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THE NEWSLETTER FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

BDO KNOWS: GOVERNMENT CONTRACTING

CONTENTS

SEQUESTRATION HITS GOVERNMENT CONTRACTORS

The impact of sequestration on government contractors was comprehensively addressed in an article co-authored by Peter McDonald, a director in BDO's Government Contract Services practice (see "Preparing for Sequestration's Storm," with David Metzger, Esq., and Caitlin Cloonan, Esq., BNA *Federal Contracts Report*, Vol. 98, No. 9, Sept. 11, 2012. Reprinted in *The Clause*, Vol. XXII, Issue No. 3, September 2012). That article recommended the following steps contractors needed to take in advance of sequestration:

- Inventory all contracts and perform a risk assessment.
- Evaluate prime contract/subcontract risk assessment with respect to the agency mission.
- Eliminate any and all performance issues.
- Maintain open communications with agency officials.
- As necessary, qualify revenue projections.
- Reassess commercial market opportunities.
- Conduct compliance reviews as required.
- Do not assume any terminations for convenience.
- Develop cash flow models as if selected contract options were not exercised.
- Revisit litigation strategies for any current contract disputes, and seek to resolve all disputes as quickly as possible.
- Develop indirect cost projections for business case scenarios with regard to program terminations and/or downscopings.
- Create cost cutting steps consistent with performance requirements
- Reduce debt.
- Develop WARN Act implementation strategies.

Now that the first tranche of sequestration has occurred, these recommendations have become even more valid.

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REGULATORY UPDATES

▶DOD ACCELERATED PAYMENT PROGRAM

In July 2012, the Department of Defense (DoD) initiated a program to accelerate payments to prime contractors. The intent of the government-wide program, as set forth in OMB Policy memorandum M-12-16, was to quicken payments prime contractors made to their small business subcontractors and suppliers. This DoD policy was also consistent with a proposed FAR rule issued in December 2012 along the same lines.

However, on February 5, 2013, the DoD announced that the policy of accelerated payments to prime contractors would be cancelled. By not accelerating payments to prime contractors, DoD would be able to increase its working capital by at least $1 billion. According to a DoD spokesperson, DoD generally keeps a working capital amount that is good for one week, but lately that amount has dwindled to two to four days. The need to have greater amounts of working capital on hand caused the policy of accelerated payments to be rescinded.

Prime contractors can generally handle a slower payment schedule. However, small businesses that are subcontractors to DoD prime contractors will also be adversely affected because they too will wait longer to be paid. Because small businesses are more thinly capitalized, the impact of delayed payments will be greater. Contradictorily, this policy change conflicts with proposed changes to DFARS 202.903 and 202.906, which will require DoD to pay small businesses that are prime contractors as quickly as possible.

Other federal agencies, such as the Department of Energy (DoE) and Health & Human Services (HHS), are expected to soon announce similar policy changes.

▶GAO REPORT ON PENSION COSTS

For contractors still struggling with the allocation of pension costs to their contracts, a recent report by the Government Accountability Office (GAO) noted that there

was still a need for further guidance. In this regard, the GAO was concerned that pension cost projections vary greatly depending on the economic assumptions used. In any event, contractors and government agencies project that the "harmonization rule" will cause Cost Accounting Standards (CAS) pension costs to increase starting in 2014. This is because the discount rates used to value liabilities under CAS will be the Employee Retirement Income Security Act of 1974 (ERISA)-based rates, which are more volatile. This volatility makes forecasting future CAS pension costs more difficult. Because of the wide disparity in pension cost projections, there is reduced consistency in future pension cost amounts used in contract pricing. GAO noted that DoD's guidance on projecting ERISA-based discount rates for CAS calculations lacked specificity, which will cause greater variation among the rates contractors could use. In addition, a contractor is required to settle any pension cost differences with the government whenever a pension plan is terminated. However, the discount rates used for such settlements were not updated in the harmonization rule. As a result, pension plan liabilities would likely be calculated differently under CAS- and ERISA-based rates, which would lead to inconsistent results among contractors. Unfortunately, anomalous results will occur because there is no guidance addressing this lack of uniformity.

As a result of the changes made to ERISA by the Pension Protection Act of 2007, as well as the new harmonization rule by the CAS board, many government contractors changed their pension plans to 401(k) plans. As a consequence, fewer and fewer contractor employees are covered by either defined benefit or defined contribution pension plans. For this reason, GAO's call for additional guidance in this area will not have a significant impact on the government contractor community.

▶COMMERCIAL ITEM TEST PROGRAM

Many small businesses have been involved with the Commercial Item Test Program under FAR Part 13.5. The test program authorized contracting officers to use simplified acquisition procedures for the acquisition of certain commercial items that exceeded the simplified acquisition threshold ($100,000), but did not exceed $6.5 million. The ceiling for the acquisition of items falling under FAR 13.500(e) is $12 million. In either case, the final rule announced in FAR Case 2013-007 extended the Commercial Item Test Program to Jan. 1, 2015.

▶ASBCA DECISION GOES AGAINST THE GOVERNMENT

In a decision of the Armed Services Board of Contract Appeals (ABCA) announced on Feb. 26, a claim by the government against a contractor was dismissed for being

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REGULATORY UPDATES

untimely under the Contract Disputes Act (CDA) (*Raytheon Missile Systems*, ASBCA No. 58011, Jan. 28, 2013). In that case, the Navy made a defective pricing claim against Raytheon related to an audit performed by the Defense Contract Audit Agency (DCAA) in 1999. However, DCAA did not issue its audit report to the contracting officer until 2006. The government argued that the time for measuring the six-year limitation under the Contract Disputes Act should be when the contracting officer received the audit report. If so, then the government's claim would be timely. The ASBCA disagreed, however, pointing out that all of the relevant facts about the claim were known to the government in 1999 when DCAA performed the audit. Accordingly, the time to begin measuring the six-year CDA limitation was 1999.

This case was significant because for the first time, the ASBCA held the government to the same time-limit standard applicable to contractors.

▶CERTAIN FOREIGN EXCISE TAXES PROHIBITED

A new statutory cost allowability rule was announced on Feb. 28, 2013 (FAR CASE 2011-011). This rule implemented requirements found in §301 of the Health and Compensation Act of 2010. Specifically, §301 established a 2 percent excise tax on particular federal procurement payments made to certain foreign nationals. The new rule made the costs of that excise tax unallowable. In addition, §301 provided that payments to a foreign contractor to reimburse it for the excise tax were prohibited.

This new rule will have little impact on small businesses because it only applies to foreign nationals in countries that are not a party to an international procurement agreement with the United States. Small businesses operating in the international market, however, need to be aware of this development.

For more information or questions regarding recent regulatory updates, please contact Anthony Kim at 703-752-2784 or via email at askim@bdo.com.

EXECUTIVE COMPENSATION:

Challenges And Best Practices

By Chris Carson, Assurance Services, BDO USA, LLP

While the challenges of compensating your management team predate the Obama administration's call earlier this year to cap the amount of money federal agencies pay to government contracting executives at $200,000 (on par with the amount earned by top career federal employees), it is likely to become more complicated before it is all over.

▶BACKGROUND

Factors affecting executive compensation decisions go beyond the "how much" question and include:

- How to compensate (methods/ types/ allowability)
- Who to compensate (relative compensation)
- When to compensate (stage of company, vesting)

The definition of compensation itself is complex and varied. In addition to salaries and wages (whether paid or deferred), Federal Acquisition Regulation (FAR) 31.205-6 includes "directors' and executive committee members' fees; bonuses, including stock bonuses; incentive awards; employee stock options, stock appreciation rights and stock ownership plans; employee insurance; fringe benefits; contributions to pension, annuity and management employee incentive plans; and allowances for off-site pay, incentive pay, location allowances, hardship pay, severance pay and cost of living differential."

However, the allowability of the compensation costs of government contractor executives is capped by a statute using a benchmark computed annually based on a survey of the median amount of total compensation of highest paid executives of publicly traded U.S. companies with annual sales over $50 million. This benchmark does not limit the amount of compensation that an executive may otherwise receive, but requires the excess to be treated as unallowable (i.e., not recoverable under government contracts). The benchmark for calendar year 2011 is $763,029 (published April 23, 2012). The 2012 benchmark has not yet been published.

It is important to note that this is not a safe harbor as executive compensation is subject to reasonableness tests, as well as additional compensation caps for those government contractors participating in the Small Business Administration's 8(a) Business Development Program and similar programs. Reasonableness of executive compensation is often determined using published surveys that include factors for revenue size, industry, location and performance of the operations managed by the executives being measured.

For example, the Defense Contract Audit Agency (DCAA) currently evaluates reasonableness of the five highest paid executive management positions using a methodology that involves all of the factors listed above per three different published compensation surveys. DCAA then averages the results and adds 10 percent.

Competing priorities of attracting experienced management teams, maintaining cost competitiveness and ensuring adequate cash flow have forced the development of creative compensation choices, such as those based on increases in company share value, while tempering owner/CEO desires to expand the compensation earned in their role as CEO to include amounts that would have been paid as owners (i.e., dividends/distributions). However, there are many companies where these factors have become unbalanced for one reason or another, often at the expense of one or more of these priorities.

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EXECUTIVE COMPENSATION

ANALYSIS

Taking the following steps to manage executive compensation can mean the difference between success and failure:

Conserve and Protect Cash Flow – Adequate cash flow is absolutely critical to a company's growth and success. Yet, too often, excessive CEO/owner compensation as well as distributions, car allowances, loans, personal expenses, etc., plays a significant role when there are cash flow problems. This is your company – invest in it, keep it well-fed and, as it matures; it will pay back far more than you invest in future cash flows. Compensation that is commensurate with your peers' (or lower, if warranted) is an important first step toward ensuring the financial health of your company.

Maximize Cost Recovery – Cost reimbursable and other contracts based on a cost buildup or cost and pricing data provide an opportunity to recover reasonable operating costs. Government contractors, particularly those in the early stages of development, tend to underpay their CEOs and leave "money on the table." Savvy CEOs will evaluate their company's cost structure and price their contracts to maximize cost recovery, even if it means increasing their compensation to reasonable levels. If appropriate, timing differences between compensation payments and contract billings can be accomplished through stockholder loans back to the company but not by deferring the initial payment of the compensation, as this may be deemed unallowable.

Maximize Valuation – Companies are often valued and acquired based on a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA), among other factors. Successful companies use EBITDA and other benchmarks to measure their success against their peers, regardless of any current plans to sell. Any valuation process will include steps to "normalize" EBITDA, including adding back any discretionary expenses such as excessive executive compensation. However, the best practice is to ensure that executive compensation is consistent with the market. This maximizes EBITDA, without creating an add-back situation that is subject to judgment and interpretation. *Remember: each additional dollar of EBITDA adds as much as eight – 10 times that in purchase price.*

Minimize Disallowed Executive Compensation Costs – Be aware of what is considered reasonable compensation for FAR purposes as it applies to your company and manage accordingly. Lack of compliance in this area has resulted in significant disruption of cost recovery and cash flow for many government contractors, long after the expense was incurred. Accounting firms focused primarily on supporting government contractors, such as BDO USA, invest in maintaining the capability to determine and, in the event of a DCAA audit, support, what reasonable compensation is for your particular circumstances.

> ***For example***, a review of one popular published compensation survey found that for government contractors working in the Washington, D.C., metro area providing engineering services (SIC 8711 / NAICS 541330), the mean annual base salary for CEOs (rounded) as $220,000 for contractors with $5 million in revenue, $250,000 with $10 million in revenue, $290,000 with $20 million in revenue and $320,000 with $30 million in revenue. Note that the survey provides salary data not only for the mean, but also the first quartile and third quartile to further refine "reasonable compensation" for those CEO's in less or more successful companies than their peers.

Design and Implement an Incentive Compensation Program that Aligns the Executive Management Team's Goals with that of the Stockholders – The FAR dictates the structure of allowable incentive compensation plans (i.e., "paid or accrued under an agreement entered into in good faith … before the services are rendered or pursuant to an established plan … and the basis for the award is supported"), but not the design. Most government contractors include an incentive compensation plan as an integral part of executive management compensation, but tailor the plan to the goals of the company (e.g., revenue growth, profitability, production, awards). When designed effectively, incentive compensation plans attract and retain a strong executive management team, contribute to the success of the company, and are fully recoverable through the application of the company's indirect rates.

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EXECUTIVE COMPENSATION

Utilize Alternative Compensation Programs to Motivate Executive Compensation Teams While Maximizing Cash Flow – Alternative compensation programs, such as stock option plans and restricted stock, can be effective in motivating your executive management team with little or no impact on cash flow until the stock appreciates or the company is sold. Stock options generally offer to sell a fixed number of shares of company common stock at a price fixed at the then-current fair market value for a fixed number of years, thus providing the option holder the value of any appreciation in the underlying company stock.

> ***For example***, if an option for a share of company stock is worth $10 at grant date and $15 three years later (presumably due, in part, to the option holder's/executive's efforts), then the net increase benefits the option holder upon exercise of the option and subsequent sale of the stock without any expense to the company, other than a typically insignificant non-cash expense. Similarly, restricted stock can be issued to key executives. However, the value and compensation to the executive is the entire share value – original value plus any appreciation – since the executive does not normally pay for the stock. However, restricted stock awards can be designed to vest only upon an event, such as the sale of the company. This results in no expense and no compensation until the event occurs (if it occurs). Further, payment for this expense generally comes out of the sale proceeds under this scenario. However, use of such programs is often limited, as the perceived value is based on the likelihood of an executive's ability to impact share price or drive a successful sale.

Avoid Equity-Based Compensation Programs – Stock Appreciation Rights (SAR), phantom stock and the like pay incentive compensation based on the appreciation of a company's stock, e.g., if the value of a share of a company's stock increases by $1, then $1 is paid as an incentive compensation for each SAR granted. While the expense is recorded like any other incentive compensation plan, amounts determined in this manner are unallowable per the FAR. Such programs may be beneficial under certain, limited circumstances, but many of the programs described above accomplish the same goals while having the benefit of being allowable.

Consider Compensation Limits Set by 8(a) Business Development and Other Set-Aside Programs – Note that many of these programs have their own restrictions on executive compensation that should be taken into account when evaluating the recommendations described above. Failure to comply with these additional restrictions may result in an involuntary termination from the applicable program.

Use Guaranteed Payments in Limited Liability Companies (LLCs) – Amounts paid to owners/members as compensation need to be designated as "guaranteed payments" through the company's operating agreement in order to be recorded as an expense. Otherwise, they are considered draws or distributions. Treatment as an expense is necessary to consider such expenditures as allowable costs.

One final thought – the management team that helps you build a $20 million revenue company may not be the management team that helps you build a $50 million company. Be judicious in your compensation programs, incentivize using longer-term plans that provide benefits incrementally and make sure that you can afford to retire the management team if it's not working out.

If you have questions or concerns about your executive compensation structure, please contact Chris Carson at 703-770-6324 or via email at ccarson@bdo.com and we can help you evaluate or restructure your executive compensation plan improve its effectiveness.

D.C. LOSES TO GOVERNMENT CONTRACTOR IN DEFINITION OF HIGH TECHNOLOGY COMPANY

Late last year, the D.C. Court of Appeals affirmed that BAE Systems Enterprise Systems, Inc. (BAE) qualified for the D.C. franchise tax exemption because it is an eligible Qualified High Technology Company.

A high technology company is eligible for exemption from the District of Columbia corporate franchise tax if it has a sufficient number of employees performing qualifying high technology work at a fixed location in a high-technology zone for a sufficiently long period of time. The company need not exercise "predominant authority, dominion or control" over an office or base of operations to get the exemption as argued by the D.C. Office of Tax and Revenue (OTR). Thus, a company that performed high-technology activities under contract with the federal government at government facilities within a "High Technology Development Zone" was exempt where the government assigned the company's employees specific work areas in its facilities, and the company in turn selected desk and office workspaces for its own employees. The Office of Administrative Hearings correctly concluded that BAE maintained a base of operations in the District, because its employees reported to work daily at locations in the District to provide high technology services to the federal government. The ordinary meaning of the words "maintaining an office . . . or base of operations" does not require BAE to exercise "predominant dominion, control or autonomy" over the office or base of operations, nor has the OTR cited any legal authority that would impose such a requirement. Moreover, the statute can be interpreted as a harmonious whole if "maintaining an office . . . or base of operations" is interpreted more broadly so that it applies when a company is doing business through a substantial number of employees working at a fixed location in a high-technology zone. The legislative history of the exemption is ambiguous, so it does not support either interpretation of the law. The language and structure of the exemption do not support the OTR's narrow interpretation, nor does the doctrine that tax exemptions should be strictly construed require the court to adopt the OTR's interpretation. (D.C. Office of Tax and Revenue v. BAE Systems Enterprise Systems Inc., D.C. Ct. App., Dkt. No. 10-AA-1071, 11/29/2012.)

M&A UPDATE

SEQUESTRATION IS HERE.

UNCERTAINTY AND CAUTION CONTINUE.

THE STOCK MARKET CONTINUES TO CLIMB!?!

After strong M&A activity in the fourth quarter that spilled over into January, we hear many potential buyers talking about transactions, though not jumping to sign Letters of Intent (LOIs). We also see potential sellers eager to understand today's market valuations for their business, though not ready to fully commit to a sales process. In our experience serving both buyers and sellers, the current M&A market understandably lacks a sense of urgency to execute the deal as both sides are updating their analyses of the short-term and long-term impacts of sequestration and various contingency plans.

Potential buyers are continuing to look at accretive opportunities as valuations decline but are wary of paying too much. They continue to spend considerable time diligencing contracts, funding sources and quality of backlog. In the quality of earnings, consideration is given to the Lowest Priced Technically Acceptable (LPTA) environment. In the net worth capital analysis, buyers question the possible impact of delays in processing payments.

Potential sellers continue to consider carve-outs and are preparing themselves for longer sales processes. They are spending additional resources on the front end, to show transparency in the cashflows and certainty in the contract funding. As private equity continues to be active in this space, sellers are considering the pros and cons of selling to a strategic or financial buyer.

The impact of today's environment is that we see: (i) smaller transactions are getting completed at a higher success rate than larger transactions; (ii) longer M&A processes with increased focus on contract diligence and the forecasted periods; and (iii) earnouts are more prevalent to bridge the gap between buyer and seller valuations.

HOW DOES D.C.'S NEW TECHNOLOGY ACT AFFECT QUALIFIED HIGH TECHNOLOGY COMPANIES?

By Jeffrey Schragg, Tax Partner and Jeremy Migliara, Senior Tax Director, BDO USA, LLP

The District of Columbia recently passed the Technology Sector Enhancement Act of 2012 ("Act"). This Act changed the tax treatment of Qualified High Technology Companies ("QHTCs") in several key areas, including a change in the qualification requirements of a QHTC, the establishment of a tax exemption limit of $15 million for each QHTC, and the expansion of certain tax benefits applicable to all QHTCs located in the District.

For the tax year beginning after Dec. 31, 2000, the District has provided certain tax benefits to QHTCs. A QHTC is subject to a reduced D.C. Franchise tax rate of 6 percent, as opposed to the regular rate of 9.975 percent. In addition, if a QHTC is located in a designated "High Technology Development Zone," the taxpayer is exempt from the franchise tax for five years after the QHTC commenced business in that zone.

The Act makes several changes to the tax treatment of QHTCs.

- The Act changes the qualifications of QHTCs in the District:
  - The prior law required that a QHTC derive "at least 51 percent of its gross revenue" from engaging in certain qualifying activities. The Act amended this definition to read "a QHTC derive at least 51 percent of its gross revenues *earned in the District*" from qualifying activities.
  - The Act also changed a qualifying requirement of QHTC by limiting eligibility for QHTC status to companies that have two or more employees *in the District*. The prior law stated that companies with "two or more employees" could qualify regardless of the employment location of the employees.

- The Act eliminated the requirement that a company must be located in the designated High Technology Zone to receive certain QHTC tax benefits. Therefore, all QHTCs located in the District are now exempt from business franchise tax for five years after the date that the company has taxable income. However, the exemption is limited to $15 million per QHTC.

- The Act removes the exclusion from tax for capital gain from the sale of a QHTC. Beginning Jan. 1, 2013, capital gain from the sale of common or preferred shares of a QHTC is subject to 3 percent tax, provided that (1) shares of the QHTC were held by the investor for at least 24 continuous months; and (2) the QHTC was headquartered in the District on the date of sale. Under the prior law, capital gains from the sale or exchange of QHTC was excluded from gross income if held for more than five years.

Please be aware that the franchise tax rates (6 percent for QHTCs and 9.975 percent for all other businesses) remain unchanged. In addition, certain tax credits remain unchanged, including credits for the cost of retraining qualified disadvantaged employees, wages paid by a corporation to qualified disadvantaged employees, wages paid by a corporation to qualified employees for the first two years, and reimbursement payments made by corporations for employee relocation costs.

Companies operating in the District of Columbia, including those already certified as QHTCs, should evaluate the effect these changes may have on the availability of tax benefits under the QHTC program.

Should you have questions about how the changes under this act may affect your company, please contact either Jeffrey Schragg, Tax Partner at 703-770-6313 (jschragg@bdo.com) or Jeremy Migliara, Senior Tax Director, State and Local Tax at 703-770-0596 (jmigliara@bdo.com).

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