (FAR Case 87-19), Golden Parachutes/ Handcuffs and Organization Costs

The DAR Council has approved revisions to FAR 31.205-6, Compensation for personal services, and FAR 31.205-27, Organization costs, to provide final rules under the subject case. The analysis of the public comments and the rationale supporting the proposed rule are contained in the attached report. If the CAAC agrees with our position, please forward the case to the FAR Secretariat for further processing and inclusion in the next Federal Acquisition Circular.

DUNCAN A. HOLADAY
Director
Defense Acquisition
Regulatory Council

Attachment

TAB C
DAR Case 84-18A

PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31 (Federal Acquisition Circular 84-XX)

Federal Acquisition Regulation (FAR); Golden Parachutes/Handcuffs and Organization Costs

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

ACTION: Final rule.

SUMMARY: Federal Acquisition Circular 84-XX amends the Federal Acquisition Regulation (FAR) 31.205-6, Compensation for personal services, and 31.205-27, Organization costs.

EFFECTIVE DATE: ___________.

FOR FURTHER INFORMATION CONTACT: Ms. Margaret A. Willis, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405. Telephone (202) 523-4755.

SUPPLEMENTARY INFORMATION:

A. Public Comments.

A notice of the proposed rule was published in the Federal Register on May 13, 1987 (52 FR 18159), recommending revisions to FAR 31.205-6 and 31.205-27 to control costs and clearly state the policy of the Government regarding the allowability of these costs. Of 20 comments received, 17 either concurred or had no

objection or comment. Two commenters partially objected with the proposed rules and one commenter totally disagreed. Minor editorial changes were made to the definitions of the proscribed costs, and the slang terms, "golden parachutes" and "golden handcuffs" were deleted.

B. Regulatory Flexibility Act.

The 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 business entities are awarded on a competitive fixed-price basis and cost principles do not apply.

C. Paperwork Reduction Act.

The Paperwork Reduction Act (Pub. L. 96-511) does not apply because the changes to FAR 31.205-6 and 31.205-27 provide clarification as to the allowability of compensation for personal services and organization costs and do not impose any reporting or recordkeeping requirements or collection of information from offerors, contractors, or members of the public which require the approval of OMB under 44 U.S.C. 3501 et seq.

LIST OF SUBJECTS IN 48 CFR PART 31

Government Procurement.

Dated: ________, 1987

Harry S. Rosinksi,
Acting Director, Office of Federal Acquisition and Regulatory Policy.

PART 31 -- CONTRACT COST PRINCIPLES AND PROCEDURES

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).

2. Paragraphs (l) of subsection 31.205-6 and (b) 31.205-27 are revised to read as follows:

(See approved version of TAB A)

TAB D
DAR Case 84-18A

RECOMMENDED FAC PREAMBLE

Item No. _____ - Golden Parachutes/Handcuffs and Organization Costs

There has been a proliferation of business combinations leading to concomitant questions regarding appropriate costing on Government contracts. The Government found that the previous cost principles at FAR 31.205-6 and 31.205-27, lacked specificity regarding certain costs. FAR 31.205-6 did not address the issue of special compensation in conjunction with a planned or executed merger or business combination. FAR 31.205-27 did not prescribe the treatment to be accorded costs resulting from resistance or planned resistance to the reorganization of the corporate structure of a business or change in the controlling interest in the ownership of a business.

The revised rules clarify the policy of the Government regarding these costs and specifically describes the costs which are unallowable. The revisions do not reflect or result from a change in allowability policy.

MANAGEMENT RECORD 7/22 7—

| ORIGINAL | |
|---|---|
| UPDATED | X |

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

TITLE: Accounting for Mergers & Other Business Combinations

REFERENCE:

22 JUL 1987

ORIGINATION DATE: 22 July 87

SYNOPSIS:

CAS Working Group Report on Tab A, Part 3 of the Commercial Cost Principles report on subject case.

| PRIORITY: | ORIGINATOR CODE: |
|---|---|

| KEYWORDS | | | | |
|---|---|---|---|---|
| CASE REFERENCES | | | | | |
| FAR CITES | 30.404-50 | 30.409-50 | 31.205-16 | | |
| DFARS CITES | | | | | |

| CASE MANAGER: F | SUBCOUNCIL ASSIGNMENT: |
|---|---|

| COGNIZANT COMMITTEES | CAS | CCP | |
|---|---|---|---|

RECOMMENDED ACTION:

Discussion 5 Aug 87

22 JUL 1987

| BOX RECORD | 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION: |

**DEPARTMENT OF THE AIR FORCE**
**WASHINGTON, D.C. 20330-1000**

OFFICE OF THE ASSISTANT SECRETARY

July 20, 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. PROBLEM:

To review and coordinate on Tab A, Part 3 of the Commercial Cost Principles Committee (CPC) report on the subject case, dated 4 February 1987 and amended on 12 March 1987.

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 (CAS).

II. Recommendations:

That FAR 30.404-50(a) and (d); and 30.409-50(j)(1), (2), and 3 be revised as shown in Tab A-1.

That the last sentence of FAR 31.205-16(a)(1) which appears in Tab A, Part 3, p.3, of the CPC report of 4 February 1987 (Tab A-3) be changed as shown in Tab A-2.

That FAR 31.205-16(e) remain unchanged as shown in Tab A-2.

III. Discussion:

A. Revaluation of Assets

The Cost Accounting Standards Policy Group (CASPG) approached this problem with the objective of seeking the best policy for costing Government contracts. We concur with the CPC basic "no write-up" policy as being fairest to both the Government and the contractor.

The CPC correctly saw the problem of asset revaluations as having two possible solutions. Either the asset could be written up with an equitable recognition of the disposal gain or the transaction could be ignored for Government contract costing purposes. The CPC chose "no write-up" as the primary or default rule which will apply unless both parties can reach a satisfactory arrangement regarding the disposal credit. The CASPG also believes "no write-up" to be the fairest rule for the following reasons:

(1) Basing contract prices upon cost incurred is, at best, an unavoidable surrogate for a commercial price-competive marketplace. A supplier in a price-competitive marketplace could not successfully raise the price of his products because his company had been acquired by another corporation. The acquirer's investment cost would have to be recovered through other realized efficiencies or the deal is not likely to be done. It makes no sense to have the Government, as a customer, suffer a price increase because someone acquired its supplier, whether or not it is good financial accounting on the consolidated books of the acquirer.

(2) The pass through nature of the cost of revalued assets creates the circularity argument, i.e., a prospective takeover target would become more attractive if any increase in asset values could be passed on to the customer. This would drive up the cost of the acquisition of a defense contractor which would pass through to the Government in the form of increased depreciation cost despite whatever depreciation recapture takes place under current regulations.

(3) Congress expressed its feelings in the general area of revaluation of assets in Sec. 2314 of the Deficit Reduction Act of 1984. P.L. 98-369.

That law amends the Social Security Act to require that "... in establishing an appropriate allowance for depreciation ... with respect to an asset of a hospital or skilled nursing facility which has undergone a change of ownership, such regulations shall provide that the valuation of the asset after such change of ownership shall be the lesser of the allowable acquisition cost of such asset to the owner of record as of the date of enactment of this subparagraph ... or the acquisition cost of such asset to the new owner... Such regulations shall provide for recapture of depreciation..."

So Congress placed a legislative cap on the revaluation of hospital or skilled nursing facility assets after change of ownership to the lower of the predecessor or successor cost. The resulting cost of any increase in asset valuation dealt with above would be passed on to insurance companies in a non-competitive environment in a situation similar to the cost being passed to the Government in non-competitive defense contracting.

(4) The same general approach of using predecessor cost of assets is used in business combinations of public utilities and some other industries operating in a non-competitive environment where prices are regulated. In these industries an increase in the value of the asset base would be passed through to the customer as increased prices similar to the way they would be passed through to the Government in non-competitive defense contracting.

(5) The situations in reasons (a)(1) through (a)(4) above deal with business combinations made in a non-competitive environment where the cost of revalued assets are passed directly through to the customer as increased prices. Since price competition does not constrain the price paid for the acquired company, a pass through of the costs of the revalued assets to the customer usually does not achieve equity. While the disposal credit route may provide equity in some circumstances, it can also produce results that are grossly unfair to either of the contracting parties because of the mix of Government participation and contract types, or the fact that the increase in the revalued assets far exceeds the depreciation previously paid.

B. Changes to CAS 404

The CPC recommended that 30.404-50(d) and (e) concerning the "purchase method" and "pooling of interest method" of accounting for business combinations be eliminated in their entirety. The CASPG does not agree with that recommendation because it believes that most of the coverage in the paragraphs recommended for deletion, retains some applicability. Under the rules proposed by the CPC, the purchase method may still be used when other equitable arrangements have been mutually agreed to. Our recommendations for a compatible revision to CAS 404 are set out in Part I of Tab A.

C. Exception to the No Write-Up Rule

While laying down a general policy of no write-up of assets in a business combination, the CPC recommendations leave some latitude for the exercise of judgement in making exceptions by the contracting officer faced with the specific business combination. The CASPG concurs that exceptions to the general no write-up rule are appropriate, but believes they will be utilized in a minimal number of cases.

In the case where the contracting officer does allow assets to be revalued upward, it is assumed he will obtain a credit to the Government for the gain from the acquiring company. The gain was previously limited in 31.205-16(b) and in 30.409-50(j)(1) to the amount of depreciation previously taken. The CPC recommended raising the limit specified in 31.205-16(b) by increasing the depreciation previously taken to present value using the Treasury rate. The CASPG concurs that it is equitable and logical to convert the measurement of depreciation taken to its present value. We also agree that the Treasury Rate of Interest is a practical index for this purpose. It is worthy of note that the CAS Board had considered a proposal to increase the limit on gain recognition to the sum of depreciation taken plus the cost-of-money related to the asset.

Our recommended changes to CAS 409 make the standard consistent with the CPC proposed change to the cost principles by raising the limit on a gain to the depreciation taken inflated by the Treasury rate. In addition, we have clarified CAS 409 to assure that the coverage on gains and losses on disposal of tangible assets applies to business combinations as well as disposal of individual assets of on going businesses.

D. Gains or Losses Arising from Mass or Extraordinary Dispositions

The CASPG recommends adjusting 30.409(j)(3) and 31.205-16(a)(1) as shown in Tab A and to leave 31.205-16(e) unchanged. The reasons for our recommendation are as follows:

The amount of a gain or loss on an asset disposed of is indicated in the existing cost principle (31.205-16(b)) and CAS (30.409-50(j)(1)) as the difference between "...the net amount realized ... and its undepreciated balance..." Both the existing cost principle and CAS go on to indicate the general rule that a gain or loss should be assigned to the cost accounting period in which the disposition occurs. The CAS makes an exception to gains or losses, arising from mass or extraordinary dispositions, by allowing the contracting parties to account for them in an equitable manner. The cost principles have similar coverage at 31.205-16(e).

The original CPC coverage at 31.205-16(a)(1) would have expanded the exception to apply to all individual dispositions as well as mass and extraordinary dispositions. It is believed that the change would have potentially made the gain or loss on every individual asset disposed of, subject to adjustment for amount or timing at either party's discretion or whim. The only claim necessary would have been that the application of the general rule determining amount and timing of the gain or loss did not achieve equity. The lack of consistency, thus created, would have been undesirable from both the Government and contractor's viewpoints. Consequently, the CASPG believes that limiting the exception to mass and extraordinary dispositions would be more appropriate as long as extraordinary is properly defined.

Accounting Principles Board Opinion No. 30 (APB 30) places very strict limitations on items classified as extraordinary. Both committees believed this limitation to be much too restrictive. Consequently, the recommended coverage expands the definition of extraordinary dispositions to include real property transactions and those groups of transactions which in total would result in a material inequity if assigned to the period in which disposition occurs.

We believe that this change will cover the situation in which a contractor chooses to sell all major assets individually over a short time period rather than all at once as in the usual business combination. The Chairman of the CPC and the two joint members of both committees concur with the changes to 31.205-16(a)(1) and 31.205-16(e) in the CPC report.

E. All CASPG members concur with the contents of this report.

David C. Relly

DAVID C. RELLY
Chairman, CAS Policy Group

5 Atch
1. Tab A-1 CASPG Proposed Revision to FAR 30.404 & 30.409
2. Tab A-2 CASPG Proposed Revision to FAR 31.205-16(a)(1) & 31.205-16(e)
3. Tab A-3 CPC Report, DAR Case 84-18, Tab A, Part 3
4. Tab B Proposed Transmittal Memo to CAAC
5. Tab C Proposed Federal Register Notice

CAS Policy Group Members

David P. Calder, Army (AMCPP-SC)
Ted Godlewski, Navy (MAT 0224B)
Steve Araki, DLA
Robert Lynch, NASA
Patrick Duffy, DCAA
LTC Robert Gustin, OASD (A&L)/CPF
Harry Hindman, OASD (C)
Frank Van Lierde, GSA

CAS 404 - CAPITALIZATION OF TANGIBLE ASSETS

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.404-50 Techniques for Application.

(a) Except for the limitations described in paragraph (d) of this subsection. [T] the cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(d) The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the "purchase method" when other equitable arrangements (see 31.205-49(a)) have been mutually agreed to. 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.

Key:
[bracket] = deletion
underline = new

(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.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

CAS 409 - DEPRECIATION OF TANGIBLE CAPITAL ASSETS

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-40 Fundamental Requirement.

(a) The depreciable cost of a tangible capital asset (or group of assets) shall be assigned to cost accounting periods in accordance with the following criteria:

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(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.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(b) The annual depreciation cost of a tangible capital asset (or group of assets) shall be allocated to cost objectives for which it provides service in accordance with the following criteria:

(4) The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-50 Techniques for Application.

(j) (1) Gains and losses on disposition of tangible capital assets (including business combinations in which the Contracting Officer agrees to use of the "purchase method" of accounting to revalue the assets for contract costing purposes) 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] amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction. (ii) assets are grouped and such gains and losses are processed through the

accumulated depreciation account, or [(ii)] (iii) 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.

(3) The contracting parties [may] <u>shall</u> account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. <u>Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which the disposition occurs.</u>

(4) Gains and losses on disposition of tangible capital assets transferred in other than an arms-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

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 31.205-49) of depreciable 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 or charges resulting from mass or extraordinary dispositions shall be adjusted in accordance with subparagraph (a)(2) and (e) of this subsection when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.

" " " "

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis.

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 ~~if~~[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.

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(a) and (d); 30.409-50(j)(1), (2), and (3); and 31.205-10, 31.205-11, 31.205-16, and 31.205-49; to provide clear rules on the allocability and allowability of costs flowing from asset writeups resulting from business acquisitions. 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

<u>PROPOSED FEDERAL REGISTER NOTICE</u>

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: Exposure draft.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 30.404-50(a) and (d), 30.409-50(j)(1), (2), and (3), 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to set forth new or clarified rules on the allocability and 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 proposed 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 Council's 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 30.404-50(a) and (d); 30.409-50(j)(1), (2), & (3); and 31.205-10, 31.205-11, 31.205-16, and 31.205-49; to implement this decision.

B. Regulatory Flexibility Act.

The proposed changes to FAR 30.404.50(a) and (d); 30.409-50(j)(1), (2), and (3); 31.205-10, 31.205-11, 31.205-16, 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. In addition small business are exempt from cost accounting standards.

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 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 3, and 4 as approved)

CAS 404 - CAPITALIZATION OF TANGIBLE ASSETS

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.404-50 Techniques for Application.

(a) [Except for the limitations described in paragraph (d) of this subsection,] ~~T~~ [t]he cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(d) [The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the "purchase method" when other equitable arrangements (see 31.205-49(a)) have been mutually agreed to.] 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.

Key:

\- - - - - = deletion

[ ] = new

DEPARTMENT OF THE AIR FORCE
WASHINGTON, D.C. 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

July 20, 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

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

I. Problem:

To review and coordinate on Tab A, Part 3 of the Commercial Cost Principles Committee (CPC) report on the subject case, dated 4 February 1987 and amended on 12 March 1987.

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 (CAS).

II. Recommendations:

That FAR 30.404-50(a) and (d); and 30.409-50(j)(1), (2), and 3 be revised as shown in Tab A-1.

That the last sentence of FAR 31.205-16(a)(1) which appears in Tab A, Part 3, p.3, of the CPC report of 4 February 1987 (Tab A-3) be changed as shown in Tab A-2.

That FAR 31.205-16(e) remain unchanged as shown in Tab A-2.

III. Discussion:

A. Revaluation of Assets

The Cost Accounting Standards Policy Group (CASPG) approached this problem with the objective of seeking the best policy for costing Government contracts. We concur with the CPC basic "no write-up" policy as being fairest to both the Government and the contractor.

The CPC correctly saw the problem of asset revaluations as having two possible solutions. Either the asset could be written up with an equitable recognition of the disposal gain or the transaction could be ignored for Government contract costing purposes. The CPC chose "no write-up" as the primary or default rule which will apply unless both parties can reach a satisfactory arrangement regarding the disposal credit. The CASPG also believes "no write-up" to be the fairest rule for the following reasons:

(4) The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

30.409-50 Techniques for Application.

(j) (1) Gains and losses on disposition of tangible capital assets [(including business combinations in which the Contracting Officer agrees to use of the "purchase method" of accounting to revalue the assets for contract costing purposes)] 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~~ [amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.]

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where: (i) [assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction.] (ii) assets are grouped and such gains and losses are processed through the

accumulated depreciation account, or (ii) [(iii)] 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.

(3) The contracting parties ~~may~~ [shall] account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. [Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which the disposition occurs.]

(4) Gains and losses on disposition of tangible capital assets transferred in other than an arms-length transaction and subsequently disposed of within 12 months from the date of transfer shall be assigned to the transferor.

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

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 31.205-49) of depreciable 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 or charges resulting from mass or extraordinary dispositions shall be adjusted in accordance with subparagraph a(2) and (e) of this subsection when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include real property transactions and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

* * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * * *

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis.

31.205-10 Cost of Money.

(a)(1) - Unchanged.

(2) <u>Allowability.</u> 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) <u>Allowability</u>[.] 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;

Key:
[bracket] = new
~~line-through~~ = deletion

| | |
|---|---|
| Asset Acquisition Cost | $10 |
| Depreciation Method | Straight Line |
| Useful Life | 10 years |
| Date Asset Acquired | 1 January of year 1 |
| Disposal Date | 31 December of year 10 |
| Disposal Price | $15 |

| Depreciation Inflated | | | | | Cost of Money | |
|---|---|---|---|---|---|---|
| End of Year | Depreciation | Interest Rate (i) | n | $(1+i)^n$ | Average Net Book Value (Avg NBV) | Cost of Money (Avg NBV x i) |
| 1 | 1 | .07 | 9.5 | 1.902 | 9.5 | .665 |
| 2 | 1 | .07 | 8.5 | 1.777 | 8.5 | .595 |
| 3 | 1 | .07 | 7.5 | 1.661 | 7.5 | .525 |
| 4 | 1 | .07 | 6.5 | 1.552 | 6.5 | .455 |
| 5 | 1 | .07 | 5.5 | 1.451 | 5.5 | .385 |
| 6 | 1 | .07 | 4.5 | 1.356 | 4.5 | .315 |
| 7 | 1 | .07 | 3.5 | 1.267 | 3.5 | .245 |
| 8 | 1 | .07 | 2.5 | 1.184 | 2.5 | .175 |
| 9 | 1 | .07 | 1.5 | 1.107 | 1.5 | .105 |
| 10 | 1 | .07 | .5 | 1.034 | .5 | .035 |
| | | | | 14.291 | | 3.5 |

Present Recapture Rule:

| | |
|---|---|
| Book Gain | $15 |
| Depreciation Allowed | $10 |
| Recapture Credit | $10 |

Proposed Recapture Rule

| | |
|---|---|
| Book Gain | $15 |
| Inflation Adj. Depr. | 14.291 |
| Recapture Credit | 14.291 |

Recapture based upon depreciation (in nominal dollars) allowed plus cost-of-money

| | |
|---|---|
| Book Gain | $15 |
| Depreciation (nominal dollars) | $10 |
| Cost of Money applied | 3.5 |
| Recapture Credit | 13.5 |

31.205-10 Cost of money.

(a)(1) - Unchanged.

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

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with 30.414;

(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. (i) Whether or not the contract 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--

Key:

[ ] = Bracketed words are additions to FAR.

~~Lined-through~~ words are deletions from FAR.

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with 30.417;

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

(C) The cost of money for tangible capital assets is 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.

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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.]

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

(a)[(1) Except for limitations elsewhere in this subsection,] ~~G~~[g]ains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall 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)~~.

[(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. [The timing (or the amount, if necessary) of the recognition of such gains and losses resulting from mass or extraordinary dispositions shall be adjusted when the impact of current year recognition does not achieve equity. Mass and extraordinary dispositions include any transactions in which the acquirer employs the purchase method of accounting for subsequent valuation of the property, real property transactions, and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

(f) - Unchanged.

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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 allowed 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.

(iv) Assets which did not exist on the books of the acquired entity may be capitalized and recognized on the books of the acquiring entity only if the Government agrees to accept an equivalent credit to achieve equity on Government contracts.

(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 -40 - Unchanged.

-50(a) [Except for the limitations described in paragraph (d) of this subsection,] T[t]he cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use.

-50(a)(1) through (c) - Unchanged.

-50(d)[The "purchase method" of accounting for business combinations shall not ordinarily be used for contract costing when the assets or controlling interest in the ownership of a contractor have been acquired or transferred in a combination. In such cases, asset values shall ordinarily remain at the levels recorded on the books of the acquired entity prior to the combination transaction. However, the contracting officer may permit the use of the purchase method when other equitable arrangements have been mutually agreed to (see 31.205-49(a)(2)).] 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 the 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 the capital assets shall be reduced by a proportionate part of the excess.

-50(e) through -60(b)(2) - Unchanged.

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30.409 - Cost accounting standard-depreciation of tangible capital assets.

30.409-10 through -50(i) - Unchanged.

(j)(1) Gains and losses on disposition of tangible capital assets [(including business combinations in which the Contracting Officer agrees to use of the purchase method of accounting to revalue the assets for contract costing purposes)] 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~~[amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken.]

(2) Gains and losses on the disposition of tangible capital assets shall not be recognized where:

(i) [Assets which were disposed of in a business combination (see 30.404-50(d)) have not been revalued to reflect that transaction, (ii)] assets are grouped and such gains and losses are processed through the accumulated depreciation account, or, ~~(ii)~~ [(iii)] 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.

(3) The contracting parties ~~may~~ [shall] account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties. [Mass and extraordinary dispositions include any transactions in which the acquirer employs the purchase method of accounting for subsequent valuation of the property, real property transactions, and those groups of transactions which would aggregate to a material inequity if assigned to the period in which disposition occurs.]

-50(j)(4) through (l) - Unchanged.

31.109 Advance agreements.

(a) through (h)(17) - Unchanged

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

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42.1200

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 (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, whether or not there is a 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.

Tab D
DAR Case 84-18B

PROPOSED TRANSMITTAL MEMO TO CAAC

MEMORANDUM FOR CHAIRMAN, CIVILIAN AGENCY ACQUISITION COUNCIL

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

The DAR Council has approved proposed revisions to FAR 30.404, 30.409, 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to provide clear rules on the allowability of costs flowing from asset write-ups resulting from business acquisitions and on the allowability of certain other costs incidental to such combinations. The rationale for these decisions is contained in attachments 1 and 2. If the CAAC agrees with the positions as set forth, please forward the case to the FAR Secretariat for further processing as proposed rules.

DUNCAN A. HOLADAY
Director
Defense Acquisition
Regulatory Council

Attachments

TAB E
DAR Case 84-18B

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 Rules.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council are considering revising FAR 30.404, 30.409, 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to set forth new or clarified rules on the allowability of costs stemming from business combinations.

DATE: 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 final rules. Please cite FAR Case 87-43 and DAR Case 84-18B in all correspondence related to this issue.

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

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

SUPPLEMENTARY INFORMATION:

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. Comments on these matters were previously solicited by a Federal

Register notice dated October 28, 1987 and have been considered in drafting these proposed rules. This review has been occasioned by the increased pace and size of such events in recent years and 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 the cost of money expense flowing from asset write-ups 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 the price, the Government should be at risk of paying higher prices simply because of ownership changes at its suppliers. Accordingly, the Councils are proposing changes to FAR 30.404, 30.409, and corollary changes to 31.205-10, 31.205-11, 31.205-16, and 31.205-49 to implement this decision.

B. Regulatory Flexibility Act.

The proposed changes are not expected to have 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. Additionally, small businesses are exempt from the cost accounting standards. An initial Regulatory Flexibilty analysis has therefore not been performed. Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected FAR subpart will also be considered in accordance with section 610 of the Act. Such comments must be submitted separately and must cite FAR Case 89-610 in correspondence.

C. Paperwork Reduction Act.

The Paperwork Reduction Act does not apply because the proposed rule does not change 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:_______________

Harry S. Rosinski

Acting Director, Office of Federal Acquisition and Regulatory Policy

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).

Parts 30 and 31 - (Amended)

(See TABs A and B as approved)

# CASE MANAGEMENT RECORD

| ORIGINAL | |
|---|---|
| UPDATED | ✓ |

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

TITLE: Accounting for Mergers and Business Combinations

REFERENCE: Cost Principles Committee supplemental report of 17 March 87

ORIGINATION DATE:

SYNOPSIS:
The Treasury Rate of interest should be used to adjust the limit on depreciation recapture following disposition of assets at a gain.

| | |
|---|---|
| PRIORITY: | ORIGINATOR CODE: |

| | | | | |
|---|---|---|---|---|
| KEYWORDS | | | | |
| CASE REFERENCES | | | | |
| FAR CITES | | | | |
| DFARS CITES | | | | |

| | |
|---|---|
| CASE MANAGER: N | SUBCOUNCIL ASSIGNMENT: |

| | | | |
|---|---|---|---|
| COGNIZANT COMMITTEES | | | |

RECOMMENDED ACTION:

Discussion 3-25-87

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

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| DISCUSSION DATE: | DOCKET DATE: |

REPORT DATE:

| | | | |
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| FAC | NUMBER: | DATE: | ITEM: |
| DAC | NUMBER: | DATE: | ITEM: [illegible] 1987 |

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| DEPARTMENTAL | NUMBER: | DATE: 11 [illegible] 1987 |
| BULLETIN | NUMBER: | DATE: |

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| CASE CLOSED: | CASE COMPLETED: |
| REG FLEX APPLICABLE: | PAPERWORK REDUCTION: |

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| PROPOSED RULE: | INTERIM RULE: | FINAL RULE: |

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, DC 20360-5000

DAR Staff
Case 84-18

12 March 1987

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

Subject: DAR Case 84-18, Accounting for Mergers and Business Combinations--SUPPLEMENTAL REPORT

I. PROBLEM:

The 4 February 1987 report of the Commercial Cost Principles Committee could be misinterpreted as it relates to the Committee's description of the relationship of the cost accounting standards and the proposed cost principles coverage.

The inflation adjustment of the limit on previously recognized depreciation expense which is recouped as a gain upon a contractor's disposition of depreciable assets should be changed to require use of the facilities capital cost of money (i.e, Treasury) rate.

II. RECOMMENDATION:

That the Committee's previously recommended coverage for FAR 31.205-16(b) be changed to read as indicated below.

III. DISCUSSION:

A. Background.

In its 4 February 1987 report, the Commercial Cost Principles Committee, aware of a frequent criticism of times past, discussed the relationship of the cost accounting standards (CAS) and the cost principles, and accusations of "impermissible conflict" between the two bodies of regulations within the FAR. At the meeting of 27 February 1987 of the DAR Council, the Cost Principles Committee was requested to clarify its earlier comments.

Also at the same DAR Council meeting, the Committee was requested to revise its proposed coverage at FAR 31.205-16, "Gains and losses on disposition of depreciable property or other capital assets," by deleting reference to "inflation adjusted" in paragraph (b) and instead use the Treasury rate as the adjustment index.

B. <u>Committee Comments.</u>

1. CAS/Cost Principles Relationship.

In the 27 February 1987 meeting of the DAR Council, certain members expressed concern that one of the the Committee's comments in the report could be taken out of context. The comment in question (p. 23) recommended deletion of certain sections of CAS "to eliminate the inconsistency between the standard ... and the new cost principles coverage..." The Committee went on to say that it believed that, even without the CAS deletions, there would probably not be an "impermissible conflict" of the sort found by the courts in the Boeing SERP case but that there was no reason to run whatever litigative risk was inherent in leaving the CAS unchanged. The Committee believes that, read in light of this further comment, the meaning of the sentence in question is clear and defensible. It remains the Committee's opinion on this matter. The Committee would reemphasize that the litigative risk here is real, particularly since it seems virtually impossible to assess the precise degree of such risk before one reaches court. After all, the Government was so confident of victory in the Boeing SERP case that it requested a summary judgment--and then lost the case.

2. Adjusted Limit for Depreciation Recapture.

At the 27 February meeting, the DAR Council tentatively concurred with the concept that the limit for depreciation recapture on asset disposition should be increased beyond the absolute amount of depreciation previously taken to reflect the time value of money. However, the Council requested that the Committee develop coverage that more precisely implemented this concept in lieu of the vague reference to "inflation-adjusted" depreciation previously taken as recommended in the Committee report of 4 February. The new coverage for 31.205-16(b) developed by the Committee in compliance with this request reads as follows:

> The gain recognized for contract costing purposes shall be limited to the amount of depreciation previously taken increased to present value at the time of disposition by using the interest rates determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect for the time period over which the depreciation was taken (except see subdivision (c)(1)(i) or (ii) below).

JW Ermerins
J. W. ERMERINS
Chairman
Cost Principles Committee

OFFICIAL MASTER CASE RECORD

**DATE:** 9-30-87 **CAM POSTED** DARC

**DAR CASE:** 84-18 YES DARSC

**DISCUSSION:** Acctg/Mergers NO

O, to check out need for FR notice inviting comments on this case.

**APPROVAL DATE:** Return to O,

(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 | | |

File - 10/2

Charlie Doing Fed Register notice.

**VOTE:**

| YES | NO | ABSTAINED |
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| A1 | A1 | A1 |
| F1 | F1 | F1 |
| S1 | S1 | S1 |
| D1 | D1 | D1 |
| M1 | M1 | M1 |
| O1 | O1 | O1 |

84-18 B
EXEC. SEC.
Oct. 6, 1987

(Billing Code 6620-61-M)

**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:** Notice of intent to develop a proposed rule pertaining to the allocability and allowability of costs stemming from mergers and other business combinations.

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**SUMMARY:** The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council invite public comment

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Copies to Council on Oct. 6th 87 if approved transmit ASAP to CAAC by FAX machine ee

**COMMENTS:** Com ... t

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

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

84-18 ℬ
EXEC. SEC.
Oct. 6, 1987

(Billing Code 6620-61-M)

**DEPARTMENT OF DEFENSE**

**GENERAL SERVICES ADMINISTRATION**

**NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Parts 30 and 31**

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**ACTION:** Notice of intent to develop a proposed rule pertaining to the allocability and allowability of costs stemming from mergers and other business combinations.

---

**SUMMARY:** The Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council invite public comment concerning the development of coverage proposed for FAR Parts 30 and 31 on the allowability of costs incident to 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 date of publication), to be considered in the formulation of a proposed rule. Please reference FAR Case 87-19 in all correspondence relating to this issue.

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

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

**SUPPLEMENTARY INFORMATION:**

**A. Background**

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing the subject of business combinations, and particularly the allowability of costs resulting from such combinations. This review has been occasioned by the Councils' concern that existing regulations on certain aspects of this subject may not be adequate as evidenced by recent litigation. Specifically, the Councils are considering whether, in most circumstances, the Government should or should not recognize depreciation or cost of money expense flowing from asset write-ups that result from the "purchase" method of accounting for business combinations. Government representatives have expressed concern whether, in the circumstances when a company's' recorded cost structure is directly reflected in the price, the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. Accordingly, the Councils will consider comments from interested parties regarding approaches the Councils might employ in dealing with this issue.

HARRY ROSINSKI
Acting Director, Office of Federal
Acquisition and Regulatory Policy

Kelly called
10/6

(Billing Code 6620-61-M)

DEPARTMENT OF DEFENSE

GENERAL SERVICES ADMINISTRATION

NATIONAL AERONAUTICS AND
SPACE ADMINISTRATION

48 CFR Parts 30 and 31

Federal Acquisitic
Mergers and Other

draft Fed. Reg. item on Mergers — to Eimeiris/Kelly via policy member 10/2

AGENCIES: Depart
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The disc for this is labeled "Dictionary" (in case you need to correct it)

ADDRESS: Interested parti nts to:
General Services Administra 18th & F
Streets, NW, Room 4041, Was

(Billing Code 6620-61-M)

**DEPARTMENT OF DEFENSE**

**GENERAL SERVICES ADMINISTRATION**

**NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

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HARRY ROSINSKI
Acting Director, Office of Federal
Acquisition and Regulatory Policy

(Billing Code 6620-61-M)

**DEPARTMENT OF DEFENSE**

**GENERAL SERVICES ADMINISTRATION**

**NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Parts 30 and 31**

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**SUPPLEMENTARY INFORMATION:**

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The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing the subject of business combinations, and particularly the allowability of costs resulting from such combinations. This review has been occasioned by the Councils' concern that existing regulations on certain aspects of this subject may not be adequate as evidenced by recent litigation. Specifically, the Councils are considering whether, in most circumstances, the Government should or should not recognize depreciation or cost of money expense flowing from asset write-ups that result from the "purchase" method of accounting for business combinations. ~~The~~ Government representatives have expressed concern ~~over~~ whether, in the ~~special~~ circumstances ~~of Government procurement in which~~ when a company's ~~companies'~~ recorded cost structure~~s~~ is ~~are often~~ directly reflected in the price, the Government should be at risk of paying higher prices simply because of a change in ownership ~~changes at its~~ of the supplier~~s~~. Accordingly, the Councils will consider comments from interested parties regarding approaches the Councils might employ in dealing with this issue.

HARRY ROSINSKI
Acting Director, Office of Federal
Acquisition and Regulatory Policy

B

DAR Case 84-18
July 28, 1987

Reference DAR Case 84-18, CAS Policy Group Committee Report dated July 20, 1987:

Remove page 11, Tab A-3, and replace with the attached page 11.

29 JUL 1987

31.205-10 Cost of Money.

(a)(1) - Unchanged.

(2) <u>Allowability.</u> 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) <u>Allowability</u>[.] 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;

Key:
[bracket] = new
~~line-through~~ = deletion

DISC

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# *Case Management Record*

A

| DAR Case No. 8418 | CAAC No. | Original | | Date 3/25 |
|---|---|---|---|---|
| | | Updated | ✓ | |

**Title** Mergers and other Business Combinations

**Reference**

**Synopsis** Additional Public Comments

| Priority | Submitted By | Originator Code | Case Manager |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

**Recommendation**

**Notes**

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

MAR 18 1988

Mr. Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council
ASD(P&L)DASD(P)DARS
c/o 3D139, The Pentagon
Washington, DC 20301-3062

Dear Mr. Holaday:

Additional comments received concerning the subject FAR Case are forwarded for your appropriate action:

FAR Case: 87-43, Mergers and Other Business Combinations

Federal Register Notice: 52 FR 41474, October 28, 1987

Letter to Industry: November 19, 1987

The Department of Defense is the lead agency on this case, therefore, the enclosed comments are to be reconciled by the DAR Council and recommendation for concurrence forwarded to the CAAC Chairman for approval prior to publication of a final rule.

Sincerely,

M. A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

cc: Chairman, Civilian Agency Acquisition Council
ATTN: Jim Ermerins, Chairman, Cost Principles Committee

FAR Case # 87-43 Comme s Due: 12/28/87

Subject: Mergers and Other Business Combinations

To: Defense Acquisition Regulatory Council

Date: 3/15/88

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-43-29 | 3/4/88 | 2/29/88 | General Accounting Office, Office of General Counsel | |
| 87-43-30 | 3/4/88 | 3/2/88 | Office of GSA Acquisition Policy and Regulations | |

3-13

GAO

United States
General Accounting Office
Washington, D.C. 20548

Office of the General Counsel

87-43-29

B-224782.7

February 29, 1988

Ms. Margaret A. Willis
FAR Secretariat
General Services Administration

Dear Ms. Willis:

This responds to your letter of November 19, 1987, requesting our comments concerning the allowability of costs incident to mergers and other business combinations. This is Federal Acquisition Regulation (FAR) case No. 87-43.

Generally accepted accounting principles (GAAP) and the Cost Accounting Standards recognize two methods of accounting for the costs of tangible capital assets following a merger or other business combination: the purchase method and the pooling of interests method. Accounting Principles Board Opinion No. 16, August 1970; FAR § 30.404-50(d), (e) (Federal Acquisition Circular No. 84-30, Sept. 30, 1987). Under the purchase method, a business combination is viewed as the acquisition of one company by another, and the acquiring company records the acquired assets at its cost. Under the pooling of interests method, on the other hand, the transaction is viewed as an exchange of equity securities that unites the ownership interests of two or more previously independent companies; the historical cost (acquisition cost less accumulated depreciation) of assets is carried forward from the constituent companies to the combined corporation. Under GAAP, the pooling of interests method should be used if specified conditions are met. Otherwise, the purchase method is used.

When the book value of an asset used in performing government contracts is increased, or "stepped up," under the purchase method of accounting in connection with a business combination, the total depreciation that may be charged with respect to that asset also is increased. Thus, having reimbursed one contractor for some or all of the cost of an asset through annual depreciation allowances, the government may be required to reimburse the acquiring company for the same asset through further depreciation allowances based on the stepped-up value. In addition, a step-up in the value of assets increases the base for

MAR 4 1988

measuring the return on investment, or profit, of the acquiring company for purposes of future contract negotiations. In both cases, the incentive for the acquiring company to hold down acquisition costs is reduced. Moreover, both depreciation allowances and contractor profit may increase even though there may be no benefit to the government resulting from the business combination.

Although GAAP would require a stepped-up book value for financial accounting purposes, we believe that as a general rule the book value of an asset subsequent to a business combination should be limited to the book value of the asset when first devoted to government contracting, less accumulated depreciation. Revaluations of assets should be permitted on a case-by-case basis only where it can be shown that a business combination will result in increased benefits to the government, for example, lower unit costs.

Sincerely yours,

for Seymour Efros

James F. Hinchman
General Counsel

5-12

General Services Administratio
Office of Acquisition Policy
Washington, DC 20405

87-43-30

MAR 2 _ 1988

MEMORANDUM FOR HARRY ROSINSKI
ACTING DIRECTOR
OFFICE OF FEDERAL ACQUISITION
AND REGULATORY POLICY (VR)

FROM: IDA M. USTAD
DIRECTOR
OFFICE OF GSA ACQUISITION
POLICY AND REGULATIONS (VP)

Ida Ustad

SUBJECT: Allowability of Costs Incident to Mergers and Other Business Combinations thru the Purchase Method (FAR Parts 30 and 31, FAR Case 87-43)

The General Services Administration recommends a decision on the allowability of asset write-ups and its effect on depreciation and the cost of money on government contracts be decided on a case by case basis, if the purchase method is used to account for the business combination. The decision regarding government acceptance or disallowance of asset write-ups should be decided on equity considerations of the parties. In each case one of two results would be the outcome:

1. No asset write-ups allowed.

2. Asset write-ups are allowed provided a credit is given to the government for any depreciation or cost of money that previously flowed from these assets.

MAR 4 1988

B

# *Case Management Record*

| DAR Case No. | CAAC No. | Original | | Date |
|---|---|---|---|---|
| 84-18 | | Updated | X | 2-24-88 |

**Title** Mergers + Other Business Combinations

**Reference**
FAR Sec Ltr of 2/16/88

**Synopsis**
Add'l Public Cmt.

| Priority | Submitted By 04 | Originator Code | Case Manager |
|---|---|---|---|
| Keywords | | | |

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|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

**Recommendation**

**Notes**
Case at CCP Cmte.

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

84-18

FEB 1 F '88

Mr. Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council
ASD(P&L)DASD(P)DARS
c/o 3D139, The Pentagon
Washington, DC 20301-3062

Dear Mr. Holaday:

An additional comment received concerning the subject FAR Case is forwarded for your appropriate action:

FAR Case: 87-43, Mergers and Other Business Combinations

Federal Register Notice: 52 FR 41474, October 28, 1987

Letter to Industry: November 19, 1987

The Department of Defense is the lead agency on this case, therefore, the enclosed comments are to be reconciled by the DAR Council and recommendation for concurrence forwarded to the CAAC Chairman for approval prior to publication of a final rule.

Sincerely,

M. A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

cc: Chairman, Civilian Agency Acquisition Council
ATTN: Jim Ermerins, Chairman, Cost Principles Committee

FAR Case # 87-43 Comments Due: 12/28/87

Subject: Mergers and Other Business Combinations

To: Defense Acquisition Regulatory Council

Date: 2/10/88

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-43-28 | 2/2/88 | 1/25/88 | Equal Employment Opportunity Commission | 87-37-26<br>87-42-22 |

1-79

87-43-28

EQUAL EMPLOYMENT OPPORTUNITY COMMISSION
WASHINGTON, D.C. 20507

OFFICE OF
THE CHAIRMAN

January 25, 1988

Ms. Margaret A. Willis
FAR Secretariat [VRS]
General Services Administration
18th and F Streets, N.W.
Washington, D.C. 20405

Dear Ms. Willis:

This responds to the request from the Civilian Acquisition Council and the Federal Acquisition Regulatory Council that the Equal Employment Opportunity Commission (EEOC) provide comments on the following proposed changes to the Federal Acquisition Regulations (FAR):

-26

- FAR Case 87-37, Contracts Simplification Program;

-22 Sources

- FAR Case 87-42, Services Sought Synopsis for Research and Development; and
- FAR Case 87-43, Mergers and Other Business Combinations.

-28

The proposed Contracts Simplification Program, FAR Case 87-37, will provide a simplified contract format for the acquisition of supplies and services under firm-fixed price or fixed-priced with economic price adjustment contracts. The Contracting Officer could use the proposed simplified format or the courrent uniform contract format as circumstances dictate.

The requirement that an offeror submit annual representations and certifications would reduce the paperwork and result in administrative cost savings in the case of those contractors who bid on a number of contracts in the course of a year. EEOC concurs with the proposed revisions contained in FAR 87-37.

? Sources

The proposed revision in FAR Case 87-42, Services Sought Synopsis for Research and Development, would clarify the purpose of advance notices and allow the public to comment on synopsized solicitations. EEOC currently uses a similar system to obtain names

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FEB 2 - 1988

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of experts for our expert witness solicitations. However, the experts are requested to submit their resumes. EEOC's expert witness mailing list is developed based on those submissions. EEOC concurs with the proposed revisions contained in FAR Case 87-42.

EEOC has no comments on the proposed revision in FAR 87-43, Mergers and Other Business Combinations.

If you have any questions concerning this response, please let me know.

Sincerely,

Clarence Thomas

Clarence Thomas
Chairman

# Case Management Record — ~~Discussion~~ EXEC. SEC. —

A

| DAR Case No. 84-18 | CAAC No. | Original | | Date 16 Feb. 88 |
|---|---|---|---|---|
| | | Updated | X | |

**Title** Mergers AND Other Business Combinations

**Reference** Fed. Register Notice: 52 FR 41474, Oct. 28, 1987 (FAR CASE 87-43)

**Synopsis** Additional Public Comments

| Priority | Submitted By | Originator Code | Case Manager |
|---|---|---|---|
| Keywords | | | |

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| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | | | | |

**Recommendation**

**Notes**

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

FEB 1 1988

Mr. Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council
ASD(P&L)DASD(P)DARS
c/o 3D139, The Pentagon
Washington, DC 20301-3062

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Sincerely,

Margaret A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

cc: Chairman, Civilian Agency Acquisition Council
ATTN: Jim Ermerins, Chairman, Cost Principles Committee

FAR Case # 87-43 Comments Due: 12/28/87

Subject: Mergers and Other Business Combinations

To: Defense Acquisition Regulatory Council

Date: 1/29/88

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-43-26 | 1/20/88 | 1/14/88 | Council of Defense and Space Industry Associations (CODSIA) | |
| 87-43-27 | 1/26/88 | 1/26/88 | American Bar Association | |

1-35

87-43-26


# COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

1620 Eye Street, N.W., Suite 1000
WASHINGTON, D.C. 20006
•
(202) 659-5013


January 14, 1988
CODSIA Case No. 24-87

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W., Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

The undersigned member associations of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to provide comments on the appropriate approaches for handling administrative, contract and cost related issues arising from business combinations, and the possible development of changes to FAR parts 30 and 31 that address the allowability of costs incident to mergers and other business combinations. FAR Case 87-43 has been assigned to this action.

Industry has a serious concern that, unless current guidance and regulations clarify the allowability of depreciation and cost of money resulting from the recognition of fair market value of assets acquired in mergers and business combinations, there will be far-reaching consequences. Industry should be allowed to recover investment costs in property, plant and equipment, whether purchased separately or acquired through a merger or business acquisition. The government should be concerned that the incentive for such business transactions, which help stabilize and avoid significant reductions in the defense industrial base, may be lost if the regulations are not clarified.

Cost and price increases that could result from business combinations would be controlled through the competitive forces of the marketplace. No business entity can price its product at unacceptable, noncompetitive levels and expect to stay in business. If a company chooses to include increased depreciation and amortized expenses in the price of its product, it still faces the test of competition and intrinsic value judgments by its customers who may or may not choose to acquire its products. In a free market system the price of a product should be governed by competition and the buyer's desire to purchase goods and services at a particular price. Both competition and the government's prerogative to purchase or not purchase products from a specific company limit the government's risk in absorbing increased costs. Prices will be a reflection of value in the economic marketplace if the forces of competition and buyer's prerogative are left to have their effect.

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The subject of business combinations is complex and the Defense Acquisition Regulatory and Civilian Agency Acquisition Councils need to recognize the magnitude of the matter being addressed. Business combinations can be separated a number of ways and we suggest the following. First, there are distinct issues impacting the responsibility of the buyer and the seller, dependent on the type of business combination that transpired. The three major types of transactions are: (1) direct purchase of assets and liabilities; (2) purchase of stock through a tender offer; and (3) purchase of stock from a parent company. The last two transactions are further complicated depending on whether the purchased legal entity is dissolved or retained, and if there has been any prior involvement in government contracting. Regulations would need to be drafted in a manner that promotes a fundamental responsibility of accounting for the total investment by the new company in this business transaction. Accounting for the total investment is critical when operating in a market where cost is a major consideration. Because this issue is so complex, it would be administratively easier if the accounting treatment was the same whether or not government contracting was involved.

The current regulations and approach to handling business combinations are described in and guided by Accounting Principles Bulletin 16 (APB16), which provides for revaluing assets based on the current fair market value on the books of the acquiring company. APB16 was in existence and analyzed when the developers of Cost Accounting Standard (CAS) 404 (Capitalization of Tangible Assets) and CAS 409 (Depreciation) addressed the subject of business combinations. The studied opinion of the CAS Board was that the provisions of APB16 were equitable and sufficient to govern business combinations. Thus, the applicable standards were adopted consistent with the principles of APB16.

Application of the "purchase accounting" method for use on business combinations is backed by significant historical accounting precedent. "Purchase accounting" is based on sound accounting philosophy and represents a perspective of good common sense business and the most equitable solution for both buyer and seller.

The government is already protected from absorbing increased costs on existing contracts by FAR and the novation process. Therefore, the cost of depreciation resulting from revalued assets would be absorbed only on a prospective contracting basis. The marketplace offers the government every opportunity to review and negotiate such costs. If resultant prices are unreasonable, competition and negotiation would work to bring prices back to an acceptable level.

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Business combinations can also provide economies that would offset increased costs due to revaluation of assets. A business combination can create a larger base over which to spread fixed costs, provide for the elimination of management levels and effect a teaming of resources that can lead to faster technological development with more efficient use of property, plant and equipment. All of these offset increased depreciation and amortization.

Because of the current divergence of interpretations concerning mergers and business combinations, there is a need to clarify the regulations on this subject. However, no changes should be made at this time. Due to the complexity of the subject, a thorough research and compilation of a comprehensive issue identification paper is in order prior to making any changes. The research should include consideration of existing accounting practices and the need for changes to such practices for the appropriate recognition of gain in the value of assets. Support from industry is available to help with such an effort.

Don Fuqua
President
Aerospace Industries Association

for Wallace H. Robinson, Jr.
President
National Security Industrial Assn.

Jean A. Caffiaux
Senior Vice President
Electronic Industries Association

John Stocker
President
Shipbuilders Council of America

ABA

AMERICAN BAR ASSOCIATION Section of Public Contract Law
Writer's Address and Telephone



1575 Eye Street, N.W.
Washington, DC 20005
(202) 789-7559

Hand Delivered - 1/26/88

87-43-27

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W.
Room 4041
Washington, DC 20405

Re: Mergers and Other Business Combinations
FAR Case 87-43;

Dear Ms. Willis:

Pursuant to my conversation with your Office today, enclosed are the comments of the ABA Public Contract Law Section on the above-referenced notice. We understand that these somewhat belated comments will be considered, despite their late submission, in the formulation of a proposed rule.

Thank you for your consideration.

Sincerely,

David A. Churchill, Chairman
Regulatory Coordinating Committee

cc: All Officers and Council Members
The Hon. Robert P. Bedell, Esq.
The Hon. Austin G. Roe
Kathleen C. Barger, Esq.
Gregory A. Smith, Esq.
William L. Walsh, Jr., Esq.
John T. Sant, Esq.
Joe Wiener, Esq.
Thomas A. Lemmer, Esq.
Alex Brittin, Esq.
John Ordway, Esq.

JAN 26 1988

MS

AMERICAN BAR ASSOCIATION Section of Public Contract Law
Writer's Address and Telephone



1575 Eye Street, N.W.
Washington, DC 20005
(202) 789-7559

87-43-27

January 25, 1988

General Services Administration
FAR Secretariat (VRS)
18th and F Streets, N.W.
Room 4041
Washington, D.C. 20405

Re: FAR Case 87-43; Mergers and Other Business Combinations, 52 F.R. 41474, October 28, 1987

Dear Sir or Madam:

This letter is written on behalf of the Section of Public Contract Law of the American Bar Association pursuant to special authority extended by the Association's Board of Governors for comments by the Section on acquisition regulations. The views expressed are those of the Section and have not been considered or adopted by the Association's Board of Governors or its House of Delegates.

On October 28, 1987, the Civilian Agency Acquisition Council (CAAC) and the Defense Acquisition Regulatory Council (DARC) issued a notice in the Federal Register soliciting comments regarding the development of changes to FAR Parts 30 and 31 concerning the allowability of costs incident to mergers and other business combinations. Changes to the subject regulations may be appropriate in light of the uncertainty surrounding those regulations in their current form and as currently implemented by the procuring agencies. It is felt, however, that such changes should be implemented only after careful study and analysis. The comments set forth below identify some of the reasons such an analysis should be undertaken, but are not meant to be a definitive statement of all such reasons. The Section of Public Contract Law is prepared to offer additional comments as any such study may progress.

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I. The Current Regulations Reflect Reliance On The "Purchase Method" Of Accounting For Business Combinations, An Accounting Practice That Has Been Widely Accepted By The Accounting Profession.

The purchase method of accounting has been relied upon for many years in the financial accounting community as a Generally Accepted Accounting Principle (GAAP). Accounting Principles Board (APB) Opinion No. 16 recognizes the purchase method of accounting as acceptable and, in fact, mandates its use for the most common types of business combinations. Similarly, Cost Accounting Standard (CAS) 404, Capitalization of Tangible Capital Assets, specifically recognizes the purchase method as appropriate to certain business combinations (CAS 404.50(d)).

Case law has generally accepted and followed the purchase method of accounting as well.[1] In Gould Defense Systems, Inc. ASBCA No. 24881, 83-2 BCA ¶ 16,676 the Armed Services Board of Contract Appeals favorably discussed the purchase method of accounting and the "step-up" of assets in mergers and acquisitions (at 82,960):

> Purchase accounting is widely used in Government contract accounting and is accepted by the Government. In general, the Government allows the step-up of tangible capital assets to fair value at the time of business acquisitions properly accounted for under the purchase method, and accepts depreciation on a stepped-up value of the tangible capital assets as an allowable cost for Government contract pricing purposes.

In light of its longstanding acceptance and use in Government contract accounting, any change contemplated by the

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[1] In the more recent case of The Marquardt Company, ASBCA No. 29888, 85-3 BCA ¶ 18,245, aff'd on reconsideration, 86-3 BCA ¶ 19,100, aff'd 822 F.2d 1573 (Fed Cir. 1987), the proper application of the purchase method was at issue. Appellant argued that the purchase method permits the acquired company to "step-up" its assets. The Government did not dispute the validity of the purchase method of accounting, but argued it should not apply to an acquired entity. The Court, in holding the purchase method does not apply to the acquired entity, noted its application to the purchasing entity.

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CAAC and DARC should not modify or eliminate the purchase method of accounting without careful study.

## II. The Problem Perceived By The CAAC And DARC May Not Warrant Changes To The Current Regulations.

The only basis for a change to the current regulations stated in the Federal Register notice is the perceived problem that "in circumstances when a contract price will be based upon the contractor's cost, the Government [is] at risk of paying higher prices simply because of a change in ownership of the supplier". This statement assumes that it is inappropriate to revalue assets as part of or incident to a business combination, if such a revaluation will increase the price to be paid by the Government.

The purchase method of accounting, however, provides that acquisitions and mergers are an appropriate time to determine whether an asset's book value is below or above its fair market value and make the necessary adjustment. Thus, the Government is not paying a higher price just because there has been a change in ownership, but because a business combination represents an appropriate point at which to gauge an asset's current value. When an asset is sold or transferred as part of a business combination, its current fair market value can readily be determined.

In those cases in which a revaluation occurs, the Government is clearly protected from incurring increased costs due to such a business combination by the requirement that the new owner and the seller enter into a novation agreement. Under the terms of the standard novation agreement (found at FAR 42.1204(e)(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 of 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.

87-43-27



This provision has been held to prohibit the write-up of assets on ongoing contracts. See Sundstrand Turbo Division v. United States, 182 Ct. Cl. 31, 389 F.2d 406 (1968); LTV Aerospace v. United States, 192 Ct. Cl. 191, 425 F.2d 1237 (1970).

To the extent the CAAC and DARC may contemplate extending the current protection afforded by novation agreements by permanently precluding a contractor from recovering depreciation and other asset-related costs based upon the stepped-up fair market value, they would, in effect, be altering or rejecting the purchase method of accounting for Government contractors. The Government would thus be demanding treatment more favorable than the acquiring or surviving corporation's commercial customers. Furthermore, the acquiring contractor would be precluded from recouping its costs of acquisition through the price it would otherwise charge its customers. Any such contemplated change to the current regulations could prevent a contractor from recovering its investment costs and may have the unforeseen and deleterious effect of discouraging business combinations involving Government contractors. Companies would be dissuaded from investing in Government contractors if the acquiring or surviving corporation cannot depreciate the assets on their books at their purchase price or fair market value. In such a case, the Government's interests would be harmed by not being able to take advantage of the economies of scale, the increased efficiency and the other benefits that can flow from business combinations.

## III. A CAAC And DARC Study Of The Current Regulations Is Appropriate In Light Of The Current Practice Of The Department Of Defense Requiring Contractors Who Are Party To Business Combinations To Agree To Conditions Of Recognition That Go Beyond The Current Regulations.

In a number of recent combinations involving defense contractors, the Department of Defense has insisted upon novation agreements (in some cases called "advance" agreements) that preclude the acquiring company from ever charging the Government for asset-related costs that are based upon stepped-up values. The current regulations do not provide for, much less require, such agreements. Such agreements substantially alter the effect of the purchase method of accounting.

The practice of insisting upon such terms and conditions as the Government's price of recognition of the

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acquiring company is inappropriate for a number of reasons. First, it is a practice that arose without benefit of normal CAAC or DARC consideration and analysis. Accounting policy and cost allowability issues should be decided on a Government or department-wide basis and only after careful review. The practice at issue arose on an *ad hoc* basis, without any opportunity for public scrutiny.

Second, the practice induces confusion and uncertainty in the implementation of business combinations. If the terms of the Government's recognition of a successor contractor are not resolved until after the combination has occurred (as part of the "novation" process), the parties to the combination do not know what to expect when considering the terms and condition of the combination itself. Published, clear Government regulations on the subject will avoid this unnecessary uncertainty.

## Conclusion

The purchase method of accounting for business combinations has been utilized and accepted for many years by both the financial and governmental accounting communities. Pursuant to that method, the acquiring or surviving corporation in a business combination has been permitted to charge the Government for its investment in assets that the contractor will use on future Government contracts. The development of additional rules concerning accounting for business combinations should recognize the considerable reliance already placed upon the purchase method of accounting already part of the current regulations and case law. Any such changes should be implemented only after careful study and analysis that would include an opportunity for public comment.

Sincerely,

David A. Churchill, Chairman
Regulatory Coordinating Committee

A

# Case Management Record

| DAR Case No. 84-18 | CAAC No. FAR NO. 87-43 | Original / Updated X | Date 2-1-88 |
|---|---|---|---|

**Title** Mergers & Other Business Mergers

**Reference**
FAR Sec ltr of 1/20/88

**Synopsis**
FAR Sec sends Pub Cmts.

| Priority | Submitted By | Originator Code | Case Manager N |
|---|---|---|---|
| Keywords | | | |

| | | | | |
|---|---|---|---|---|
| Case References | | | | |
| FAR Cites | | | | |
| DFARS Cites | | | | |
| Cognizant Committees | CCP | | | |

**Recommendation**
Task to CCP Cmte

**Notes**

FAR Case # 87-43 Comments Due: 12/28/87

Subject: Mergers and Other Business Combinations

To: Defense Acquisition Regulatory Council

Date: 1/21/88

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-43-01 | 11/24/87 | 11/17/87 | Davey Compressor Company | |
| 87-43-02 | 12/3/87 | 11/18/87 | William J. Ryan, Jr. | |
| 87-43-03 | 12/10/87 | 12/2/87 | U.S.A. Occupational Safety and Health Review Commission | 87-37-02<br>87-42-02 |
| 87-43-04 | 12/8/87 | 12/2/87 | Avco Research Laboratory, Textron | |
| 87-43-05 | 12/15/87 | 12/7/87 | McKenna, Conner & Cuneo | |
| 87-43-06 | 12/17/87 | 12/9/87 | U.S. Department of Housing and Urban Development | |
| 87-43-07 | 12/17/87 | 12/10/87 | Federal Home Loan Bank Board | 87-37-08<br>87-42-04 |
| 87-43-08 | 12/17/87 | 12/10/87 | Armed Forces Communications and Electronics Association | 87-37-09<br>87-42-05 |
| 87-43-09 | 12/15/87 | 12/4/87 | Agency for International Development | 87-37-10<br>87-42-06 |
| 87-43-10 | 12/15/87 | 12/7/87 | National Endowment for the Humanities | 87-37-11<br>87-42-07 |
| 87-43-11 | 12/15/87 | 12/3/87 | Central Intelligence Agency | 87-37-12<br>87-42-08 |
| 87-43-12 | 12/23/87 | 12/15/87 | Pennsylvania Avenue Development Corporation | 87-37-13<br>87-42-09 |
| 87-43-13 | 12/23/87 | 12/16/87 | U.S.A. Railroad Retirement Board | 87-37-14<br>87-42-10 |
| 87-43-14 | 12/24/87 | 12/18/87 | United States Arms Control and Disarmament Agency | 87-37-15<br>87-42-11 |
| 87-43-15 | 12/23/87 | 12/15/87 | National Labor Relations Board | 87-42-13 |
| 87-43-16 | 12/23/87 | 12/16/87 | U.S. Small Business Administration | 87-42-14 |

FAR Case # 87-43 Comments

Due: 12/28/87

Subject: Mergers and Other Business Combinations

To: Defense Acquisition Regulatory Council

Date: 1/21/88

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-43-17 | 12/23/87 | 12/18/87 | United States Commission on Civil Rights | 87-42-15 |
| 87-43-18 | 12/24/87 | 12/21/87 | Vincent T. Noone | |
| 87-43-19 | 12/24/87 | 12/21/87 | American Institute of Certified Public Accountants | |
| 87-43-20 | 12/30/87 | 12/18/87 | American Defense Preparedness Association | 87-42-15<br>87-37-18 |
| 87-43-21 | 12/31/87 | 12/28/87 | Panama Canal Commission | 87-37-19 |
| 87-43-22 | 12/31/87 | 12/23/87 | Professional Services Management Association | |
| 87-43-23 | 1/7/88 | 12/30/87 | Veterans Administration, Office of the Administrator | 87-37-23 |
| 87-43-24 | 1/7/88 | 12/29/87 | Department of Defense, Inspector General | |
| 87-43-25 | 1/14/88 | 12/28/87 | Emerson Electric Company, Electronics and Space Division | |

11-44

87-43-01

DAVEY... the world's 2nd greatest AIR FORCE

DAVEY COMPRESSOR CO.

DAVEY AEROSPACE

Davey Compressor Company

11060 Kenwood Road / Cincinnati, Ohio 45242

Tel 513 793 9400 / Telex 21-4372 / FAX 513 793 4119

November 17, 1987

General Services Administration
FAR Secretariat (VRS)
18th and F Street N.W.
Room 4041
Washington, D. C. 20405

Reference: Allowability of Costs of Business Combinations

FAR Case 87-43

Dear Ms. Willis:

We are very interested in the continued reviewing of the allowability of costs resulting from business combinations. Davey Compressor Company is a prime contractor for the Department of the Defense.

The capital stock of Davey Compressor Company (a privately held corporation) was purchased, in its entirety, by another party. The purchase price exceeded the book value of the corporation and through a merger with the acquisition company resulted in the "write-up" of certain fixed assets. The "purchase method" was used to record the increase in value of those assets. The "write-up" is a genuine cost, because cash changed hands for the additional value.

Generally Accepted Accounting principles (G.A.A.P.) requires that this additional value be depreciated. Now, we have to prepare two sets of financial statements, one according to G.A.A.P., the other according to F.A.R.

While the preparation of the two sets of financial statements presents some confusion, the reality of the matter is that the depreciation of increased value of fixed assets, is a real and true cost. Therefore, we feel it should be recognized as a cost by the Government.

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We hope and trust that the reviewing agencies will hear our comments and take them into consideration. We have continued interest in this matter and request that we be placed on a mailing list.

Sincerely,

DAVEY COMPRESSOR COMPANY

Carl J. Wurtz

Carl J. Wurtz, C.P.A.
Vice President Finance

CJW/mw

cc: T. V. Purvin
T. C. Purvin
W. L. Graham
Boyd Colglazier, Arthur Young & Company

87-43-01



costs incident to mergers and other business combinations.

DATE: Comments should be submitted to the FAR Secretariat at the address shown below on or before December 28, 1987, to be considered in the formulation of a proposed rule. Please cite FAR Case 87-43 in all correspondence related to this issue.

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

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

SUPPLEMENTARY INFORMATION:

## Background

The Defense Acquisition Regulatory and Civilian Agency Acquisition Councils have been reviewing the subject of business combinations, and particularly the allowability of costs resulting from such combinations. This review has been occasioned by the Councils' concern that existing regulations on certain aspects of this subject may not be adequate, as evidenced by recent litigation. Specifically, the Councils are considering whether, in circumstances where a Government contractor is acquired, the Government should recognize depreciation or cost of money flowing from asset write-ups that result if the "purchase method" is used to account for the business combination. Government representatives have expressed concern whether, in the circumstances when a contract price will be negotiated based upon the contractor's cost, the Government should be at risk of paying higher prices simply because of a change in ownership of the supplier. Accordingly, the Councils will consider comments from interested parties regarding approaches the Councils might employ in dealing with this issue.

## List of Subjects in 48 CFR Parts 30, and 31

Government procurement.

Dated: October 22, 1987.

12-11

87-43-02

William J. Ryan, Jr.
3896 Carriage Gate Drive
Duluth, Georgia, 30136
Home Phone: 404-497-1347
Office: 404-497-5451

18 November 1987

General Services Administration
FAR Secretariat (VRS),
18th and F Streets, N.W.,
Room 4041, Washington, D.C., 20405

REFERENCE: Proposed Change to the FAR Relative to the Allowability of Costs Arising from the Assessed Value of Assets Following Corporate Mergers or Acquisitions (52 Fed. Reg. 41474; 10/28/87)

FAR CASE 87-43

Sirs,

The question of the allowability of the cost of depreciation expense or the cost of money where those costs have been generated solely by the accounting machinations which arise as the result of corporate mergers and acquisitions is indeed interesting and complex. This issue came to my attention several years ago, when I worked as a Contract Specialist at the Defense Contract Administration Region (DCASR) New York. In 1982, I submitted a suggestion for a FAR change, but the suggestion was rejected by the DCASR Chief of Financial Services. In 1986, I submitted another suggestion for a FAR change, and this time my suggestion was rejected because the Defense Acquisition Regulatory (DAR) Council was considering the issue. I am pleased to see (Federal Contracts Report, BNA, 11-16-87, p. 767) that the Civilian Agency Acquisition Council and the DAR Council have finally approached the problem and have requested comments from the public.

The problem, as I understand it, is that by current accounting rules, assets subject to depreciation when acquired are revalued at their assessed market value for the purpose of (1) establishing a new depreciation schedule and (2) determining the amount, if any, paid in excess of the asset's market value that should be charged to Goodwill. Where Government contracts and contractors are concerned, this practice of revaluing assets creates opportunities for profit generation at the Government's expense and from which the Government acquires nothing of value. Take, for example, the case of two businesses primarily engaged in Government contracting, one an *acquiring* entity (call it "Predator") and one an *acquired* entity (call it "Prey") which merge in a fashion other than "pooling." By current accounting rules, the assets of the Prey corporation will be revalued and depreciation schedules will be reestablished. It may well be

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however, that the Government has over several years effectively paid for the assets of Prey corporation through indirect cost billings on the contracts let to Prey. The revaluation of those assets does nothing except allow Predator to express the market value of the assets on its financial statements, compute its cost of Goodwill, and reduce its taxes by deducting the attendant depreciation expense and Goodwill amortization from its income. The Government has no need to buy those assets again, and should not be made to pay for them in the form of the depreciation costs embedded in the contractor's overhead charges.

It may be argued that (1) merger or acquisition costs are legitimate business costs incurred as the result of managerial decisions to expand the business base;(2) that this type of activity enables the company to acquire badly needed assets at bargain prices;(3) that mergers and acquisitions permit the company to procure systems or to gain new technical competencies and capabilities;(4) that mergers and acquisitions allow the company to experience the "synergistic" effects of the mating of new and different managerial and technical skills; (5) that these transactions are prudently undertaken in an effort to protect markets and ensure future profitability; and (6) that these business acquisition actions are in the best interests of the Government because they will contribute to the overall productivity and efficiency of the defense industrial base and provide other benefits in the form of expanded industrial technological capabilities.

All of these arguments may be true, but even if they are true they do not justify a subsidy in the form of higher overhead or cost of money charges on Government contracts. The reasons why can be readily seen if a commercial business analogy is applied. A commercial business in a competitive environment will not be able to raise its prices just because it has newly merged with another firm. If it does so, its market share will decline, its profits will founder, and its competitors would fill the market gap. When Predator acts to acquire Prey, it should do so confident that the cost of the acquisition will be accommodated not by its customers but by all of those things that made the action a prudent business decision: hightened efficiencies, new technologies and capabilities, and the "synergistic" effects of business combinations. If Predator makes the acquisition with the thought that it will now be able to dominate a market and charge higher prices (which is the only way it can charge higher prices and survive in business), then the acquisition is in restraint of trade and as such is patently illegal.

What is true for the commercial marketplace should also be true for the Government. The Government as customer should not be made to absorb the cost of the merger or acquisition, just as in the commercial marketplace the customer cannot be made to absorb those costs. If the merger is made with the idea that the Government is a captive customer and can be made to subsidize the transaction under the rules for cost allowability, then the reason for merging is clearly determined not by the intrinsic economic value of the acquisition but by the special market conditions that endow that acquisition with value, i.e., the Government subsidy earned. A merger or acquisition whose economic viability is contingent upon the special conditions that prevail when the Government is the customer is, therefore, viable only in terms of its cost to the Government. Such a transaction burdens the Government with being forced to pay something (presumably a great deal) for nothing. The acquisition regulations should have been changed years ago to disallow such costs.

The first problem in attempting to amend the regulations is to define terms. I would recommend the following:

***REDEPRECIATION:*** The depreciation expense generated from capital assets procured as the result of the acquisition of an Asset-Owning Entity by another Asset-Owning Entity, or as the result of the merger of Asset-Owning Entities, where the depreciation schedule is based on the fair market value of those assets as set shortly before, at the time or, or following the acquisition of the Asset-Owning Entity by another or of the merger of the Asset-Owning Entities.

***ASSET-OWNING ENTITY:*** A corporation, partnership, or proprietorship, or any subdivision thereof which is organized for the purpose of conducting business and which owns or has owned capital assets or capitalizable leases.

***NEW ASSET:*** An asset that is manufactured, fabricated, engineered or developed by the asset-owning entity, or an asset that is purchased directly or indirectly (i.e. through the agency of manufacturer's representatives, equipment brokers or dealers, or other middlemen who act as intermediates between the original source and its customers) from the original source of manufacture, fabrication, assembly or development, or any combination of assets purchased from the Original Source and work performed with or on those assets by the purchaser that is capitalizable.

***NORMAL DEPRECIATION:*** Depreciation expense calculated on the basis of the price of the asset as a New Asset, or in the event of the acquisition of a Previously-Owned asset, on the

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basis of whichever is lower: the fair market value of the asset or the price paid for the asset at the time of its most recent acquisition.

***PREVIOUSLY-OWNED ASSET:*** An asset acquired from an Asset-Owning Entity where the selling Entity is not the original source of manufacture, fabrication, development, or engineering of the asset, nor is the selling Entity a manufacturer's representative, dealer, broker, or other middleman who acts as an intermediate between the Original Source of the asset and its customers.

I would recommend the FAR be changed to include the following:

The costs of *Redepreciation*, as defined above, are disallowed as either direct or indirect costs to the Government on all negotiated contracts for goods or services. Depreciation expense will be allowed to the extent that it entails charges for *Normal Depreciation*, as defined above, and to the extent that the method of depreciation expense calculation conforms to all the other rules and regulations governing depreciation. Depreciation based on the revaluation of assets, where that revaluation has been generated solely as the consequence of the merger of Asset-Owning Entities, or as the consequence of the acquisition of one Asset-Owning Entity by another Asset-Owning Entity or Entities or as the result of any other form of business combination is not allowed.

Depreciation expense calculated on the basis of the purchase price or fair market value of Previously-Owned assets will be allowed to the extent that the assets were not acquired as the result of an acquisition of an Asset-Owning Entity by another Asset-Owning Entity, or as the result of the merger of Asset-Owning Entities. The Normal Depreciation expense of Previously-Owned assets will be allowed only if those Previously-Owned assets were acquired as the result of the acquisition of one or more individual items, but they will not be allowed if those individual items collectively could constitute the bulk of the assets of a business entity, i.e., an independent company, a division of a company, or a manufacturing plant. One test of whether or not the acquisition of a set of assets would, in effect, constitute the acquisition of a business entity would be found in whether or not that acquisition generated a change in the acquiring entity's Goodwill account. Any acquisition which generates a change in Goodwill, whether that change is positive or negative, will be considered subject to Redepreciation and the costs of its depreciation expense will be allowed only to the extent that the costs of depreciation expense arising from the merger of Asset-Owning Entities or the acquisition of an Asset

87-43-02



Owning Entity (or Entities) by another Asset-Owning Entity (or Entities) is allowable.

The depreciation expense of assets acquired through the acquisition of an Asset-Owning Entity (or Entities) by another Asset-Owning Entity (or Entities) or through the merger of Asset-Owning Entities will be allowable only to the extent that it is based on the un-revalued book value of the assets at the time of the merger or acquisition unless that book value is greater than the assessed market price of the assets, in which event it will be based on market value. The book value utilized for the calculation of depreciation expense must be the book value of the assets when they were owned by an Asset-Owning Entity which was not associated in ownership with the acquiring Asset-Owning Entity. This association in ownership would include but not be limited to holding companies, businesses created by the acquiring entity, businesses in which the acquiring entity owns any equity, or businesses which are in debt to the acquiring entity.

The Cost of Money, as defined in CAS 414, will be allowed to be charged on the basis of the value of assets only to the extent that the value of those assets is calculated under this regulation for the purpose of determining allowable depreciation expense. That is, the same value for assets will prevail for the calculation of Cost of Money as for the calculation of allowable depreciation expense.

The acquisition of assets will be monitored at least annually by the Defense Contract Audit Agency (DCAA) for the purpose of determining whether or not assets have been acquired which burden the acquiring Entity with unallowable depreciation expenses. In the event that the contractor disputes the determination of the DCAA Auditor regarding the extent of the allowability of an asset's depreciation expense, the Auditor will remand the case to the Administrative Contracting Officer (ACO) for a decision regarding the status of the asset. The ACO will render a decision in writing indicating that he/she has considered the advisements of the DCAA Auditor, and other recommendations and advisements as he/she requires. The ACO may sustain all or any part of the DCAA recommendation, or may act on the basis of other recommendations or his/her own independent evaluation of the Contractor's position. The contractor may appeal the ACO's decision and ask for a final consideration of facts in the matter, if such appeal is made within 30 days of the issuance of the ACO's written decision. Should the ACO's final decision still be the subject of dispute, the Contractor may appeal the decision to the Armed Services Board of Contract Appeals, if such appeal is made within 60 days of the ACO's final decision. Alternatively, the contractor may

87-4-02



appeal the ACO's final decision to the Court of Claims, if such an appeal is made within 60 days of the ACO's final decision.

* * * * * * * * * * * * * * * * * * * * * * * * *

Thank you for considering my comments on the change to the FAR. I hope these thoughts will be somewhat useful to you. In any event, I thought you might be interested in the ideas of a working Contracting Officer.

Sincerely Yours,

William J. Ryan, Jr.

William J. Ryan, Jr., CPM, CPCM

15-43

87 340

UNITED STATES OF AMERICA
OCCUPATIONAL SAFETY AND HEALTH REVIEW COMMISSION
1825 K STREET, N.W.
4TH FLOOR
WASHINGTON, D.C. 20006-1246

87-43-03

December 1, 1987

Miss Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
Room 4041
18th & F Streets, N.W.
Washington, D.C. 20405

Dear Miss Willis,

In response to your recent request for comments on proposed rules identified as FAR Cases 87-37, 87-42 and 87-43, please be advised that the Review Commission offers no opinion.

Being a small independent Federal agency, we utilize the services of GSA to handle our contracting and procurement processing.

Thank you for the opportunity to provide input to proposed rules and rule changes.

Sincerely,

Paul M. Lyons

Paul M. Lyons
Executive Director

RECEIVED

DEC 10 1987

12-30

# Avco Research Laboratory TEXTRON

87-43-04

Andrew P. Heaton
Controller and
Chief Financial Officer

**Avco Research Laboratory, Inc./
Subsidiary of Textron Inc.**

2385 Revere Beach Parkway
Everett, Massachusetts 02149
617/381-4554

December 2, 1987

General Services Administration
FAR Secretariat (VRS)
18th and F Sts., NW
Room 4041
Washington, D.C. 20405

FAR Case
87-43

Dear Sir:

I do not feel that the government would ever pay a higher price simply because of a change in ownership of a supplier.

True economic value must be recoverable in the marketplace or a company being acquired can no longer deliver to that market. Conversely that true value will not be more than the market is willing to pay.

The price paid by an acquiring company for the company being acquired, regardless of the type of business transaction, reflects earnings power or potential earnings power and/or the true economic value of the assets of the acquired company.

The value assigned to depreciable assets by an acquiring company may or may not result in higher prices. Several other factors effect price: volume, cost savings, etc. Also, the recovery of a higher depreciable cost at any point in time never offsets the lower bargain value previously recoverable.

Competition in performance and price should determine the price paid by the government not the supplier's structure or ownership history.

Andrew P. Heaton

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DEC 8 1987

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87-43-05

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HERBERT L. FENSTER

DIRECT DIAL (202) 789-

December 7, 1987

Mr. Frank Lierde
Acting Director
Office of Federal Acquisition
and Regulatory Policy
c/o General Services Administration
FAR Secretariat (VRS)
18th and F Streets, N.W.
Room 4041
Washington, D.C. 20405

Re: FAR Case No. 87-43

Dear Mr. Lierde:

This will refer to the Federal Register notice of October 28, 1987 titled "Mergers and Other Business Combinations." The subject notice indicated an intent to develop rules limiting allowability of costs where increases in costs may be incident to mergers or other business combinations. The notice invited comments.

We are setting forth below our comments and statement of position on this subject. It should be understood that the comments and position reflect the views of this firm and not necessarily the views of any particular client of the firm. As you will note, it is our position that the subject presents significant legal, business and economic issues which should be addressed before any substantive regulatory or rulemaking language is considered.

Neither the Federal Acquisition Regulations nor any of its predecessor regulations has addressed this subject other than in the form of novation agreement, which is prescribed for use in the case of acquisitions of assets. Nor do the Cost Accounting Standards directly address this subject. Regulation of this subject, therefore, would be entirely new and it is appropriate to consider not only the immediate impact of such regulation, but also the larger and potentially more important business, economic and political issues.

DEC 15 1987

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The limited historical treatment of this subject in the form of novation agreement prescribed by the regulations made unallowable increases in costs of contracts in the hands of a transferee over and above those which would have been incurred by the government had a transfer not taken place. Two distinct limitations existed even as to this provision. First, the provision was limited to increases in costs resulting from changes in business combinations other than by operation of law. Thus, while sales of assets were (and are) covered by the provision, mergers were (and are) not.

Second, the provision importantly related only to contracts in being. This limitation, while seemingly very obvious, appears not to have been considered in more current thinking: While it may be that the government is entitled not to pay more for goods and services than the amount it bargained for when a contract was entered into, the government has no such entitlement as to contracts not yet in being. In the latter case the government, like any other customer, should expect to deal with the seller just as it finds him.

We are aware of no business, economic or political reason for the government to place itself in a position as a buyer which is distinctly more favorable than that of any other buyer. Indeed, there are important business and economic reasons why the government should forbear from such conduct. Among these reasons is the fact that many mergers and other business combinations in today's unsettled economy have as their objective the strengthening of the business base.

The government, like any other customer, derives an important advantage from such strengthening, including the ability of the emerging seller to finance the ever increasing costs of sustaining the defense mobilization base. While these benefits may not necessarily be translated immediately into dollar terms, it is hardly deniable that they are significant to the government's interests.

In this context, it would appear that the objections which are presently being raised, particularly by DCAA, to a stepped up basis for assets passed in connection with mergers and other business combinations is that the government might "pay for these assets twice." The seeming initial attractiveness of this argument is belied by a more careful analysis.

87-43-05



One of the significant objectives of many mergers and other business combinations is, in fact, to generate capital and the ability to acquire capital by stepping up asset values. In today's marketplace, this process is frequently far more feasible than borrowing or the issuance of additional equity paper.

Mergers and other business combinations are crucial means available to the aerospace and defense industry for the generation of capital. Step up in asset values and business combinations provide both direct additional capital and the improved ability to borrow. These means are critical, since severe limitations continue to exist on the extent to which the government will directly recognize cost of capital in the pricing of government contracts. Similarly, the ability of defense contractors to borrow at reasonable rates in the open marketplace is becoming increasingly limited, particularly by the uncertainty which attaches to initiation and continuation of major programs from which revenues may be derived.

On the other hand, the Department of Defense is calling upon defense contractors to finance far more of the costs of weapons programs. This, for example, has led to the initiation of RDT&E cost sharing contracts which at this time project a financing burden on the defense industry in excess of $6 billion.

The imposition of limitations on revaluation of assets and other step ups through mergers and other business combinations would, in our view, severely depress the attractiveness of aerospace and defense oriented companies in the marketplace. This is particularly true since no projected time limitation would be placed on such restrictions. For companies whose principal markets are in the aerospace and defense business, the limitations would make them extremely poor acquisition and lending candidates, since the limitations would cause rather dramatic underrecoveries of indirect costs.

We believe that business and economic considerations such as those just discussed strongly suggest that it is in the interest of the national defense to continue the present regulatory pattern which clearly permits the stepping up of asset bases resulting from mergers and other business combinations. In this context, the government is not paying twice for these assets. To the contrary, it is, like every other customer, sharing the enormously increased capital burden of sustaining production which includes the maintenance and replacement of capital, plant and equipment.

87-43-05



To the foregoing should be added our view that regulatory attempts to curtail the right to a stepped up basis would (with the exception of contracts subject to novation agreements) not be legal.

It is our view that any regulations on this subject could legally apply only to contracts in being which are of a cost reimbursement variety or to the incentive portion of FPI contracts. In our opinion, an attempt to interpose limitations on recovery based on growth in basis or other cost resulting from mergers and acquisitions for firm fixed price contracts or future contracts would be illegal as regulation in excess of statutory authority.

In fact, it is our view that such regulations would interpose an unconstitutional condition upon future contracting. Perry v. Sindermann, 408 U.S. 593, 597 (1972); Parks v. Watson, 716 F.2d 646 (9th Cir. 1983). This would be particularly true where contracts subject to such a limitation could be unilaterally imposed under provisions of the Defense Production Act of 1950, even if authority under this statute were not directly asserted. In this particular connection, the application of such regulations might well constitute a compensable taking.

We believe that this subject deserves most careful and deliberate attention, particularly as to the business, economic and legal considerations which it raises. We stress that the proposed regulation is not merely an additional limitation in cost allowability, but has far larger and broader implications. In this connection, we believe that the subject should be aired in hearings which would enable the councils to elicit publicly the views of interested and expert parties.

Respectfully submitted,

MCKENNA, CONNER & CUNEO

By Herbert L. Fenster
Herbert L. Fenster

HLF/gt

12 64

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-3000

87-43-06

December 9, 1987

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, NW, Room 4041
Washington, DC 20405

Dear Ms. Willis:

The Department of Housing and Urban Development has reviewed Federal Acquisition Regulation (FAR) Case 87-43 concerning mergers and other business combinations. We have no comment.

We appreciate the opportunity to review the proposed FAR rule.

Very sincerely yours,

Roosevelt Jones

Roosevelt Jones
Director
Office of Procurement and Contracts

DEC 17 1987
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87-43-07 12-65

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

**Federal Home Loan Bank Board**

DEC 10 1987

Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

The Federal Home Loan Bank Board has reviewed the GSA letter of November 19, 1987, wherein a notice of intent to develop a proposed rule and a copy of two proposed rules were included.

Upon review of the proposed form identified as "Solicitation/Contract Form" in Case 87-37, we would like to know the purpose/intent of Block 9, since there are no identifying titles.

The Agency has no problem with the intent of the proposed language of the Federal Acquisition Regulation (FAR) Cases identified as:

- FAR Case 87-37, Contract Simplification Program;
- FAR Case 87-43,-07 Mergers and Other Business Combinations; and
- FAR Case 87-42,-04 Sources Sought Synopsis for Research and Development.

Sincerely,

for

Richard L. Petrocci
Director
Administration Office

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'2-75
87-43-08

**Armed Forces Communications and Electronics Association**
AFCEA International Headquarters
4400 Fair Lakes Court • Fairfax, Virginia 22033-3899, USA
Telephone (U.S.) 703-631-6100 • (International) 001-703-631-6100
Facsimile (U.S.) 703-631-4693 • (International) 001-703-631-4693
Telex 90 1114 AFCEA FFX

December 10, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Room 4041
Washington, DC 20405

Dear Ms. Willis:

Reference your letter of November 19, 1987. The Armed Forces Communications and Electronics Association appreciates the opportunity to provide, when appropriate, comments on FAR proposals. Concerning FAR CAses 87-37, 87-43 and 87-42, we have no comment to propose.
9 08 05

Sincerely,

Joeseph F. Denniston
Colonel, USAF (Ret.)
Director of Finance

/mmd

12-48

87-43-09

**AGENCY FOR INTERNATIONAL DEVELOPMENT**
**WASHINGTON, D.C. 20523**

DEC 4 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Reference: FAR Cases 87-37, 42, and 43

Dear Ms. Willis:

Thank you for your letter of November 19, 1987 concerning proposed FAR revisions for:

a. Contract simplification program;

b. Sources-sought synopsis for research and development; and

c. Mergers and other business combinations.

The Agency for International Development has no objections to or comments on the proposed changes.

Sincerely,

John F. Owens

John F. Owens
Procurement Executive

DEC 15 1987

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87-43-10

NATIONAL ENDOWMENT FOR THE HUMANITIES

WASHINGTON, D.C. 20506

December 7, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W.
Washington, DC 20405

Dear Ms. Willis:

I am writing in regards to FAR Case 87-37, Contract Simplification program, proposed rule;

FAR Case 87-42, Sources Sought Synopsis for Research and Development, proposed rule;

The National Endowment for the Humanities (NEH) has no objection to the above cases as drafted in the Federal Register.

Far Case 87-43, Mergers and other Business Combinations, NEH declines to comment as there are few applications in which the NEH is likely to be involved.

Sincerely,

Robert P. Stock
Contracting Officer
National Endowment for the Humanities

DEC 15 1987

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EXEC SEC
25 Sept 87

C MANAGEMENT RECORD

| ORIGINAL |
|---|
| UPDATED |

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

TITLE: COSTS IN Connection with MERGERS + Business Combin.

REFERENCE: GOLDEN Parachutes + Handcuffs

ORIGINATION DATE:

SYNOPSIS: Additional Public Comment

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| PRIORITY: | ORIGINATOR CODE: |

| KEYWORDS | | | | |
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| COGNIZANT COMMITTEES | | | |
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RECOMMENDED ACTION:

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

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| DISCUSSION DATE: | DOCKET DATE: |

REPORT DATE:

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

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| DEPARTMENTAL | NUMBER: | DATE: |
| BULLETIN | NUMBER: | DATE: |

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| CASE CLOSED: | CASE COMPLETED: |
| REG FLEX APPLICABLE: | PAPERWORK REDUCTION: |

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| PROPOSED RULE: | INTERIM RULE: | FINAL RULE: |

87-43-14

UNITED STATES ARMS CONTROL AND DISARMAMENT AGENCY
Washington, D.C. 20451

Ref: (1) FAC 84-31
(2) FAR Case 87-37
FAR Case 87-43
FAR Case 87-42

December 18, 1987

FAR Secretariat (VRS)
General Services Administration
Room 4041
18th and F Streets, NW.
Washington, D.C. 20405

Attention: Margaret A. Willis

Gentlemen:

Reference is made to Ms. Willis' letters of October 20, 1987, and November 19, 1987, which requested comments on Federal Acquisition Circular 84-31 and FAR Cases 87-37, 87-43 and 87-42.
'15 '14 '11

This Agency appreciates the opportunity to review the proposed and interim rules, but has no comment on any of the rules at this time.

Sincerely,

Evalyn W. Dexter

Evalyn W. Dexter
Chief,
Contract Division

RECEIVED DEC 24 1987

87-43-15

# NATIONAL LABOR RELATIONS BOARD

Washington, D.C. 20570

15 DEC 1987

Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Street, NW - Room 4041
Washington, DC 20405

Dear Ms. Willis:

We have reviewed the proposed revisions to the Federal Acquisition Regulations with respect to FAR Case 87-43, Mergers and Other Business Combinations, and FAR Case 87-42, Sources Sought Synopsis for Research and Development, and we have no substantive comments to offer.

Thank you for the opportunity to comment.

Sincerely,

Ernest Russell
Director of Administration

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DEC 23 1987

87-43-16

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DEC 16 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W.
Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

This is in response to your letter furnishing a copy of a proposed rule and a notice of intent to develop a proposed rule with request for comment as provided in the Federal Register and published as follows:

November 5, 1987, FAR Case 87-42, .4 Sources Sought Synopsis for Research and Development.

October 28, 1987, FAR Case 87-43, .16 Notice of intent to develop a proposed rule, Mergers and Other Business Combinations.

The Small Business Administration, Office of Procurement Assistance, interposes no objection at this time to the issuance of the proposed amendment to the FAR contained in FAR Case 87-42 as a final rule. Further, it has no comment with respect to the notice of intent to develop a proposed rule regarding mergers and other business combinations (FAR Case 87-43).

Sincerely,

Robert J Moffitt

Monika Edwards Harrison
Associate Administrator
for Procurement Assistance

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UNITED STATES
COMMISSION ON
CIVIL RIGHTS

1121 Vermont Avenue, N.W.
Washington, D.C. 20425

87-43-17

December 18, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, NW, Room 4041
Washington, D.C. 20405

Re: FAR Case 87-43

Dear Ms. Willis:

This responds to your request for comments on the notice of intent to develop a proposed rule noted above. The Commission has not administered a contract involving a merger or acquisition of the contractor; therefore, we have no comments to offer on this subject.

Thank you for providing us the opportunity to contribute to the development of this proposed rule.

Sincerely,

William H. Gillers

WILLIAM H. GILLERS
Solicitor

RECEIVED DEC 23 1987

# Vincent T. Noone

Management Consulting
Government Contract Costing
and Accounting

934 Pinecroft Road
Berwyn, PA 19312
(215) 647-7306

December 21, 1987

87-43-18

General Services Administration
FAR Secretariat (VRS)
18th and F Streets, N.W.
Room 4041
Washington, D. C. 20405

Subject: FAR Case 87-43

Gentlemen:

Thank you for this oportunity to comment on the subject FAR Case. I understand this Case has been established to examine whether the Government should recognize depreciation and cost of money resulting from asset writeups under the purchase method of accounting for a business combination, and whether existing regulations for this subject are adequate.

I believe the following general principle should apply concerning the allowability of the costs:

> Depreciation and cost of money should be allowable on contracts entered into after the effective date of the business combination, but should be unallowable on contracts entered into on or before the effective date of the business combination.

Before explaining my rationale for the above, or commenting on the adequacy of existing regulations, I feel it would be instructive to review the events involved in the Marquardt case, which brought this subject to the fore.

The first event was the sale of the Marquardt subsidiary by one parent (CCI) company to another parent (ISC) company. In effect, Marquardt remained a legal entity, but in the process one business combination (Marquardt and CCI) was displaced by a new and different business combination (Marquardt and ISC). I am emphasizing this point (a change in the business combination) because existing regulations covering the use of novation agreements do not address this situation adequately. This may be seen from the next event.

The next event was the decision not to require novation agreements for the contracts then being performed by Marquardt. This was based on the idea that Marquardt was the same legal entity before and after the change in parents, and that there was no need to novate the contracts. This was correct from a narrow legalistic viewpoint, but it indicates a weakness in the use of novation agreements under current regulations. Had the novation agreements been executed, the Marquardt appeal and subsequent litigation would probably have been avoided.



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87-43-18

Vincent T. Noone
FAR Case 87-43
December 21, 1987

Using the Marquardt case as an example, the point can be made that something significant occurs, when a new business combination is formed, that can affect and add to the costs of the subsidiary segment of the combination. Under Cost Accounting Standard 403 (Allocation of Home Office Expenses to Segments), the new parent is permitted to allocate costs from the parent company to the subsidiary. Examples of these costs are central accruals, central payments, staff management costs, and residual costs.

The Government should have some positive means to protect itself from increased costs on the subsidiary's contracts arising from such allocations. This protection should extend to the entire gamut of home office expenses, not just depreciation and costs of money.

One way this protection might be provided would be to require novation agreements for the contracts being performed by the subsidiary segment of a new business combination. If, in the Marquardt case, novations had transferred the contracts from Marquardt, a subsidiary of CCI, to Marquardt, a subsidiary of ISC, the increased costs flowing from the asset writeups would have been nonreimbursable under Paragraph (b) (7) of the agreements.

Skipping past the ACO's disallowance of the increased depreciation costs, and the Marquardt appeal, the next event was the Board of Contract Appeal's decision to deny the appeal. The Board's decision, in my opinion, was correct, even though the Board's explanation of the decision was strained and unconvincing. It included the statement: "As a result of the transaction, ISCE incurred the cost, not Marquardt, and if ISCE is to recover the purchase costs of acquiring Marquardt, it can only do so under its own Government and commercial contracts." This statement is unrealistic because any attempt by ISC to recover the purchase costs of Marquardt against its own contracts would violate the principle of cost allocability. The Government, for one, would reject such costs under ISC's own contracts for the simple reason that the depreciation of Marquardt's assets are not applicable nor allocable to ISC's own contracts.

Here the Board overlooked important facts - that ISC is a home office of Marquardt and that CAS 403 would come into play. Even if the depreciation of the stepped up assets were to be recorded on ISC's books, CAS 403 requires these costs to be allocated on a beneficial or causal relationship to Marquardt.

To support its decision, the Board also stated: "Marquardt remains a separate legal entity, obligated to perform its contracts, and these costs cannot be burdened with costs incurred by a third party." The first part of the statement (legal entity obligated to perform) is true, but the second part (cannot be burdened with costs incurred by a third party) is patently incorrect. The Cost Accounting Standards in several places recognize burdening by a third party. One example is CAS 403 whereby central accruals, central payments, staff management costs, and residual costs of a home office (third party) are charged to segments for burdening to their contracts. Another example is CAS 420 (Accounting for IR&D and B&P Costs) where it is recognized that IR&D costs incurred by

87-43-18



the home office (a third party) may be transferred to a benefitting segment for burdening to its contracts. In like manner, Cas 404 (Capitalization of Tangible Assets) can be construed to set the stage for transferring the depreciation costs of stepped up assets from the third party parent corporation to the acquired subsidiary, in compliance with the allocation procedures set forth in CAS 403.

Contrary to what the Board said in its original decision, it is evident that depreciation on the stepped up asset values was and is allocable to the Marquardt segment. However, allocability is but one of several factors bearing on allowability. The next two events established the unallowability of the increased depreciation costs, at least for the contracts then under performance by Marquardt as of the date of the Marquardt/ISC business combination.

The next event was the Board's rejection of Marquardt's request for reconsideration. Here the Board acknowledged some errors in its earlier opinion, but decided that Marquardt had not satisfied the requirement of "cost incurrence" - that Marquardt had incurred no cost with respect to performance of its Government contracts as the result of the purchase of its stock by ISC.

The final event was the decision of the U. S. Court of Appeals rejecting Marquardt's attempt to recover the increased costs, holding that the Board correctly disallowed the writeup of the assets for the purpose of charging depreciation thereon to the Government as part of overhead.

The Marquardt case serves to establish the principle that a parent corporation may not burden the existing contracts of its subsidiary with the increased cost of depreciation (and by extension - cost of money) arising from the use of the purchase method of accounting for a business combination. In my opinion, equity demands that the contracts should continue to be performed without any obligation on the Government's part to pay for increased costs simply because some other company decides to acquire the contractor. The Government has the right to expect performance and completion of the contracts in accordance with the bargains reached originally with the contractor.

Conversely, the Government cannot expect that this compact continues and applies to negotiations of new contracts following the formation of the new business combination. For proposals and negotiations after this happening, wholly new circumstances apply. Typically, these are:

1) The parent company has paid out good money for the acquisition of the subsidiary.

2) The purchase method of accounting recognizes that part or all of the investment pertains to physical things, whose current values are to be determined and used for financial accounting purposes.

3) The new asset values are recognized for Federal income tax purposes.

4) Depreciation, based on the new asset values, is recognized both for financial accounting and Federal income tax purposes.

5) The new asset values, less depreciation, represent a fair measure of facilities capital employed by the contractor.

6) The DOD profit policy is based largely on facilities capital employed, and the profit policies of other agencies give consideration to facility investments.

7) The new business combination will be expecting to realize a fair return on its investment.

For new contracts, negotiations cannot be structured around old and no longer applicable cost data. Accordingly, depreciation and cost of money should be calculated and allowed on the basis of the revised values of the assets. It should be recognized that the revised asset values are not necessarily increased under the purchase method of accounting. Instances may occur where the revised asset values are lower than the asset values previously on record. Whether higher, lower, or the same as before, the asset values established under the purchase method should form the basis for depreciation and cost of money used in negotiation of contract prices and determinations of allowable costs on contracts entered into after the date of the new business combination.

Turning to the subject of the adequacy of current Government regulations, I have the following suggestions and comments:

a. Consideration should be given to revising FAR Subpart 42.12 to require contractors, that are acquired and take on a subsidiary relationship within a business combination, to seek novation agreements in order to recognize the business combination as the successor in interest. Such novation agreements would protect the Government contracts from any increased costs (not just depreciation and cost of money) that may be allocated to the performing subsidiary by the home office.

b. Ordinarily, one should expect that the regular Cost Accounting Standard clauses (FAR 52.230-3 and 52.230-5) would prevent additional costs to be paid by the Government due to changes to cost accounting practices which increase depreciation and cost of money allocations to contracts. However, it can also be argued that such increases flow from changes in asset values required by CAS 404.50 (d) when the purchase method of accounting applies to a business combination. CAS 404 is the impediment, and consideration should be given to eliminating it entirely. CAS 404 is a financial accounting standard, not a true cost accounting standard. Its issuance by the CAS Board was probably an ultra vires act on their part. The subject of capitalization of tangible assets should be left to the Financial Accounting Standards Board of the AICPA.

87-43-18



c. Probably the most efficacious thing that could be done to improve Government regulations covering this subject would be to include a provision in FAR 31.205-27 (Organization Costs) and/or in FAR 31.205-11 (Depreciation) and FAR 31.205-10 (Cost of Money) to the effect that depreciation and cost of money, flowing from revised asset values under the purchase method of accounting, are allowable, except that any increases in these costs are not allowable for contracts entered into on or before the effective date of the business combination.

I hope the above comments will be helpful in your considerations of the subject under FAR Case 87-43.

Sincerely,

Vincent T. Noone

Vincent T. Noone

47-43-19


American Institute of Certified Public Accountants

1455 Pennsylvania Avenue, N.W., Washington, DC 20004-1007, Telephone (202) 737-6600


December 21, 1987

General Services Administration
Margaret Willis, FAR Secretariat (VRS)
18th & F Street, N.W.
Room 4041
Washington, DC 20405

**RE: FAR Case 87-43**

Dear Ms. Willis:

The American Institute of Certified Public Accountants (AICPA) is the national professional organization which represents approximately 250,000 CPAs in public practice, industry, government and education.

The AICPA's Defense Contractors Committee (the Committee) has recently reviewed the notice of intent to develop a proposed rule regarding "Mergers and Other Business Combinations" (FAR Case 87-43). Because of the complexity and importance of the issues involved in the proposed rule, the Committee believes that a discussion of the issues with the Defense Acquisition Regulatory (DAR) Council Subcommittee will be more beneficial to the government than submitting a comment letter at this time. Accordingly, the Committee requests a meeting with the DAR Council Subcommittee to dicuss this matter.

Please contact me at Arthur Andersen & Co., 1666 K Street, N.W., Washington, D.C. 20006, (202) 862-6726 or Bob Moran, at the AICPA's Washington office to arrange a mutually convenient date.

Sincerely,

William T. Keevan

William T. Keevan
Chairman
AICPA Defense Contractors Committee

Bob Lynch - Actg Chmn. of CAS Policy Gp. was notified of this Ltr. on 12/28/87. fl

cc: Defense Contractors Committee

WTK:aks

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87-43-20

AMERICAN DEFENSE PREPAREDNESS ASSOCIATION

DEDICATED TO PEACE WITH SECURITY THROUGH DEFENSE PREPAREDNESS

ROSSLYN CENTER, SUITE 900, 1700 NORTH MOORE STREET ARLINGTON, VIRGINIA 22209
703-522-1820

December 18, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
Room 4041, 18th & F Streets, NW
Washington, DC 20405

Dear Ms. Willis:

This is in response to your request for comments on proposed rules concerning simplification of contract forms (Case 87-37) and clarification of requirements for synopses of research and development solicitations (Case 87-42)-15; and notice of intent to develop a proposed rule concerning increased contract costs after sale and merger of Government contractors (Case 87-43)-20

Attached are brief comments concerning the three cases. We appreciate the opportunity to review and comment on the proposed rules. Please send us a copy of the draft rule resulting from Case 87-43 when it is ready for further review.

Sincerely,

William E. Eicher

William E. Eicher
Major General, US Army (Ret.)
Vice President and Director
Advisory Service

WEE:meh

DEC 30 1987

87-43-20

COMMENTS OF AMERICAN DEFENSE PREPAREDNESS ASSOCIATION

Case 87-37

The purpose of the changes proposed in this case is to include as an authorized form of solicitation and contract a new "simplified" contract format in place of the current "uniform" contract format. We have reviewed the FAR changes needed to accomplish the stated purpose and find them to be appropriate. In using the "simplified" format a(SF 14XX), contracting officers should find the preparation and organization of the new format to be an easier task to accomplish.

Likewise, the submission by offerors of annual representations and certifications instead of repetitive individual representations and certifications should simplify and expedite their preparation of bids and proposals and contracting officers' preparation of contract awards.

Case 87-42

FAR 5.205(a) is proposed to be revised to change from mandatory to discretionary the publication of Commerce Business Daily advance notices of the interest of contracting officers "in potential R&D programs whenever existing solicitation mailing lists do not include a sufficient number of concerns to obtain adequate competition". While the change is more than merely "clarification", we agree that the change is desirable in that it authorizes publication of CBD notices when necessary to fill out R&D solicitation mailing lists.

Case 87-43

The problem in this case is whether the Government should be at risk for increased cost where ownership of a Government contractor is changed during the life of a contract. It seems to us that, where a segment of a business unit is performing an existing Government contract, there should be no change in the contractor's cost or price merely as a result of a change in ownership of the contractor. If any change in costs results from a change in ownership, the increased cost should be absorbed by the contractor and should not be charged to the Government. The financial position of the contractor as to cost and profit should not be changed because of a change in ownership. The contractor's position should be no different than it would be if only its name were changed by "novation", without changing cost or price.

The Cost Accounting Standards published in Federal Acquisition Circular 87-30 include a provision to the effect that an unallowable cost remains unallowable as a Government cost notwithstanding the sale of the Government contractor to another entity, the "purchase method," even though the unallowable cost is absorbed by the contractor. This is an indication to us that the position we have expressed is sound.

87-43-21

PANAMA CANAL COMMISSION
2000 L STREET, NW.
SUITE 550
WASHINGTON, DC 20036

OFFICE OF
THE SECRETARY

December 28, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W., Room 4041
Washington, D. C. 20405

Dear Ms. Willis:

This is in response to your request of November 19 for comments on a proposed rule and a notice of intent to develop a proposed rule that revises the Federal Acquisition Regulation (FAR) with respect to FAR Case 87-37-19 and FAR Case 87-43-21.

We have reviewed both proposals and offer no comments.

Sincerely,

Barbara A. Fuller

Barbara A. Fuller
Assistant to the Secretary
for Commission Affairs

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DEC 31 1987

PSMA
PROFESSIONAL SERVICES MANAGEMENT ASSOCIATION
1213 Prince Street Alexandria, Virginia 22314
703/684-3993

87-43-22

December 23, 1987

FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Washington, D.C. 20405

Gentlemen:

Reference is made to your letter of November 19, 1987, concerning your notice of intent to develop a proposed rule on Mergers and Other Business Combinations, FAR Case 87-43.

Our comments on the subject of July 9, 1987, related to FAR Case 87-19, are enclosed.

Very truly yours,

PROFESSIONAL SERVICES MANAGEMENT ASSOCIATION

By E. P. James PJA
Edwin P. James

dja

Reply to: c/o Arthur Andersen & Co.
33 West Monroe Street
Chicago, Illinois 60603

RECEIVED
DEC 31 1987

Ed James

PSMA

**PROFESSIONAL SERVICES MANAGEMENT ASSOCIATION**

1213 Prince Street Alexandria, Virginia 22314

703/684-3993

87-43-22

July 9, 1987

FAR Secretariat (VRS)
General Services Administration
18th and F Streets, Northwest
Room 4041
Washington, D.C. 20405

Gentlemen:

Reference is made to your May 29, 1987, letter concerning proposed revisions to the FAR on two subjects. Our comments are as follows:

1. <u>FAR CASE 87-18--TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITY COSTS, FAR 31.205-43</u>

   This Association commends you on proposing a revision which is not detrimental to industry and clarifies the kinds of costs that are allowable. It is a welcome relief from your many recent revisions beamed at cutting the Defense Department budget at the unfair expense of industry.

2. <u>FAR CASE 87-19--EXTRAORDINARY COMPENSATION AND CERTAIN ORGANIZATION COSTS IN CONNECTION WITH MERGERS AND OTHER BUSINESS COMBINATIONS, FAR 31.205-6 AND 31.205-27</u>

   These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.

In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions

87-43-22

put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary cost of doing business in today's business merger atmosphere (condoned by Congress).

Very truly yours,

PROFESSIONAL SERVICES
MANAGEMENT ASSOCIATION

By Edwin P. James/gs
Edwin P. James, Consultant
Arthur Andersen & Co.

JJB

Blind copy to: Mr. Lowell V. Getz, Certified Public Accountant
Mr. Daniel R. Shevchik, Malcolm Pirnie, Inc.
Mr. Thomas M. Swoyer, Roy F. Weston, Inc.
Mr. Herbert A. Hoyles, Hoyles Associates, Inc.
Mr. Kerry Harding, PSMA

Gary E. Holdren, Chicago
GCC-002

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

NOV 19 1987

Received 11/30/87

Enclosed is a copy of a notice of intent to develop a proposed rule and a copy of two proposed rules. All three proposals request comment to revise the Federal Acquisition Regulation (FAR) as provided to and published by the Federal Register as follows:

a. FAR Case 87-37, Contract Simplification Program, comments due December 7, 1987.

b. FAR Case 87-43, Mergers and Other Business Combinations, comments due December 28, 1987.

c. FAR Case 87-42, Sources Sought Synopsis for Research and Development, comments due January 4, 1987.

Please cite the appropriate FAR Case(s) and send your comments to the FAR Secretariat (VRS), General Services Administration, 18th & F Sts., NW, Room 4041, Washington, DC 20405.

Sincerely,

Margaret A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

1-8

Office of the
Administrator
of Veterans Affairs

Washington DC 20420

87-43-23

**Veterans Administration**

DEC 30 1987

In Reply Refer To:

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, NW., Room 4041
Washington, DC 20405

Dear Ms. Willis:

-23 -23

I appreciate the opportunity to comment on FAR Cases 87-43 and 87-37. The Veterans Administration takes no objection to the proposed rules to amend the FAR.

We do, however, offer the following additional comments concerning FAR Case 87-37, Contract Simplification:

a. 14-201-9(e)(4) - In large part, this material restates proposed FAR subpart 14.201-1(c). Eliminate the redundancy. While proposed FAR subpart 14.201-9 as a whole strives to simplify the solicitation structure, it appears that it has only eliminated the valuable indexing aid offered on the SF 33. All of the content elements of the Uniform Contract Format (UCF) appear here, except that they are not identified as individual sections. Subpart 14.201-9(c) requires a Contracting Officer to "include the clauses required by law or by this regulation," and to incorporate additional clauses when necessary to the acquisition. The proposed FAR revision, therefore, does not appear to offer regulatory relief, but instead seems to provide cosmetic rather than substantive changes.

b. 14.213(b) - The VA is not highly centralized at this time. The requirement for "centrally requesting, receiving, storing, verifying, and updating offeror's annual submissions" may be difficult to implement given our limited access to ADP data bases. Thus, the annual certifications would initially be of limited value to VA Contracting Officers.

c. 15.406-1(b) - Revise the proposed wording. The intent of the simplified contract form is to eliminate use of the UCF. Therefore, paragraph (b) should not state "or SF 14XX, incorporates Section K by reference in the resultant contract." SF 14XX does not contain a section K.

d. 15.406-2(a)(1) - Same comments as above, SF 14XX does not have a section A.

e. 15.406-2(a)(3) - The grammar is incorrect. The Contracting Officer shall select a single SF 33, SF 18, or SF 14XX. The statement should correctly read, "When neither the SF 33, SF 18, nor SF 14XX is used...."

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f. 14.213, 15.407, and 15.416 - Recommend stating guidance concerning annual representations and certifications will be outlined in the implementing agency procedures. Otherwise, wording such as the Contracting Officer "may use the simplified contract format" or "shall insert" the FAR provision "if annual representations and certifications are utilized," does not offer clear guidance.

g. 52.214-20 and 52.215.35 - Delete the reference to paragraph (a) since there is no paragraph (b) in the provisions.

h. 53.215-1(g) - Is the reference to 15.414(a) correct? It appears it was intended to reference 15.414(c).

We also have the following comments on the proposed SF 14XX:

a. Review the format - It is awkwardly designed; for example, there is no reason for the contract number and award date to appear as blocks 2 and 3 when the actual award action is oriented toward blocks 23-28. Suggest that blocks 12 and 14 be moved toward the bottom of the page. There is no block identified for due date for receipt of offers. Block 9 does not reflect an identifying heading as to the nature of the information to be reflected there. Block 10 restates block 18. Block 12 does not require the amount of space allocated. Block 13, contractor offeror, would more suitably appear with block 27 and its unnumbered, related block, "Name and Title of Signer." It is not clear why the last four blocks on the page were not numbered. Block 22 may not offer sufficient space for large dollar amounts. Suggest adding a reference to block 8 to the page on which the set-aside notices may be located. Also, review the terminology, "combined small business & labor surplus area concerns?" Why "combined" and not the standard "joint" reference? What happened to FOB point or delivery requirements?

b. Block 11 - Would allow the offeror to insert a time period other than the identified in Block 9 within which the Government can accept its offer. As noted in the parenthetical, this time period will be "60 calendar days unless offeror inserts a different period...." With regard to similar provisions found on current standard forms, if an offeror should insert a time period less than the 60 days ordinarily contemplated by the Government for acceptance of offers (which is possible, based on the wording of this provision), its bid would be declared nonresponsive (see General Elevator Co., Inc., B-226976, April 7, 1987, 87-1 CPD, paragraph 385). Therefore, we recommend that this issue be raised with the Civilian Agency Acquisition Council in an effort to avoid the confusion, and nonresponsive offers, that ensue as a result of improperly completing this block.

87-43-23



c. "No Response for Reasons Checked" - It is not clear whether this is the reverse of SF 14XX or if this is a separate document to be returned if the offeror elects not to submit pricing. If this is a separate document, add the solicitation number somewhere.

Sincerely,

A. Beeton

FOR: SUSAN LIVINGSTONE
Associate Deputy Administrator
for Logistics

87-43-24

1-7

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

Audit Policy
and Oversight

DEC 29 1987

MEMORANDUM FOR FEDERAL ACQUISITION REGULATORY SECRETARIAT, GENERAL SERVICES ADMINISTRATION

SUBJECT: Federal Acquisition Regulation Case No. 87-43, Mergers and Other Business Combinations

This memorandum is in response to your request for comments related to the allowability of costs incident to mergers and other business combinations.

Below is a summary of our recommendations. The enclosure to this memorandum provides the rationale upon which our recommendations are based. The sections to the enclosure are listed after each summary.

1. The Government should not recognize on its contracts any increased depreciation or cost of money costs which result from the write-up of asset values subsequent to a business merger/acquisition. (Section 1)

2. Any Federal Acquisition Regulation (FAR) changes with respect to the allowability of business combination costs should include the requirement to adhere to FAR Subpart 42.12, Novation and Change-of-Name Agreements. (Section 2)

3. Any increased costs resulting from a business acquisition involving the purchase or exchange of stock should be explicitly disallowed. (Section 3)

4. Since Cost Accounting Standards (CAS) take precedence over FAR with regard to cost allocability, we recommend that any stepped up values only be recognized when the Government has shared in the seller's gain. (Section 4)

5. Any regulatory changes should incorporate specific criteria which must be met by contractors to ensure that a change in the "new" contractor's identity does in fact occur. (Section 5)

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6. Specific criteria should be included in the procurement regulations to address both the requirements for independent appraisals of assets and the treatment and definition of long-term contracts as an intangible asset. (Section 6)

7. Changes to FAR should include comprehensive definitions of all terms relating to mergers/acquisitions. (Section 7)

We appreciate the opportunity to comment on this proposed revision. Should you have any questions regarding our comments, please contact Mr. Charles L. Cipolla, Deputy Assistant Inspector General for Audit Policy and Oversight, on 693-0002.

James H. Curry
Assistant Inspector General
for Audit Policy and Oversight

Enclosure

87-43-24

Federal Acquisition Regulation Case No. 87-43,
Mergers and Other Business Combinations

The central question to be addressed is whether or not there are any circumstances under which the Government should recognize increased contract costs flowing from the write-up of asset values as the result of a business merger or acquisition. In recent appeals cases (Marquardt ASBCA 29888 and Marquardt Co. v. U.S., CA FC No. 86-1546), the decisions which have been rendered strongly indicate the need for additional government regulatory action regarding business combinations. Among these indications are:

- o The apparent lack of direct benefit to government contracts in accordance with FAR 31.201-4 (DAR 15-201.4).

- o The necessity for generally accepted accounting principles (GAAP) to be consistent with government procurement rules and regulations.

- o The determination that full acquisition cost treatment in accordance with Internal Revenue Service (IRS) Section 338(a)(1) and Securities and Exchange Commission requirements is <u>not</u> binding on the Department of Defense.

- o The need for emphasizing prudence on the part of contractors in their dealings with the Government and the public at large.

- o The conclusion that acquiring entities cannot accomplish through a stock purchase what could not be accomplished through a purchase of assets.

Specifically, we believe that any Federal Acquisition Regulation (FAR) changes which affect the allowability of costs arising from mergers and other business combinations should address the following topics:

1. <u>Recognition of Gain by Sellers</u>. Although FAR 31.205-16 does not specifically mention business mergers and acquisitions, we think that a case can be made for identifying the excess of the selling price received over the stated net book values as a gain to the sellers in which the Government should share. The FAR 31.205-16(e) states that gains from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis. However, we are aware that under current conditions, once the merger/acquisition has taken place, the sellers or stockholders no longer form an identifiable entity to which gains can be assigned for purposes of crediting the Government. Therefore,

Enclosure

87-43-24



it may be appropriate for the regulations to require the sellers in a business merger/acquisition be assigned proportionate shares of the transaction's total gain in order to enable the Government to partake of the gain as it would under the disposition of individual assets. Perhaps, the sellers could be required to make a cash payment to the Government for the Government's allocable share of any gain. It may also be desirable to achieve some measure of consistency with the IRS tax treatment accorded to the sellers with respect to gains.

2. Novation Agreements. Although FAR Subpart 42.12 clearly sets forth the responsibilities and requirements for executing novation agreements, we have observed in at least three recent business acquisitions that novation agreements were not executed. As a result, increased depreciation costs based on stepped-up asset values were charged to government contracts in force at the time of the acquisitions. In two of these cases, the contractors' attorneys argued that novations were unnecessary since the "new" contractors (post-acquisition) continued to perform as contractually required. Consequently, in accord with the established legal principle, "operation of law," obligations under existing government contracts were automatically assumed by the "new" contractor. The contractors further claimed that since novations had not been executed, increased depreciation costs based on stepped-up asset values were permitted on government contracts in force prior to the acquisition. However, had the Government insisted on executing the proper novation agreements, increased costs could have been avoided. Therefore, we recommend that any FAR changes with respect to the allowability of business combination costs include the requirement to adhere to FAR Subpart 42.12. It may be most appropriate to insert this requirement in the appropriate subpart of FAR Part 15.

3. Purchase of Assets Versus Purchase of Stock. The primary rationale employed by contractors to step up asset values subsequent to a business merger/acquisition is that such a measure is required by Accounting Principles Board Opinion No. 16 under the "purchase method" of accounting. In several recent acquisitions, the medium of exchange has been stock. This is especially prevalent with regard to leveraged buy-outs. In the Marquardt case ASBCA 29888, the Board ruled that the purchase method of accounting was inappropriate since only stock had been exchanged and that the acquired company (Marquardt) had not in fact changed its identity. The U.S. Court of Appeals (CA FC No. 86-1546) upheld the ASBCA's decision and specifically concluded that a company acquired in a pure stock transaction cannot increase the value of its assets under the purchase method for government contracts. The

87-43-24



Court of Appeals added that any reliance upon generally accepted accounting principles must be consistent with applicable procurement regulations. We recommend that any increased costs resulting from a business acquisition involving the purchase or exchange of stock be explicitly disallowed.

4. Cost Accounting Standards. Cost Accounting Standards (CAS) 404.50(d) states that under the purchase method of accounting for business combinations, tangible capital assets shall be assigned a portion of the cost of the acquired business, not to exceed their fair values as of the date of acquisition. We see a potential problem in disallowing all increased costs as a result of asset reevaluation since CAS recognizes the purchase method of accounting for purposes of allocating costs. A contractor might argue that if it properly used the purchase method of accounting in conjunction with an acquisition, CAS would then permit the write-up of its assets. As a result, it would be entitled to pass along increased depreciation and cost of money costs on its government contracts. As long as the selling company shares the gain with the Government, based on the Government's prior participation in previously allocated depreciation expense, the write up of assets for depreciation and cost of money would be acceptable. See our comments on Recognition of Gain by Seller.

5. Nature of a Contractor's Identity After a Business Combination. In the Marquardt ASBCA Case 29888, the Board ruled that Marquardt, the acquired company, had not, in fact, changed its identity vis a vis the Government as a result of its purchase. The Board stated that Marquardt had (i) continued to perform on its contracts with the Government, (ii) not novated any of its existing contracts, (iii) not changed its officers, and (iv) remained, in essence, independent and autonomous with respect to its new owner. We recommend that any regulatory changes incorporate specific criteria which must be met by contractors to ensure that such a change in identity does actually take place.

6. Independent Appraisals of Fair Value. In certain recent mergers/acquisitions, there has been disagreement concerning the extent, accuracy, and objectivity of independent appraisals of purchased assets. In one instance, the Govenment employed its own appraiser to determine fair asset values, and the resulting appraisal differed significantly from the two appraisals which had been obtained by the contractor in question. There was also a dispute concerning the contractor's attempt, based on one of its appraisals, to write up existing long-term government contracts as intangible assets to be amortized. From the Government's point of view, this action appeared to be tantamount to recognizing the recovery of goodwill which is prohibited by FAR 31.205-49. We recommend

87-43-24



that specific criteria be included in the procurement regulations to address both the requirements for appraisals and the treatment and definition of long-term contracts as an intangible asset.

7. Definition of Terms. We recommend that any contemplated FAR changes regarding the allowability of stepped-up asset evaluations include definitions of appropriate terms, such as mergers, acquisitions, leveraged buy-outs, the purchase method of accounting, and pooling of interests.

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ELECTRONICS & SPACE DIVISION
EMERSON ELECTRIC CO

December 28, 1987

General Services Administration
Ms. Margaret A. Willis
FAR Secretariat (VRS)
18th & F Street NW
Room 4941
Washington, D.C. 20405

Subject: FAR Case 87-43

Dear Ms. Willis:

We appreciate the opportunity to provide comments on the Civilian Agency Acquisition and Defense Acquisition Regulatory Councils' intent to develop a proposed rule addressing the allowability of costs incident to mergers and other business combinations. Specifically, we would like to address the subject of whether costs associated with an asset write-up under the purchase method of accounting should be treated as allowable. It is our opinion that such costs should be allowed.

As an initial point, generally accepted accounting principles (Accounting Principles Board (APB) Opinion No. 16, Accounting for Business Combinations) require that the step-up of assets be included in the depreciable cost base. Moreover, it is apparent that the authors of Cost Accounting Standard (CAS) 404, Capitalization of Tangible Assets, clearly intended for the costs associated with a step-up in the value of assets as the result of a business combination accounted for under the purchase method (whether an asset acquisition or a stock acquisition) to be allocable to Government contracts entered into after a business combination occurs.

We recognize that one of the most difficult concepts regarding the cost allowability of an asset write-up hinges upon the fairness of charging the Government a higher cost on a "post-acquisition" basis for the same assets which had been used in contract performance at a lower cost on a "preacquisition" basis.

It is, however, proper and "fair" to allow the costs associated with a step-up of assets in an asset acquisition transaction for the following reasons:

EMERSON ELECTRIC CO.,
8100 W. FLORISSANT
ST. LOUIS, MISSOURI 63136
Mailing Station 3131
Telephone: (314) 553-3131
SD 1880

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87-43-25

- To do otherwise would be patently inequitable to the seller. In other words, to disallow the write-up would be to destroy the value of the property.

- In disallowing a step-up, the Government is implying it has some sort of property interest in the assets of a contractor. This, however, is not the case. The Government, in paying a cost for depreciation, does not thereby purchase a contractor's assets. Rather, the Government is purchasing a contractor's products. The Government is tasked with purchasing these products at a fair and reasonable price. In negotiated procurements, a fair and reasonable price is determined on the basis of a contractor's product cost, and the depreciation associated with the fair value of the underlying assets acquired is clearly an actual and reasonable product cost to be considered in contract pricing.

Moreover, it is proper and "fair" to allow the costs associated with a step-up in the value of underlying assets represented by a stock acquisition for the following additional reasons:

- Although the acquired contractor may legally be a separate entity, the substance of the transaction, and not the legal form of the transaction, dictates. In substance, the contracting entity is not an independent entity, but rather is clearly controlled by another company. (The concept of "substance over form" is, in fact, used by the Government in many areas of government contract accounting. For instance, at FAR Subpart 30.2, the Government imposes the CAS Disclosure Statement requirements to a company and its segments. Similary, at FAR 31.205-26(e), the Government treats companies under common control as one entity in imposing restrictions on material transfers.)

- Since a change in ownership has indeed occurred, the Government is, in substance, contracting with a new entity. The new owners have an altogether different basis in the value of the underlying assets acquired and are operating at a different level of cost than the previous owners. Accordingly, it is appropriate for the new owners to recover their cost base.

- In accounting for a business combination under the purchase method of accounting, APB No. 16 and CAS 404 make no functional distinctions between an acquiring company vs. an acquired company, or a stock acquisition vs. and asset acquisition. From an accounting standpoint, although the legal form of the transaction may be structured to acquire the stock of the company, the economic substance of the transaction is to acquire the underlying assets of the company.

- The underlying assets acquired are clearly used in contract performance, and accordingly, the costs associated with these assets plainly benefit the Government.

87-13-25

In closing, we believe costs associated with the step-up of assets, whether an asset acquisition or a stock acquisition, be allowed on contract actions entered into on or after the effective acquisition date.

Sincerely,

James T. Myrick

James T. Myrick
Director, Financial Controls

JTM/KMM/ck

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

54-15
9/25/87
EXEC. SEC.

SEP 11 1987

Mr. Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council
ASD(P&L)DASD(P)DARS
c/o 3D139, The Pentagon
Washington, DC 20301-3062

Dear Mr. Holaday:

An additional comment received concerning the subject FAR Case is forwarded for your appropriate action:

FAR Case: 87-19, (Golden Parachutes & Golden Handcuffs) Extraordinary compensation and certain organization costs in connection with mergers and other business combinations.

Federal Register Notice: 52 FR 18158, May 13, 1987

Letter to Industry: May 29, 1987

Sincerely,

M. A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

cc: Chairman, Civilian Agency Acquisition Council
ATTN: Frank Van Lierde, Contract Cost, Price & Finance

FAR Case 87-19 Comments                                                    Due: 7/13/87

Subject: Golden Parachutes and Golden Handcuffs

To: DARC

Date: 9/10/87

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-19-21 | 8/17/87 | 8/6/87 | U.S. General Accounting Office | 87-18-22 |

GAO United States
General Accounting Office
Washington, D.C. 20548

Office of the General Counsel

87-19-21

B-224782.5

August 6, 1987

Ms. Margaret A. Willis
FAR Secretariat
General Services Administration

Dear Ms. Willis:

This responds to your letter of May 29, 1987, requesting our comments on two proposed changes to the contract cost principles contained in Federal Acquisition Regulation (FAR) § 31.205. These are FAR case Nos. 87-18 and 87-19.

85-25

FAR case No. 87-18 is a proposal to revise paragraph (c) of FAR § 31.205-43 to clarify the circumstances under which costs incurred in connection with meetings, conferences, seminars, and the like are allowable. Our only comment is that the revised cost principle could be improved if it were to contain examples of the classes of individuals, such as speakers or technical experts, that the term "noncontractor personnel" is intended to encompass.

84-18

FAR case No. 87-19 is a proposal to amend FAR § 31.205-6 by adding paragraph (l) to provide coverage on special compensation paid to a contractor's employees in connection with changes in management or control of the contractor or its assets. Costs incurred pursuant to such compensation agreements, known as "golden parachutes" or "golden handcuffs," would be unallowable. Also proposed is a revision of paragraph (a) of FAR § 31.205-27 that would state that costs incurred in resisting a corporate takeover are unallowable. We have no objection to these proposed changes.

Sincerely yours,

for Seymour Efros
Harry R. Van Cleve
General Counsel

RECEIVED

AUG 17 1987

87-43-12

PENNSYLVANIA AVENUE DEVELOPMENT CORPORATION

Suite 1220 North
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1703
202/724-9091

Henry A. Berliner, Jr.
*Chairman*

M. J. Brodie
*Executive Director*

December 15, 1987

FAR Secretariat (VRS)
Attn: Margaret A. Willis
General Services Administration
18th & F Streets, NW
Room 4041
Washington, DC 20405

13 09 12

Re: FAR Cases 87-37, 42, 43

Dear Ms. Willis:

The Pennsylvania Avenue Development Corporation substantially supports the proposed rules cited above. We consider Case 87-37 an appropriate way to save time and money in the preparation of solicitations. Case 87-42 is another appropriate way to reduce unnecessary regulation of preliminary contractual matters. Case 87-43 is another money-saving measure in which we concur.

Sincerely,

M J Brodie

M.J. Brodie
Executive Director

MJB:TJN:ky

87-43-13

UNITED STATES OF AMERICA
RAILROAD RETIREMENT BOARD
844 RUSH STREET
CHICAGO, ILLINOIS 60611

BUREAU OF SUPPLY AND SERVICE

December 16, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
Room 4041
18th and F Streets, NW
Washington, DC 20405

Reference: Far Cases 87-37-14, 87-42-10, and 87-43-13

Dear Ms. Willis:

As requested in your memorandum dated November 19, 1987, we have reviewed the referenced FAR Case proposals. We have no comment to make at this time.

Very truly yours,

Henry M. Valiulis
Director of Supply and Service

CASE MANAGEMENT RECORD

ORIGINAL
UPDATED X

| | | | | | |
|---|---|---|---|---|---|
| CASE NUMBER: | DAR: 84-18A | CAAC: | FAR: | | |
| TITLE: Golden Parachute | | | | | |
| REFERENCE: FAR Sec Ltr of | | ORIGINATION DATE: | | | |
| SYNOPSIS: FAR Sec forwards Pub Comments | | | | | |
| PRIORITY: | ORIGINATOR CODE: | | | | |
| KEYWORDS | | | | | |
| CASE REFERENCES | | | | | |
| FAR CITES | | | | | |
| DFARS CITES | | | | | |
| CASE MANAGER: | SUBCOUNCIL ASSIGNMENT: | | | | |
| COGNIZANT COMMITTEES | CCP | | | | |
| RECOMMENDED ACTION: Task to CCP. | | | | | |
| BOX RECORD 1) | 2) | 3) | 4) | 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: | PAPERWORK REDUCTION: | | | | |
| PROPOSED RULE: | INTERIM RULE: | FINAL RULE: | | | |

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

AUG -4 1987

Mr. Duncan A. Holaday
Director, Defense Acquisition
Regulatory Council
ASD(P&L)DASD(P)DARS
c/o 3D139, The Pentagon
Washington, DC 20301-3062

Dear Mr. Holaday:

Comments received concerning the subject FAR Case are forwarded for your appropriate action:

FAR Case: 87-18, Trade, business, technical and professional activity costs

Federal Register Notice: 52 FR 18158, May 13, 1987

Letter to Industry: May 29, 1987

Sincerely,

Margaret A. Willis

MARGARET A. WILLIS
FAR Secretariat

Enclosures

cc: Chairman, Civilian Agency Acquisition Council
ATTN: Frank Van Lierde, Contract Cost, Price & Finance

FAR Case 87-18 Comments Due: 7/13/87

Subject: Trade, business, technical and professional activity costs

To: DARC

Date: 7/31/87

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-18-01 | 6/16/87 | 6/9/87 | Federal Communications Commission | 85-63-04<br>87-12-03<br>87-19-01 |
| 87-18-02 | 6/22/87 | 6/10/87 | U.S.A. Railroad Retirement Board | 87-19-02 |
| 87-18-03 | 6/29/87 | 6/23/87 | U.S. Small Business Administration | 87-19-03 |
| 87-18-04 | 6/29/87 | 6/23/87 | American Defense Preparedness Association | 87-19-04 |
| 87-18-05 | 6/25/87 | 6/17/87 | National Labor Relations Board | 87-19-05 |
| 87-18-06 | 6/25/87 | 6/17/87 | Agency for International Development | 87-19-06 |
| 87-18-07 | 7/7/87 | 6/29/87 | Panama Canal Commission | 85-63-16<br>85-12-23<br>87-19-08 |
| 87-18-08 | 7/6/87 | 6/26/87 | National Endowment for the Humanities | 85-63-17<br>87-12-24<br>87-19-09 |
| 87-18-09 | 7/6/87 | 6/30/87 | U.S. Department of Housing and Urban Development | |
| 87-18-10 | 7/10/87 | 7/8/87 | U.S. Department of Justice | 87-19-10 |
| 87-18-11 | 7/10/87 | 7/9/97 | Office of GSA Acquisition Policy and Regulations (GSA) | 87-19-11 |
| 87-18-12 | 7/13/87 | 7/1/87 | United States Information Agency | 87-19-13 |
| 87-18-13 | 7/13/87 | 7/6/87 | Department of Defense, Inspector General | |
| 87-18-14 | 7/17/87 | 7/9/87 | Department of Transportation (State of Georgia) | |

FAR Case 87-18 Comments Due: 7/13/87

Subject: Trade, business, technical and professional activity costs

To: DARC

Date: 7/31/87

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-18-15 | 7/17/87 | 7/9/87 | Aerospace Industries Association of America, Inc. | |
| 87-18-16 | 7/22/87 | 7/15/87 | Office of Federal Procurement Policy | |
| 87-18-17 | 7/17/87 | 7/9/87 | Professional Services Management Association | 87-19-15 |
| 87-18-18 | 7/17/87 | 7/10/87 | Pennsylvania Avenue Development Corporation | 87-19-16 |
| 87-18-19 | 7/17/87 | 7/1/87 | United States Department of Agriculture | 87-19-17 |
| 87-18-20 | 7/22/87 | 7/10/87 | Veterans Administration | 87-19-18 |
| 87-18-21 | 7/23/87 | 7/16/87 | U.S. Nuclear Regulatory Commission | 87-19-20 |

87-18-01 6-4

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

IN REPLY REFER TO:

JUN 9 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W. Room 4041
Washington, DC 20405

Dear Ms. Willis:

I am pleased to respond to your letters of May 19, 1987, and May 29, 1987, in which you request the comments of the Federal Communications Commission (FCC) concerning proposed rules to amend the Federal Acquisition Regulation (FAR). These requests for comments are identified as FAR Case 85-63, FAR Case 87-12, FAR Case 87-18 and FAR Case 87-19.

-04 -03 -01 -01

With respect to FAR Case 85-63, Unallowable Costs Under FAR 31.205, the FCC has no comments to submit on this proposed change. We endorse the proposed clarifications relative to research and development contracts outlined in FAR Case 87-12. The changes proposed in FAR Case 87-18, Trade Business, Technical and Professional Activity Costs as well as those contained in FAR Case 87-19, Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs) accomplish the intent of providing clarification as to costs that might be unreasonable.

As always, the Commission appreciates the opportunity to comment on proposed changes to the FAR. If you have any questions, please feel to contact me at (202) 634-1530.

Sincerely,

J.R. Ryan

J.R. Ryan
Chief, Procurement Branch

RECEIVED
JUN 16 1987

87-18-02 6-30

UNITED STATES OF AMERICA
RAILROAD RETIREMENT BOARD
844 RUSH STREET
CHICAGO, ILLINOIS 60611

BUREAU OF SUPPLY AND SERVICE

June 10, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, NW
Room 4041
Washington, DC 20405

Re: FAR Cases 87-18
and 87-19

Dear Ms. Willis:

As requested, we have reviewed the proposed revisions to the Federal Acquisition Regulation (FAR) concerning trade, business, technical and professional activity costs and extraordinary compensation and certain organization costs in connection with mergers and other business combinations enclosed with your letter of May 29, 1987. We have no comments to make at this time.

Very truly yours,

Henry M. Valiulis
Director of Supply
and Service

RECEIVED

JUN 22 1987

87-18-036-82

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

JUN 23 1987

Ms. Margaret A. Willis
FAR Secretariat
General Services Administration
Office of Acquisition Policy
Washington, D.C. 20405

Dear Ms. Willis:

This is in response to your letter of May 29, 1987, in which you request comments concerning FAR Case 87-18,-03 Trade, Business, Technical and Professional Activity Costs, and FAR Case 87-19, -03 Extraordinary Compensation and Certain Organization Costs in Connection with mergers and Other Business Combination (Golden Parachutes and Golden Handcuffs).

The Small Business Administration, Office of Procurement Assistance, interposes no objection at this time to the issuance of these FAR cases as final rules.

Sincerely,

Monika Edwards Harrison

Monika Edwards Harrison
Associate Administrator for
Procurement Assistance

RECEIVED
JUN 29 1987

87-18-04 6-75

AMERICAN DEFENSE PREPAREDNESS ASSOCIATION
DEDICATED TO PEACE WITH SECURITY THROUGH DEFENSE PREPAREDNESS
ROSSLYN CENTER, SUITE 900, 1700 NORTH MOORE STREET, ARLINGTON, VIRGINIA 22209
703-522-1820
Founded 1919

June 23, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
Room 4041, 18th & F Streets NW
Washington, DC 20405

Dear Ms. Willis:

This responds to your letter dated May 29, 1987 requesting our comments on FAR Cases 87-18 and 87-19, concerning, respectively, "trade, business, technical, and professional activity costs" (31.205-43(c)) and "extraordinary compensation and certain organization costs in connection with mergers and other business combinations" (31.205-6(1) and 32.205-27(a)).

Case 87-18 -04

The proposed change of 31.205-43(c) reiterates the allowability of the cost of "organizing, setting-up, and sponsoring meetings, conferences, symposia, and seminars" the principal purpose of which is to disseminate trade, business, technical, or professional information or to stimulate production or improved productivity. In addition, the cost of attendance of contractor employees at such meetings, including travel costs, is allowable. Also allowable is the cost of attendance of personnel other than the sponsoring contractor's employees, if attendance is essential to achieve the purpose of the meeting and if the cost of attendance is not paid by the individual's employer.

We find the proposed change to be unobjectionable. The Government can be expected to benefit from the improvement of contract performance brought about by such meetings. However, (c)(3) should be changed for clarity by deleting the term, "noncontractor personnel," and substituting "individuals other than the sponsoring contractor's employees." We think that "noncontractor personnel" could be misinterpreted to mean that the individual is qualified to attend such a meeting only if not employed by a Government contractor. The cost of attendance of such an individual should be allowable, whether his employer is a Government contractor or not.

Case 87-19 -04

The purpose of the proposed changes to 31.205-6(1) and 32.205-27(a) is to make unallowable extraordinary and special costs of certain kinds, resulting

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JUN 29 1987

87-18-04

from acquisitions and mergers, or resisting acquisitions and mergers, following changes in "management control over, or ownership of, the contractor or a substantial portion of its assets" including special compensation in the form of "golden parachutes" and "golden handcuffs."

The costs to a contractor, over and above ordinary and normal expenses, resulting from acquisitions and mergers should not be charged to the Government as an ordinary expense in performing a Government contract. On the other hand, it should be made clear that expenses incurred in connection with novation and change-of-name agreements (FAR 42.12) are allowable, even when resulting from objectionable costs of takeovers and mergers. Such agreements are ordinary administrative costs affecting performance of the Government contract and therefore should be allowable.

We appreciate the opportunity to review and comment on the proposed changes to FAR.

Sincerely,

William E. Eicher

William E. Eicher
Major General, US Army (Ret.)
Vice President and Director
Advisory Service

WEE:meh

87-18-05 6-70

NATIONAL LABOR RELATIONS BOARD

Washington, D.C. 20570

17 June 1987

Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Street, NW - Room 4041
Washington, DC 20405

Dear Ms. Willis:

05

We have reviewed the proposed revisions to the Federal Acquisition Regulations with respect to FAR Case 87-18, Trade, Business, Technical and Professional Activity Costs, and FAR Case 87-19, Extraordinary Compensation and Certain Organization Costs in Connection With Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs) and have no substantive comments to offer.

Thank you for the opportunity to comment.

Sincerely,

Ernest Russell
Director of Administration

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JUN 25 1987

87-18-06 6-69

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

JUN 17 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Reference: FAR Cases 87-18-06 and 87-19-06

Dear Ms. Willis:

Thank you for your May 29, 1987, letter concerning FAR Cases 87-18 (Trade, Business, Technical and Professional Activity Costs) and 87-19 (Golden Parachutes and Golden Handcuffs).

The Agency for International Development supports the proposed rules.

Sincerely,

J F Owens

John F. Owens
Procurement Executive

RECEIVED
JUN 25 1987

87-18-07

7-21

PANAMA CANAL COMMISSION

2000 L STREET, NW.
SUITE 550
WASHINGTON, DC 20036

11

OFFICE OF
THE SECRETARY

June 29, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W.
Room 4041
Washington, D. C. 20405

Dear Ms. Willis:

This is in response to your request for comments on proposed rules that would revise the Federal Acquisition Regulation (FAR) with respect to FAR Case 85-63; FAR Case 87-12; FAR Case 87-18; and FAR Case 87-19. -06 -16 -123 -07

We have reviewed the proposed rules and offer no comments.

Sincerely,

Barbara A. Fuller

Barbara A. Fuller
Assistant to the Secretary
for Commission Affairs

RECEIVED

87-18-08

7-6


NATIONAL ENDOWMENT FOR THE HUMANITIES

WASHINGTON, D.C. 20506


11

June 26, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets NW
Room 4041
Washington, DC 20405

Dear Ms. Willis:

I am writing in regards to Federal Register Articles dated April 30, May 6, and May 13, 1987, FAR Case 85-63, -17 Unallowable Costs Under FAR 31.205, proposed rule.

FAR Case 87-12-24 Research and Development Contracting Procedures, proposed rule.

FAR Case 87-18-04, Trade, Business, Technical and Professional Activity Cost, proposed rule.

FAR Case 87-19-09, Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Hand Cuffs), proposed rule.

Please be advised that the National Endowment for the Humanities (NEH) has no objection to the above cases as drafted.

Sincerely,

Robert P. Stock
Contracting Officer
National Endowment for the Humanities

87-18-09 7-7

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-3000

June 30, 1987

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, NW, Room 4041
Washington, DC 20405

Dear Ms. Willis:

The Department of Housing and Urban Development has reviewed FAR Case 87-18 concerning trade, business, technical and professional activity costs. In response to your request, we offer the following comments:

a. The stated objectives of the proposed revision are to: (1) control/reduce costs; (2) clearly state the Government's policy; and (3) describe more specifically the nature of costs which are allowable. The proposed revision accomplishes the second and third objectives but does not appear to address the first objective. In our opinion, the best way to control or reduce the costs of meetings and conferences is to place a ceiling on such expenditures as a percentage of the total indirect cost pool. Expenses above the ceiling would not be allocable to Government contracts.

b. The phrase "...subsistence and incidental and directly associated costs," as used in paragraph 31.205.43(c)(1) needs to be more clearly defined.

We appreciate the opportunity to comment on the proposed FAR change.

Very sincerely yours,

Roosevelt Jones
Director
Office of Procurement and Contracts

RECEIVED

JUL - 6 1987

U.S. Department of Justice

7-42

87-18-10

Washington, D.C. 20530

JUL 8 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Washington, D.C. 20405

Ref FAR Cases 87-18-10 and 87-19-10

Dear Ms. Willis:

This is in response to your request of May 13, 1987 for comments on the proposed rules to amend the Federal Acquisition Regulation. We have reviewed the proposed rules and have no objection to their enactment.

Thank you for the opportunity to review the rules.

Sincerely,

W. L. Vann
Procurement Executive
Justice Management Division

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JUL 10 1987

87-18-11 7-43

5

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

July 9, 1987

MEMORANDUM FOR LARRY J. RIZZI
DIRECTOR
OFFICE OF FEDERAL ACQUISITION
AND REGULATORY POLICY (VR)

FROM: IDA M. USTAD
DIRECTOR
OFFICE OF GSA ACQUISITION
POLICY AND REGULATIONS (VP)

SUBJECT: FAR Cases 87-18-11 and 87-19-11

The proposed change to FAR Part 31, concerning trade, business, technical and professional activity cost, that are intended to clarify allowability policy; and clarifying the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations, has been reviewed by GSA services/offices. GSA has no objections to the proposed changes.

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JUL 10 1987

87-18-12

**United States Information Agency**

Washington, D.C. 20547

7-17

USIA

July 1, 1987

Dear Ms. Willis: Re: FAR Case Nos. 87-18 and 87-19

We have reviewed and concur in the proposed rules to amend the Federal Acquistion (FAR) Part 31 with regard to Sections 31.205.6, 31-205-27 and 31.205-43.

Thank you for submitting this material for our comment.

Sincerely

John Shordellen for P.R.

Philip R. Rogers
Director
Office of Contracts

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Sts., N.W. Room 4041
Washington, D.C. 20405

7-4c

87-18-13

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

Audit Policy
and Oversight

JUL 6 1987

MEMORANDUM FOR FEDERAL ACQUISITION REGULATORY SECRETARIAT, GENERAL SERVICES ADMINISTRATION

SUBJECT: Federal Acquisition Regulation Case Number 87-18, Trade, Business, Technical and Professional Activity Cost

We have reviewed the proposed changes to Federal Acquisition Regulation Subpart 31.205-43, Trade, Business, Technical and Professional Activity Costs. The proposed changes do not reflect or result from a change in allowability policy but are intended to clarify the existing policy.

Based on our review, we concur with the proposed changes. We appreciate the opportunity to comment.

J.H.C.
James H. Curry
Assistant Inspector General
for Audit Policy and Oversight

RECEIVED JUL 13 1987

87-18-14 7-53

# Department of Transportation

## State of Georgia

No. 2 Capitol Square
Atlanta, Georgia 30334-1002

HAL RIVES
COMMISSIONER
ALVA R. BYROM
STATE HIGHWAY ENGINEER

JAMES D. McGEE
DEPUTY COMMISSIONER
ARTHUR A. VAUGHN
TREASURER

July 9, 1987

Ms. Margaret A. Willis
FAR Secretariat
General Services Administration
FAR Secretariat (VRS)
18th & F Streets N.W.
Room 4041
Washington, DC 20405

RE: FAR Case 87-18

Dear Ms. Willis:

In response to your request for comments concerning 48 CFR Part 31, I would like to suggest an addendum to 31.205-43 "Trade, business, technical and professional activity cost" with respect to allowable cost. I think prior approval of the contracting agency should be required as a condition of allowability of cost associated with non-Federal Government sponsored symposia that are to be charged against Government contracts. This requirement will enable the contracting agency to better control cost as well as make them directly responsible for evaluating the effectiveness of said expenditures.

I apologize for my late response and respectfully request that an exception to the deadline for responding be granted should this letter not arrive by July 13, 1987.

Sincerely,

Larry J. Markessen for
James L. Bryant
Transportation Accounts Administrator

JLB:LJM:hcc

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JUL 17 1987 MS

7-49

87-18-15

Aerospace Industries Association of America, Inc.

Don Fuqua
*President*

July 9, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

The Aerospace Industries Association (AIA) appreciates the opportunity to review and comment upon the proposed revision of FAR 31.205-43, Trade, Business, Technical and Professional Activity Costs. FAR Case 87-18 has been assigned to this action.

The proposed change is intended to clarify allowability policy and we believe that it has accomplished that purpose. However, in the proposed change to 31.205-43(c)(3)(ii), the use of the term "essential" is too restrictive for the purpose intended. Substantial benefits may accrue to the contractor as well as his government customers from attendance of non-contractor personnel at such a meeting, even though said attendance may not, strictly speaking, have been absolutely <u>essential</u> to the purpose of the meeting. Accordingly, we suggest the use of the term "relevant" to the purpose of the meeting. We recommend that 31.205-43(c)(3)(ii) be revised to read as follows:

> (ii) The individual's attendance is relevant to the purpose of the conference, meeting, symposium, etc.

Your favorable consideration of the foregoing will be appreciated.

Sincerely,

Don Fuqua

RECEIVED

JUL 17 1987 MS

7-66

87-18-16

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT POLICY

JUL 15 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

This responds to paragraph 1. of your May 29, 1987 letter and to the May 13, 1987 Federal Register notice of proposed rulemaking pertaining to trade, business, technical and professional activity costs (FAR Case 87-18).

We have no comments on, or objections to the proposed rule.

Sincerely,

David P. Baker
Associate Administrator
for Management Controls

RECEIVED

JUL 22 1987

87-18-17-48

PSMA

PROFESSIONAL SERVICES MANAGEMENT ASSOCIATION
1213 Prince Street Alexandria, Virginia 22314
703/684-3993

July 9, 1987

FAR Secretariat (VRS)
General Services Administration
18th and F Streets, Northwest
Room 4041
Washington, D.C. 20405

Gentlemen:

Reference is made to your May 29, 1987, letter concerning proposed revisions to the FAR on two subjects. Our comments are as follows:

1. FAR CASE 87-18--17 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITY COSTS, FAR 31.205-43

   This Association commends you on proposing a revision which is not detrimental to industry and clarifies the kinds of costs that are allowable. It is a welcome relief from your many recent revisions beamed at cutting the Defense Department budget at the unfair expense of industry.

2. FAR CASE 87-19--15 EXTRAORDINARY COMPENSATION AND CERTAIN ORGANIZATION COSTS IN CONNECTION WITH MERGERS AND OTHER BUSINESS COMBINATIONS, FAR 31.205-6 AND 31.205-27

   These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.

In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions

RECEIVED
JUL 17 1987

87-18-17

PSMA



put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary cost of doing business in today's business merger atmosphere (condoned by Congress).

Very truly yours,

PROFESSIONAL SERVICES
MANAGEMENT ASSOCIATION

By
Edwin P. James, Consultant
Arthur Andersen & Co.

JJB

87-18-187-55

# PENNSYLVANIA AVENUE DEVELOPMENT CORPORATION

Suite 1220 North
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1703
202/724-9091

Henry A. Berliner, Jr.
*Chairman*

M. J. Brodie
*Executive Director*

July 10, 1987

FAR Secretariat (VRS)
General Services Administration
18th & F Streets, NW
Room 4041
Washington, DC 20405

-16

Re: FAR Cases 87-18 and 87-19

Dear Ms. Willis:

The Pennsylvania Avenue Development Corporation supports the proposed changes on Trade, Business, Technical and Professional Activity Costs and on Extraordinary Compensation. We consider the changes to be an appropriate way to prevent contractors from charging for certain costs substantially unrelated to the performance of government contracts.

Sincerely yours,

M J Brodie
M.J. Brodie
Executive Director

MJB:TJN:ky

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VRS
...E SECOND DECADE

87-18-19-5

United States
Department of
Agriculture

Office of
the Secretary

Office of
Operations

Washington, D.C.
20250

July 1, 1987

General Services Administration
FAR Secretariat (VRS-Room 4041)
18th & F Streets, NW
Washington, DC 20250

Gentlemen:

This is a reply to your request for comments on FAR Cases 87-18 -19 and 87-19. -17

We recommend that the proposals to amend FAR Part 31 be finalized as written.

Thank you for the opportunity to comment.

FOR FRANK GEARDE, JR.
Director

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JUL 17 1987

7-62

Office of the
Administrator
of Veterans Affairs

Washington DC 20420

87-18-20

Veterans
Administration

JUL 10 1987

In Reply Refer To:

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W., Room 4041
Washington, DC 20405

Dear Ms. Willis:

I appreciate the opportunity to comment on FAR cases 87-18 -20 and 87-19 /19. The Veterans Administration has reviewed the proposed rules to amend the Federal Acquisition Regulation and concurs.

Sincerely,

Arlyce S. Dubbin

for SUSAN LIVINGSTONE
Associate Deputy Administrator
for Logistics

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JUL 22 1987

*"America is #1—Thanks to our Veterans"*

87-18-21 7-68

UNITED STATES
NUCLEAR REGULATORY COMMISSION
WASHINGTON, D. C. 20555

JUL 16 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

This responds to your May 29, 1987 letter regarding FAR Cases 87-18 -21 and 87-19, -20 "Trade, Business, Technical and Professional Activity Costs", and Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs)," respectively.

We have no comments regarding the proposed rules.

Sincerely,

Edward L. Halman, Director
Division of Contracts
Office of Administration and
Resources Management

RECEIVED JUL 23 1987

FAR Case 87-19 Comments Due: 7/13/87

Subject: Golden Parachutes and Golden Handcuffs

To: DARC

Date: 7/31/87

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-19-01 | 6/16/87 | 6/9/87 | Federal Communications Commission | 85-63-04<br>87-12-03<br>87-18-01 |
| 87-19-02 | 6/22/87 | 6/10/87 | U.S.A. Railroad Retirement Board | 87-18-02 |
| 87-19-03 | 6/29/87 | 6/23/87 | U.S. Small Business Administration | 87-18-03 |
| 87-19-04 | 6/29/87 | 6/23/87 | American Defense Preparedness Association | 87-18-04 |
| 87-19-05 | 6/25/87 | 6/17/87 | National Labor Relations Board | 87-18-05 |
| 87-19-06 | 6/25/87 | 6/17/87 | Agency for International Development | 87-18-06 |
| 87-19-07 | 6/29/87 | 6/24/87 | U.S. Department of Housing and Urban Development | |
| 87-19-08 | 7/7/87 | 6/29/87 | Panama Canal Commission | 85-63-16<br>87-12-23<br>87-18-07 |
| 87-19-09 | 7/6/87 | 6/26/87 | National Endowment for the Humanities | 85-63-17<br>87-12-24<br>87-18-08 |
| 87-19-10 | 7/10/87 | 7/8/87 | U.S. Department of Justice | 87-18-10 |
| 87-19-11 | 7/10/87 | 7/9/87 | Office of GSA Acquisition Policy and Regulations (GSA) | 87-18-11 |
| 87-19-12 | 7/6/87 | 6/29/87 | Department of Defense, Inspector General | |
| 87-19-13 | 7/13/87 | 7/1/87 | United States Information Agency | 87-18-12 |
| 87-19-14 | 7/13/87 | 7/9/87 | Council of Defense and Space Industry Associations (CODSIA) | |

FAR Case 87-19 Comments                                                    Due: 7/13/87

Subject: Golden Parachutes and Golden Handcuffs

To: DARC

Date: 7/31/87

| Response Number | Date Received | Date of Letter | Commenter | Comments |
|---|---|---|---|---|
| 87-19-15 | 7/17/87 | 7/9/87 | Professional Services Management Association | 87-18-17 |
| 87-19-16 | 7/17/87 | 7/10/87 | Pennsylvania Avenue Development Corporation | 87-18-18 |
| 87-19-17 | 7/17/87 | 7/1/87 | United States Department of Agriculture | 87-18-19 |
| 87-19-18 | 7/22/87 | 7/10/87 | Veterans Administration | 87-18-20 |
| 87-19-19 | 7/22/87 | 7/15/87 | Office of Federal Procurement Policy | |
| 87-19-20 | 7/23/87 | 7/16/87 | U.S. Nuclear Regulatory Commission | 87-18-21 |

87-19-01 6-4

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

IN REPLY REFER TO:

JUN 9 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W. Room 4041
Washington, DC 20405

Dear Ms. Willis:

I am pleased to respond to your letters of May 19, 1987, and May 29, 1987, in which you request the comments of the Federal Communications Commission (FCC) concerning proposed rules to amend the Federal Acquisition Regulation (FAR). These requests for comments are identified as FAR Case 85-63, FAR Case 87-12, FAR Case 87-18 and FAR Case 87-19.

04 03 01 01

With respect to FAR Case 85-63, Unallowable Costs Under FAR 31.205, the FCC has no comments to submit on this proposed change. We endorse the proposed clarifications relative to research and development contracts outlined in FAR Case 87-12. The changes proposed in FAR Case 87-18, Trade Business, Technical and Professional Activity Costs as well as those contained in FAR Case 87-19, Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs) accomplish the intent of providing clarification as to costs that might be unreasonable.

As always, the Commission appreciates the opportunity to comment on proposed changes to the FAR. If you have any questions, please feel to contact me at (202) 634-1530.

Sincerely,

J R Ryan

J.R. Ryan
Chief, Procurement Branch

RECEIVED
JUN 16 1987

87-19-02 6-30


UNITED STATES OF AMERICA
RAILROAD RETIREMENT BOARD
844 RUSH STREET
CHICAGO, ILLINOIS 60611

BUREAU OF SUPPLY AND SERVICE


June 10, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, NW
Room 4041
Washington, DC 20405

Re: FAR Cases 87-18 and 87-19

Dear Ms. Willis:

As requested, we have reviewed the proposed revisions to the Federal Acquisition Regulation (FAR) concerning trade, business, technical and professional activity costs and extraordinary compensation and certain organization costs in connection with mergers and other business combinations enclosed with your letter of May 29, 1987. We have no comments to make at this time.

Very truly yours,

Henry M. Valiulis
Director of Supply
and Service


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JUN 22 1987

87-19-03-93

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

JUN 23 1987

Ms. Margaret A. Willis
FAR Secretariat
General Services Administration
Office of Acquisition Policy
Washington, D.C. 20405

Dear Ms. Willis:

This is in response to your letter of May 19, 1987, in which you requested comments concerning FAR Case 85-63, Unallowable Costs Under FAR 31.205, and FAR Case 87-12, Research and Development Contract Procedures.

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'09

The Small Business Administration, Office of Procurement Assistance, interposes no objection at this time to the issuance of these FAR cases as final rules.

Sincerely,

Monika Edwards Harrison

Monika Edwards Harrison
Associate Administrator for
Procurement Assistance

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JUL - 6 1987

87-19-04 6-75

AMERICAN DEFENSE PREPAREDNESS ASSOCIATION
DEDICATED TO PEACE WITH SECURITY THROUGH DEFENSE PREPAREDNESS

ROSSLYN CENTER, SUITE 900, 1700 NORTH MOORE STREET, ARLINGTON, VIRGINIA 22209
703-522-1820

*Founded 1919*

June 23, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
Room 4041, 18th & F Streets NW
Washington, DC 20405

Dear Ms. Willis:

This responds to your letter dated May 29, 1987 requesting our comments on FAR Cases 87-18 and 87-19, concerning, respectively, "trade, business, technical, and professional activity costs" (31.205-43(c)) and "extraordinary compensation and certain organization costs in connection with mergers and other business combinations" (31.205-6(1) and 32.205-27(a)).

<u>Case 87-18</u> -04

The proposed change of 31.205-43(c) reiterates the allowability of the cost of "organizing, setting-up, and sponsoring meetings, conferences, symposia, and seminars" the principal purpose of which is to disseminate trade, business, technical, or professional information or to stimulate production or improved productivity. In addition, the cost of attendance of contractor employees at such meetings, including travel costs, is allowable. Also allowable is the cost of attendance of personnel other than the sponsoring contractor's employees, if attendance is essential to achieve the purpose of the meeting and if the cost of attendance is not paid by the individual's employer.

We find the proposed change to be unobjectionable. The Government can be expected to benefit from the improvement of contract performance brought about by such meetings. However, (c)(3) should be changed for clarity by deleting the term, "noncontractor personnel," and substituting "individuals other than the sponsoring contractor's employees." We think that "noncontractor personnel" could be misinterpreted to mean that the individual is qualified to attend such a meeting only if not employed by a Government contractor. The cost of attendance of such an individual should be allowable, whether his employer is a Government contractor or not.

<u>Case 87-19</u> -04

The purpose of the proposed changes to 31.205-6(1) and 32.205-27(a) is to make unallowable extraordinary and special costs of certain kinds, resulting

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JUN 29 1987

87-19-06 6-69

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C 20523

A

JUN 17 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Reference: FAR Cases 87-18.06 and 87-19.06

Dear Ms. Willis:

Thank you for your May 29, 1987, letter concerning FAR Cases 87-18 (Trade, Business, Technical and Professional Activity Costs) and 87-19 (Golden Parachutes and Golden Handcuffs).

The Agency for International Development supports the proposed rules.

Sincerely,

J F Owens

John F. Owens
Procurement Executive

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JUN 25 1987

87-19-07 6-81

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-3000

JUN 24 1987

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, NW, Room 4041
Washington, DC 20405

Dear Ms. Willis:

The Department of Housing and Urban Development has reviewed FAR Case 87-19 pertaining to extraordinary contract compensation costs and certain costs incurred in connection with mergers and other business combinations. We have no comments on the proposed changes.

Thank you for the opportunity to review the revisions.

Very sincerely yours,

Roosevelt Jones

Roosevelt Jones
Director
Office of Procurement and Contracts

RECEIVED

JUN 29 1987

87-19-08

7-21

# PANAMA CANAL COMMISSION

2000 L STREET, NW.
SUITE 550
WASHINGTON, DC 20036

11

OFFICE OF
THE SECRETARY

June 29, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W.
Room 4041
Washington, D. C. 20405

Dear Ms. Willis:

This is in response to your request for comments on proposed rules that would revise the Federal Acquisition Regulation (FAR) with respect to FAR Case 85-63; FAR Case 87-12; FAR Case 87-18; and FAR Case 87-19.
.06 .16 .123 .07

We have reviewed the proposed rules and offer no comments.

Sincerely,

Barbara A. Fuller

Barbara A. Fuller
Assistant to the Secretary
for Commission Affairs

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87-19-09

7-6

NATIONAL ENDOWMENT FOR THE HUMANITIES

WASHINGTON, D.C. 20506

11

June 26, 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets NW
Room 4041
Washington, DC 20405

Dear Ms. Willis:

I am writing in regards to Federal Register Articles dated April 30, May 6, and May 13, 1987, FAR Case 85-63, Unallowable Costs Under FAR 31.205, proposed rule. 17

FAR Case 87-12-24 Research and Development Contracting Procedures, proposed rule.

FAR Case 87-18-04, Trade, Business, Technical and Professional Activity Cost, proposed rule.

FAR Case 87-19-09, Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Hand Cuffs), proposed rule.

Please be advised that the National Endowment for the Humanities (NEH) has no objection to the above cases as drafted.

Sincerely,

Robert P. Stock
Contracting Officer
National Endowment for the Humanities

87-19-10
7-42

U.S. Department of Justice

Washington, D.C. 20530

JUL 8 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Washington, D.C. 20405

Ref FAR Cases 87-18-10 and 87-19-10

Dear Ms. Willis:

This is in response to your request of May 13, 1987 for comments on the proposed rules to amend the Federal Acquisition Regulation. We have reviewed the proposed rules and have no objection to their enactment.

Thank you for the opportunity to review the rules.

Sincerely,

W. L. Vann
Procurement Executive
Justice Management Division

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JUL 10 1987

87-19-1 7-43

6

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

July 9, 1987

MEMORANDUM FOR LARRY J. RIZZI
DIRECTOR
OFFICE OF FEDERAL ACQUISITION
AND REGULATORY POLICY (VR)

FROM: IDA M. USTAD
DIRECTOR
OFFICE OF GSA ACQUISITION
POLICY AND REGULATIONS (VP)

SUBJECT: FAR Cases 87-18 -11 and 87-19 -11

The proposed change to FAR Part 31, concerning trade, business, technical and professional activity cost, that are intended to clarify allowability policy; and clarifying the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations, has been reviewed by GSA services/offices. GSA has no objections to the proposed changes.

RECEIVED

JUL 10 1987

7-9

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

87-19-12

Audit Policy
and Oversight

JUN 29 1987

Ms. Margaret A. Willis
Federal Acquisition Regulation
Secretariat (VRS)
General Services Administration
Washington, D.C. 20405

Dear Ms. Willis:

We have reviewed the proposed changes to Federal Acquisition Regulations (FAR) 31.205-6 and 31.205-27 (FAR Case 87-19). This case proposes to clarify the allowability of extraordinary compensation and certain organization costs incurred in connection with mergers and other business combinations. Based on our review, we concur with the proposed changes.

We appreciate the opportunity to comment on these proposed revisions.

Sincerly,

James H. Curry
Assistant Inspector General
for Audit Policy and Oversight

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JUL - 6 1987

87-19-13

**United States Information Agency**

Washington, D.C. 20547

7-1-87

USIA

July 1, 1987

2 13

Dear Ms. Willis: Re: FAR Case Nos. 87-18 and 87-19

We have reviewed and concur in the proposed rules to amend the Federal Acquistion (FAR) Part 31 with regard to Sections 31.205.6, 31-205-27 and 31.205-43.

Thank you for submitting this material for our comment.

Sincerely

John Shodellen for P.R.

Philip R. Rogers
Director
Office of Contracts

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Sts., N.W. Room 4041
Washington, D.C. 20405

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

1620 Eye Street, N.W., Suite 1000
WASHINGTON, D.C. 20006
•
(202) 659-5013

87-19-14

July 9, 1987
Ref: CODSIA Case 13-87

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W., Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

The undersigned member associations of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to review and submit comments on the proposed revision of FAR 31.205-6, Compensation for Personal Services, and FAR 31.205-27, Organization Costs. FAR Case 87-19 has been assigned to this action.

We have no specific comments to offer with regard to the proposed change to 31.205-6(1)(1), governing costs commonly known as "golden parachutes."

It is the opinion of the undersigned associations that the proposed language 31.205-6 (1)(2), disallowing the cost of "golden handcuffs," is unnecessary and, moreover, is inconsistent with the policy enunciated in the background statement preceding the proposed new cost principle. While the background statement defines "golden handcuffs" as "extraordinary payments above and beyond ordinary, customary, and reasonable compensation payments to employees for services rendered," the proposed cost principle would define <u>any</u> compensation in excess of normal pay as "golden handcuffs," or <u>per se</u> unreasonable and extraordinary. CODSIA agrees that the government should not have to reimburse extraordinary and unreasonable compensation payments, and thus agrees with the statement of policy offered as background to the proposed cost principle. However, the language of the proposed cost principle is inconsistent with this policy and would disallow payments which are neither extraordinary nor unreasonable.

Since the ultimate resource of the acquired company is its employees, the success of an acquired company is usually related to its ability to retain key people, such as certain management, technical and administrative staff (e.g., tax staff personnel) for a specific period of time after the acquisition. To disallow the reasonable cost of special compensation arrangements (i.e., completion bonuses) to retain such valuable resources of an acquired company would be detrimental to the acquiring company as well as its customers - in this case, the U.S. Government.

We recommend that allowability of such arrangements continue to be handled on a case by case basis, employing the "reasonableness criteria" already provided by FAR 31.201-3 and should not, out of hand, be deemed unallowable. Therefore, it is recommended that 31.205-6(1)(2) be revised to read as follows:

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"(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 unreasonable special compensation, in addition to their normal pay, provided that they remain with the contractor for a specified period of time."

Mergers, Sales, and Reorganizations Benefit the Government

Business decisions regarding the need or desirability to compete for new programs are based, in large part, upon the company's research and production capacities, financial flexibility, and expertise in technolgies which are needed for the new system.

In a number of cases over the years, companies have concluded that their competitive abilities would add to its skills, capacity, management or technology, in a way which is crucial to its competive posture. In many of these cases, a merger, acquisition, or reorganization directly benefits the government. These benefits are enhancing the scientific, managerial or production capability of a company which it can bring to bear on the government's needs. The result is a better proposal, a better design and, ultimately a better bargain for the government.

We suggest that in the judgment of the contracting officer, where the merger or acquisition benefits the government, their costs be allowable where they are otherwise reasonable and allocable. Subparagraph (a) of section 31.205-27 should be modified accordingly.

In this connection, and applying the same reasonableness criteria as discussed above, we recommend that the proposed revision to FAR 31.205-27 addressing the allowability of expenditures incurred in resisting or planning to resist any corporate reorganization or change in controlling interest of a business be addressed in a separate paragraph (b) as follows:

"(b) Costs in connection with 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 are subject to the reasonableness criteria provided in 31.201-3."

Accordingly, the existing paragraph (b) should be renumbered as (c). Further, the reference to paragraph (b) in the first sentence of paragraph (a) should also be changed to paragraph (c).

87-19.14

We appreciate the opportunity to provide you with these comments and request that you revise the proposed revisions on reasonableness in the areas of "golden handcuffs" and organization costs.

Sincerely,

Jean A. Caffiaux
Senior Vice President
Electronic Industries Association

John J. Stocker
President
Shipbuilders Council of America

Don Fuqua
President
Aerospace Industries Association

Virginia Littlejohn
Executive Director
Professional Services Council

87-19-15 7-48

PSMA

PROFESSIONAL SERVICES MANAGEMENT ASSOCIATION
1213 Prince Street Alexandria, Virginia 22314
703/684-3993

July 9, 1987

FAR Secretariat (VRS)
General Services Administration
18th and F Streets, Northwest
Room 4041
Washington, D.C. 20405

Gentlemen:

Reference is made to your May 29, 1987, letter concerning proposed revisions to the FAR on two subjects. Our comments are as follows:

1. FAR CASE 87-18-17--TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITY COSTS, FAR 31.205-43

   This Association commends you on proposing a revision which is not detrimental to industry and clarifies the kinds of costs that are allowable. It is a welcome relief from your many recent revisions beamed at cutting the Defense Department budget at the unfair expense of industry.

2. FAR CASE 87-19-15--EXTRAORDINARY COMPENSATION AND CERTAIN ORGANIZATION COSTS IN CONNECTION WITH MERGERS AND OTHER BUSINESS COMBINATIONS, FAR 31.205-6 AND 31.205-27

   These costs are costs associated with doing business in today's atmosphere. We believe that all organization and reorganization costs should be allowed on Government contracts as they benefit the Government in the long run. We realize organization costs have been unallowable for a long time. We recommend that FAR 31.205-27 be deleted in its entirety. Why should the Government benefit from such activities and pay nothing for them? It is another example of your "one-way street," similar to Contribution and Donations.

In regard to golden parachutes and golden handcuffs, DCAA has questioned them in the past based on reasonableness and allocability. The proposed revisions

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JUL 17 1987
WRS

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put teeth in the DCAA approach. This Association believes a reasonable portion of such costs should be allowed on Government contracts as a necessary cost of doing business in today's business merger atmosphere (condoned by Congress).

Very truly yours,

PROFESSIONAL SERVICES
MANAGEMENT ASSOCIATION

By [signature]
Edwin P. James, Consultant
Arthur Andersen & Co.

JJB

87-19-16 7-55

# PENNSYLVANIA AVENUE DEVELOPMENT CORPORATION

Suite 1220 North
1331 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1703
202/724-9091

Henry A. Berliner, Jr.
*Chairman*

M. J. Brodie
*Executive Director*

July 10, 1987

FAR Secretariat (VRS)
General Services Administration
18th & F Streets, NW
Room 4041
Washington, DC 20405

Re: FAR Cases 87-18 and 87-19 .16

Dear Ms. Willis:

The Pennsylvania Avenue Development Corporation supports the proposed changes on Trade, Business, Technical and Professional Activity Costs and on Extraordinary Compensation. We consider the changes to be an appropriate way to prevent contractors from charging for certain costs substantially unrelated to the performance of government contracts.

Sincerely yours,

M.J. Brodie
M.J. Brodie
Executive Director

MJB:TJN:ky

87-19-17 7-5

United States Department of Agriculture
Office of the Secretary
Office of Operations
Washington, D.C. 20250

July 1, 1987

General Services Administration
FAR Secretariat (VRS-Room 4041)
18th & F Streets, NW
Washington, DC 20250

Gentlemen:

This is a reply to your request for comments on FAR Cases 87-18 19 and 87-19. - 17

We recommend that the proposals to amend FAR Part 31 be finalized as written.

Thank you for the opportunity to comment.

(FOR FRANK GEARDE, JR.
Director

7-62

Office of the
Administrator
of Veterans Affairs

Washington DC 20420

87-19-18

Veterans
Administration

JUL 10 1987

In Reply Refer To:

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th & F Streets, N.W., Room 4041
Washington, DC 20405

Dear Ms. Willis:

I appreciate the opportunity to comment on FAR cases 87-18-20 and 87-19, 14. The Veterans Administration has reviewed the proposed rules to amend the Federal Acquisition Regulation and concurs.

Sincerely,

Arlyce S. Dubbin
for SUSAN LIVINGSTONE
Associate Deputy Administrator
for Logistics

RECEIVED

JUL 22 1987

"America is #1—Thanks to our Veterans"

7-65

87-19-19

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT POLICY

JUL 15 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W.
Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

This responds to paragraph 2. of your May 29, 1987 letter and to the May 13, 1987 Federal Register notice of proposed rulemaking pertaining to golden parachutes and golden handcuffs (FAR Case 87-19).

We have no comments on, or objections to the proposed rule.

Sincerely,

David F. Baker
Associate Administrator
for Management Controls

RECEIVED
JUL 22 1987

87-19-20 7-68

UNITED STATES
NUCLEAR REGULATORY COMMISSION
WASHINGTON, D. C. 20555

JUL 16 1987

Ms. Margaret A. Willis
FAR Secretariat (VRS)
General Services Administration
18th and F Streets, N.W., Room 4041
Washington, D.C. 20405

Dear Ms. Willis:

This responds to your May 29, 1987 letter regarding FAR Cases 87-18, 21 and 87-19, 20 "Trade, Business, Technical and Professional Activity Costs", and Extraordinary Compensation and Certain Organization Costs in Connection with Mergers and Other Business Combinations (Golden Parachutes and Golden Handcuffs)," respectively.

We have no comments regarding the proposed rules.

Sincerely,

Ronald L. Thompson
for Edward L. Halman, Director
Division of Contracts
Office of Administration and
Resources Management

RECEIVED JUL 23 1987