

11-1970

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Margaret M. Worthington

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Recommended Citation

Worthington, Margaret M. (1970) "Small Business and Government Contracts," *Woman C.P.A.*: Vol. 32 : Iss. 6 , Article 3.

Available at: <https://egrove.olemiss.edu/wcpa/vol32/iss6/3>

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SMALL BUSINESS AND GOVERNMENT CONTRACTS

The author reminds us that small business firms often produce goods and services for the government and points out how the government reviews cost records for reasonableness.

Margaret M. Worthington
Burbank, California

As a result of the continued government demand for supplies and services, government contracts are playing an ever increasing role in our national economy. Government contracting affects not only the giants of industry but small business as well.

For the purpose of government procurements, a small business concern is defined as one that is independently owned and operated, is not dominant in the field of operation in which it is bidding on government contracts, and can further qualify (with its affiliates) under the criteria concerning sales volume or number of employees established for each industry. A small business concern can be any form of business organization—a corporation, individual proprietorship, partnership, or joint venture. A business enterprise which meets all of these requirements can be certified as a small business concern for the purpose of government procurements.

The government is interested in assuring that small business is awarded a fair share of government work either under subcontracts or prime contracts. Government contracts and subcontracts under government prime contracts are awarded in one of two ways: formal advertising or negotiation. Under formal advertising, bids are solicited from a sufficient number of qualified sources in order to provide for free competition in prices. Normally, materiel procured by formal advertising (bids) is used by industry and the general public as well as the government—what could be called “off the shelf” items. The prices are established by supply and demand and are quoted the same for both industry and government.

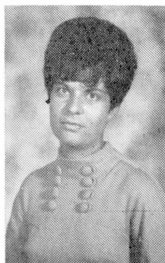
The second type of procurement is by negotiation. Materiel purchased by this type of

contracting represents items made to specifications supplied by the government or prime contractor. Since this type of materiel is not in common use, the price quotes submitted by the prospective contractor (or subcontractor) are supported by statements and analysis of estimated costs or other evidence of the reasonableness of the prices.

NEGOTIATED CONTRACTS

Contractors submitting proposals to the government for a negotiated procurement in excess of \$100,000 are required, in accordance with the Armed Services Procurement Regulations and Public Law 87-653, to submit cost or pricing data and to certify that the data are accurate, complete, and current as of the date of contract negotiation. The purpose of this law is to foster truth in negotiations by having the seller make complete disclosure of the basis for his proposal. Form DD 633, which is the standard form for the submission of cost proposals to the government, states that the contractor is to identify the data that is verifiable and factual. In addition, he must submit information explaining his estimating process, including the judgmental factors he applied, the methods he used to project estimates from known values, and the contingencies which he included in the proposed costs. This requirement places a good deal of responsibility upon the contractor for establishing and maintaining sound estimating procedures.

The government negotiating team, headed by the contracting officer, and including a price analyst, contract auditor, and technical specialist, evaluates the proposal using the techniques of price analysis and cost analysis. Price analysis is used on every procurement



MARGARET M. WORTHINGTON is a Senior Auditor with the Defense Control Audit Agency. In addition to her auditing duties, Miss Worthington also heads the Advanced Audit Techniques program in her office and is responsible for training and assisting audit personnel in such techniques as statistical sampling, correlation analysis, and time-shared computer programs.

Miss Worthington, a graduate of UCLA School of Business Administration, is Vice President of the Los Angeles Chapter of ASWA and serves as treasurer of her church. She passed the May 1967 CPA exam.

and refers to the process of comparing the proposed price with other prices, such as the price offered by another supplier, the price of a similar product, or the price negotiated on the prior year's procurement of the same item.

Cost analysis is used by the government team in conjunction with price analysis on all procurements over \$100,000 where price competition is not adequate. Cost analysis is the evaluation of the individual cost elements (including backup cost and pricing data and all the factors used by the contractor in developing his estimate of costs) which comprise the contractor's proposal. Cost analysis is normally performed by government contract cost auditors using generally accepted auditing techniques.

GOVERNMENT REVIEW

A topic of particular interest to a small business concern contemplating entrance into the field of government contracting is the extent and types of government reviews and audits to which he will be subjected.

A small businessman's initial introduction to the government auditor will take place probably at the pre-award survey. This survey is performed at the specific request of the contracting officer prior to the award of the contract. The purposes of the survey, from an audit standpoint, are to gain general information about the organization and operation of the firm and to determine the adequacy of the cost accounting system for the accumulation and identification of costs under government contracts. There are many different cost accounting systems, with varying degrees of complexity, which can be considered adequate. The cost accounting system should provide the means of measuring the reasonableness of incurred costs, particularly since the system is a major source for data used in the preparation of proposals.

Audits of incurred costs are required for all cost reimbursement type contracts. Cost reimbursement type contracts establish the estimated total cost at the time of contract award in order to obligate government funds and to establish a cost ceiling which the contractor may not exceed without advance notification to the government. Contracts of this type are used primarily on research and development effort. This involves an audit not only of direct charges to the contract, but also of the indirect expense pools, such as manufacturing overhead and general and administrative expenses, which are allocated on some basis to the direct cost input. Section XV of the Armed Services Procurement Regulations establishes general principles for the deter-

mination of allowable costs under cost reimbursement contracts.

Under the provisions of Section XV, certain cost elements, such as interest expense, donations, and entertainment expenses, are not considered allowable under government cost type contracts. Individual items of cost not specifically unallowable, such as those listed above, are evaluated on the basis of reasonableness, allocability, the application of generally accepted accounting principles, and the specific contract terms. A cost is considered reasonable if it doesn't exceed an amount which would be incurred by an ordinarily prudent businessman in the conduct of competitive business. In determining what is reasonable, consideration is given to:

1. whether the cost is generally recognized as ordinary and necessary,
2. the restraints imposed by such factors as sound business practices and arm's length bargaining,
3. the action that a prudent businessman would take in the circumstances, considering his responsibilities to the owners, employees, and customers of the business and to the government and public at large, and
4. whether significant deviations from the established practices of the contractor have resulted in substantial increases in contract costs.

A cost is considered allocable to government work if: it is incurred specifically for a government contract, such as a direct labor charge; it benefits both government contracts and commercial work, such as employee benefits expense; it is necessary to the overall operation of the business, such as help wanted advertising.

An integral part of the ability of the Department of Defense to maintain flexibility in military procurements and to obtain the maximum use of procurement funds is its ability to terminate contracts for the convenience of the government. A standard clause is inserted in every government contract which reserves the government the right to terminate the contract. When a contract is terminated for the convenience of the government, the contractor is entitled to reimbursement for his costs incurred to date on the terminated portion, a reasonable profit for work performed, and settlement expenses incurred in the preparation of the termination claim. The contracting officer submits all prime contractor termination claim proposals over \$2,500 to the Defense Contract Audit Agency for appropriate

examination. The auditor's review will include a review of the contract terms, a verification of the termination inventories, and a determination that only items allocable to the terminated portion of the contract are included in the claim.

The last area of audit review to be included in this discussion is the post award review. The present defective pricing clause which is being inserted in defense contracts is the result of Public Law 87-653, passed in 1962. This law, commonly known as the "Truth in Negotiations" Law, was enacted to give the government a legal right to adjust a contract price when that price was based on inaccurate, incomplete, or noncurrent cost or pricing data. The objective of the post-award review is to make a factual determination that all information or data available to the contractor at the date of negotiation was either properly or improperly reflected by cost element.

CONCLUSION

The small business enterprise which relies in whole or in part upon government contracts or subcontracts under government procurement for its revenues must accept the responsibilities and conditions of government contracting. However, the prudent businessman will find that the opportunities and rewards which can be achieved in government contracting, as a result of proper management, good cost controls, and sound estimating procedures, make it all worthwhile.

The information in this article has been based on material from *Armed Services Procurement Regulations*, Sections I, II, III, XV, 1969 and Department of Defense, *Armed Services Procurement Regulations Manual for Contract Pricing*, 1969.

THEORY AND PRACTICE

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that if estimates change, the unamortized cost should be allocated over the revised useful life. It also provides that if estimation of value and future benefits indicate that the unamortized cost should be reduced significantly that the deduction should be included as an extraordinary item in the determination of net income.

As to "negative goodwill," the opinion provides that it be used to reduce the value assigned to noncurrent assets acquired (except long-term investments in marketable securities) and that any balance be recorded as a deferred credit and amortized systematically to

income over the period estimated to be benefited but not in excess of forty years. A deferred credit should not be recorded unless the noncurrent assets, as defined, are reduced to zero. No part of it should be added to stockholders' equity at date of acquisition.

The opinion also provides that goodwill previously recorded by an acquired company should not be carried forward.

TAX FORUM

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not be able to use the alternative tax computation on capital gains nor the 50% maximum tax on earned income computation. Taxpayers receiving lump sum distributions from employee benefit plans will not be able to compute the ordinary income portion under Section 72, which would result in double averaging benefits.

Those taxpayers who were married or divorced during the four preceding years which will be used in the base period for the income averaging will need to reconstruct the base period income. Thus, marriage and divorce continue to have more tax implications than romantic implications in our modern world.

Increase in the standard deduction

Accelerating itemized deductions in 1970 may prove to be beneficial to some taxpayers in view of the increase in the standard deduction beginning in 1971. This increase will take place over the next three years as follows:

<i>Year</i>	<i>Rate</i>	<i>Ceiling</i>
1971	13%	\$1500
1972	14%	\$2000
1973	15%	\$2000

Decrease in rates for single taxpayers

Single taxpayers and heads of households get a break in tax rates starting in 1971; by 1972 single taxpayers will pay tax which will not exceed 120 percent of the tax that would be paid on the same taxable income on a joint return. The head-of-household rates fall halfway between the joint return rates and the new single rates. This group of taxpayers will find it advantageous to defer any noncapital income they can to 1971 and 1972, as they will be benefiting not only from the reduction in rates but also from end of the surcharge which is still with us in 1970. Married couples filing separate returns will no longer look to the single rate schedules to compute their taxes, but now have their own special schedule.