



Government Contracting Today

ACCOUNTING AND FINANCIAL NEWS

RESPONSIBILITY FOR OVERSIGHT

By K. D. "Ken" Bricker, CPA, DABFA, Senior Partner, Goodman & Company, LLP, Government Contracting Industry Specialization Group

In accordance with *Federal Acquisition Regulation (FAR) Part 42, Contract Administration and Audit Services*, at 42.003(a) "For contractors other than educational institutions and nonprofit organizations, the cognizant Federal agency normally will be the agency with the largest dollar amount of **negotiated** (emphasis added) contracts, including options." Cognizance in this case refers to the responsibility for general contract administration and audit of a government contractor. The list of responsibilities covered in Subpart 42.3 is voluminous and the FAR attempts to alleviate duplication of these responsibilities by identifying the "cognizant" agency. Unfortunately, this is not always the case and multiple agencies and / or multiple commands within an agency see fit to assert audit "rights" over a government contractor. This can be a particular problem when those agencies or commands take differing positions dependent upon what they consider to be most beneficial

to the contract or funding for which they are responsible as opposed to what is the most correct.

A contractor's goal should always be to assure they are administering, (which includes estimating, accumulating and reporting costs) within the guidelines of the FAR and in compliance with all of their contracts. While the Procuring Contracting Officer (PCO) is responsible for the content of a given contract, typically an Administrative Contracting Officer (ACO) is assigned responsibility for a **contractor** and the administration of any contracts they may hold. Accordingly, if the cognizant agency is the Department of Defense (DoD), the Defense Contract Management Agency **should** act as the Contract Administration Office (CAO). The assigned ACO is then responsible for assuring that the contractor meets their obligations to have an adequate accounting system and that the contractor provides timely incurred

cost submissions to the cognizant auditor as well as many other administrative functions required by the FAR and likely included in the contracts.

Administration and audit cognizance should then be easy to determine based upon this simple guidance included in FAR Part 42. However, who is cognizant if the contractor acts as a subcontractor and has no prime contracts directly with a government agency or if the "**largest dollar amount of negotiated contracts**" is with a prime contractor? The government does not have privity of contract in a prime / subcontractor relationship. As stated previously, the intent of the FAR at 42.002(a) is to "avoid duplicate audits, reviews, inspections, and examinations of contractor or subcontractors." Accordingly, many contractors have experienced the issue of a requirement in a solicitation to have a "government approved" or "DCAA approved" accounting system.

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LETTER FROM THE EDITOR | GREGG N. FUNKHOUSER, CPA

75TH ANNIVERSARY

Goodman & Company is proud to celebrate 75 years of providing accounting, tax and business solutions to our clients. Founded in Norfolk in 1932 by M. Lu Goodman, the firm has grown rapidly throughout Virginia and has expanded the practice into Maryland and the District. Much of the firm's growth is contributed to the firm's commitment to industry specialization groups such as the government contracting practice. We have found that committing personnel and resources to specific industry groups allows us to offer consulting support and resources to our growing businesses outside of the normal accounting and tax expected of CPA's. The firm's commitment to industry specialization groups includes auto dealerships, construction, financial institutions, foreign taxes,

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Sure, it's our 75th anniversary. But it's what we see in the next Seventy-five that really makes us want to celebrate.



At Goodman and Company, we're celebrating our 75th year as one of the region's largest and most successful Certified Public Accounting firms. We are also celebrating the success of our clients, to whom we provide everything from traditional auditing and accounting services, to guidance in tax planning and preparation, business consulting, accounting software selection, business valuation, human resources, and so much more. We are looking to the future, by investing in the next generation of accountants with a Quarter Million Dollar pledge to colleges and universities in the region. And we are the sponsor of the Goodman Accounting Challenge, an interactive collegiate competition for accounting majors.

So while we're proud of the first 75, we can't wait to see what's next.

S CORPORATION SHAREHOLDER HEALTH INSURANCE – IS YOUR PREMIUM DEDUCTIBLE?

By Peter Stratos & Melinda Davis, Goodman & Company, LLP

If you or your spouse is a shareholder in an S corporation and own 2% or more of the corporation's stock, you may be able to deduct the amount of the health insurance premiums paid for you and your spouse on your personal income tax return. However, there are some specific procedures that must be followed to obtain this benefit.

Background. Accident and health insurance premiums paid or furnished by an S corporation on behalf of its 2% shareholders in consideration for services rendered are treated for income tax purposes like partnership guaranteed payments. This allows the S corporation to deduct the cost of such employee fringe benefits as long as the shareholder-employee includes the amount in their gross income reported on Form W-2.

However, the IRS stated in a 2006 information release that unlike a self-employed individual, a 2% shareholder in an S corporation could not purchase health insurance in their own name and treat the amount as deductible on their personal income tax return.

In addition, the deduction isn't available to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer.

Eased position. The new Notice 2008-01 from the IRS has eased these requirements slightly and allows the deduction if: (1) the corporation makes the premium payments for the health insurance policy covering the 2% shareholder-employee (and his spouse or dependents, if applicable) in the current tax year; or (2) the 2% shareholder makes the premium payments and furnishes proof of payment to the corporation and it then reimburses him.

If the health insurance premiums are not paid or reimbursed by the S corporation and included in the 2% shareholder-employee's gross income, a plan providing medical care coverage for the 2% shareholder-employee is not established by the S corporation and he is not allowed the Code Sec. 162(l) deduction.

The IRS illustrates this in four examples. The examples assume that each shareholder is a 2% shareholder-employee in an



S corporation, whose earned income from the S corporation exceeds the amount of the premiums for the health insurance policies covering the shareholder, his/her spouse and dependents. No shareholder is eligible to participate in any subsidized health plan maintained by an employer of the shareholder or his/her spouse. All examples involve tax year 2008.

ILLUSTRATION 1: Shareholder Andy obtains a health insurance policy in his name and pays the premium on the policy. The S corporation makes no payments or reimbursements with respect to the premiums. Result: A plan providing medical care for Andy is not established by the S corporation and he may not deduct the premiums under Code Sec. 162(l).

ILLUSTRATION 2: The S corporation obtains a health insurance plan in its name. The plan provides coverage for shareholder Betty, her spouse and dependents. The S corporation pays all premiums and reports them as wages on Betty's Form W-2 for 2008 and she reports them as gross income on Form 1040 for 2008. Result: A plan providing medical care for Betty has been established by the S cor-

poration and she may take the Code Sec. 162(l) deduction for 2008.

ILLUSTRATION 3: Shareholder Carl obtains a health insurance policy in his name. The S corporation pays all premiums and reports them as wages on shareholder Carl's Form W-2 for 2008. Carl reports them as gross income on his Form 1040 for 2008. Result: A plan providing medical care for Carl has been established by the S corporation and he may take the Code Sec. 162(l) deduction for 2008.

ILLUSTRATION 4: Shareholder Donna obtains a health insurance policy in her name. She pays the premiums and furnishes proof of payment to the S corporation, which reimburses her for the payments. The S corporation reports the amount of the premium reimbursements as wages on shareholder Donna's Form W-2 for 2008 and she reports them as gross income on Form 1040 for 2008. Result: A plan providing medical care for Donna has been established by the S corporation and she may take the Code Sec. 162(l) deduction for 2008. ■



If you did not know in advance that the accounting rules were changing for stock options, you found out the hard way during your 2006 year-end Company audit. As of January 1, 2006, all calendar year-end companies, public and non-public alike, were required to account for their stock options under Statement of Financial Accounting Standards 123(R) (As Amended) – Share-Based Payment (SFAS 123(R)). Under the revised guidelines, any services or goods a company receives in exchange for equity based instruments, with few exceptions, needs to be measured and accounted for at its fair value, meaning the Company's income statement is going to be affected. Gone were the good old days of issuing stock options at grant date fair value (i.e. no impact to the Company's profit and loss). Instead, companies found themselves impacting their bottom line for options they had issued years before as many smaller companies had not effectively anticipated the change by speaking with their accountant before the clock struck midnight on December 31, 2005. Well, the past is the past, and instead of lamenting over your prior grants of stock options, the time is here to look into the future to decide how you are going to handle coming issuances.

To fair value an option, assumptions need to be made by management as of the options' grant date. These assumptions pertain to the strike price of the option, the current market price of the stock, the expected length of time an employee is going to hold an option before exercising, how volatile the Company's stock has been in the past (and what you anticipate it will be in the future), a risk-free interest rate and future expected dividends. These assumptions feed into a fair value pricing

model and produce the Company's per share option expense to be applied ratably over the vesting period. Now, I have made this sound terribly easy, have I not? Yet, for those of you who have had to defend your assumptions to your auditor, you know this is not the case, especially for non-public companies. Take for example, the current market price of the Company's stock. What is that share of stock really worth? Without a recent valuation of your business, you may not truly know. It is not as easy as taking your equity and dividing by the number of outstanding shares. And volatility...companies are no longer able to claim a zero volatility assumption under SFAS 123(R), but if a non-public company does not have at least 12 pricing points (stock values) during the year, enough data does not exist to properly predict volatility.

You may be wondering at this point why the auditors would ever care about the assumptions at which you arrived. Simply put, the assumptions drive the price of the option issued up or down, meaning this is an area where profit manipulation can occur if false or unjust assumptions are used, and everyone knows, auditors do not like words like "manipulation" or "false assumptions" (auditors are funny that way). For example, say a company issued 500,000 options with the following assumptions on the grant date: strike price \$5.00, fair value of stock on date of grant \$5.00, risk-free interest rate 5.5%, volatility 10%, dividend yield \$0, and expected life of option 5 years. The fair value of each option issued using the above assumptions is \$1.2504 or \$625,200 for the issuance to be expensed over the vesting period. Now, changing one assumption, say volatility, from 10% to 40% increases the price

to \$2.1794 per share or \$1,089,700 for the issuance. Changing the life of the expected option from 5 to 10 years for that last example pushes the share price to \$3.07 or \$1,535,000. So, by changing just two assumptions, the impact to the bottom line was changed by over \$900,000.

Now, manipulating assumptions is not something anyone reading this article would do; however, being savvy business people using information to your advantage, well that is a whole different scenario. Prior to finalizing any option deal, calculate the fair values by using various values in the assumption you can control to a certain degree – expected life. In the above example, changing the expected life from 10 years to 5 years reduced the impact to the bottom line by \$445,300 (at 40% volatility). Vesting periods can also help reduce the annual impact to the income statement. Remember, you spread the fair value of the issuance ratably over the vesting period. Spreading \$1,089,700 over 3 years is much less disruptive to those P&L figures than doing so over 1 year. Issuing options when the stock is less volatile or risk-free interest rates are lower will also help to lessen the impact.

Lastly, and most importantly, get your accountant involved before finalizing any option deal. SFAS 123(R) has many twists and turns hidden in its 193 pages of riveting reading (that does include appendices). Your accountant can review the language for accounting implications while your attorney can review for legal issues. By doing this, you should eliminate any last minute surprises come audit time, and that should make everyone happy, auditors included. ■

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Mr. David Collins	Government and Nonprofits
Ms. Caron Crouse	Government and Nonprofits
Mr. Gregg Funkhouser	Government and Nonprofits
Ms. Sharon McMichael	Government and Nonprofits
Mr. Michael Norton	Government and Nonprofits
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Mr. Scott Brezler	Assurance Services
Mr. Patrick Callahan	Business Valuation/Litigation
Mr. Gregory Lawson	Business Valuation/Litigation
Mr. David Rippy	Business Valuation/Litigation
Mr. Harry Schwarz	Business Valuation/Litigation
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Mr. Charles Dietz	Small Business Consulting
Mr. Jeffry Karr	Small Business Consulting
Ms. Maria Negron	Small Business Consulting
Ms. Erin Grant	Young CPAs
Mr. Gary Romer	Young CPAs



Robert has over 27 years experience with the DCAA as an auditor, audit supervisor, and technical specialist. For the past 10 years he specialized in Cost Accounting Standards (CAS) and claims, and provided technical guidance and review services to the audit staff related to both CAS and FAR issues. He has been a witness in ASBCA cases, a participant in ADR cases, and has provided litigation support. ■

FRANCHAUN B. PAYNE-ARMSTEAD HAS JOINED OUR TEAM

As a Recruiter and HR Consultant in Government Contract Consulting Services



Franchaun is a diversified HR professional with over 20 years experience in all facets of human resources including recruiting, employee relations, strategic planning, employee benefit planning administration, compensation, training and development and regulatory compliance issues. Most recently, she has served as an HR Director and Senior Technical Recruiter for several major government contractors in the Metropolitan D.C. area. Franchaun is a member of the Society of Human Resource Management and is pursuing the Professional in Human Resources (PHR) certification. ■

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SUCCESSFUL HIRING AND SUCCESSFUL RETENTION: ONCE WE FIND OUR PEOPLE, HOW SHOULD WE PAY THEM?

By Alan Luba, Director, Human Resources Management Consulting, Goodman & Company, LLP



There is no disputing that successful retention of our best employees starts at the beginning: planning for the recruiting process. We suggest that the best recruiting processes begin with a thorough understanding by those involved in the process and in the final decision making about exactly what the job requires.

There are several reasons for this, some obvious, some not so obvious:

- Understanding of the job responsibilities and requirements must be a consensus among everyone who will be involved in recruiting, selecting, and ultimately supervising the new employee
- This consensus promotes clear communication about the job, to recruiting resources inside and outside of the organization, for recruitment advertising, and to candidates
- Consensus eliminates the mixed messages regarding responsibilities and accountabilities that doom far too many hires to failure

The successful hiring and retention process starts with the team designated for finding candidates and deciding on the hire. This team should consider several areas, which we can summarize as “Top Ten” lists (well, there may not be ten items in each list, but we focus on the things that are most important!):

CORPORATE CULTURE:

- What makes this a good place to work?
- Corporate Values
- Words to Describe the Corporate Culture
- Technical Challenges for the Job
- Human Resources Challenges for the Job

WHO IS THE PERSON THAT WE WANT FOR THIS POSITION?

- Technical Skills the Person Should Have
- Desired Personal Characteristics
- Personal Values
- Education
- Experience Type
- Experience Amount
- Special Skills
- Special Knowledge

JOB REQUIREMENTS:

- Describe the job
- Will the employee supervise others?
- What is the overall goal of this job?
- Who are the job’s customers?
- To whom will the employee report?
- With whom will the employee interact, inside and outside of the organization?
- What type of temperament will work best in this environment?

Finally,

THE SELECTION PROCESS:

- Follow-Up Meeting for all Participants
- Decision Authority
- Communication with Candidate
- Authorization to Make Offer

A formal, structured process not only facilitates the decision, but announces to candidates that we know what we are doing, and are a strong employer. The above points may seem basic, and that’s true. However, more hires are unsuccessful because the basics are not part of the process.

Now that we have successfully hired the right person for the job, how will we keep that person as a satisfied, productive employee?

Here, we will look at one of the many requirements on management and especially on HR departments to achieve this goal: Compensation.

Even that can be a basic process: If our pay is competitive or better than our labor market competition, pay should not be a retention issue. We can determine this and make necessary annual adjustments using any of several tools. In this case, we will address the *compa ratio*.

The *compa ratio* is the ratio of our actual pay, by position, to the mid-point, or median, of the pay range for similar positions within our labor market. It’s a fairly simple computation, but requires somewhat sophisticated data gathering. We recommend that employers conduct, or contract for, an annual compensation survey of their positions in their labor markets. The surveys may use any of the excellent commercially available survey tools or may be a more focused survey of several competitors (although this last method can be time consuming, expensive, and, ultimately, less accurate than quality “off the shelf” resources).

Once the survey results are available, the employer can compare the organization’s pay by position to the median/mid-points for the survey positions. General practices look for close correlation between actual pay and survey mid-points (as close to 1:1 as possible). The employer then can determine at what point along the range it is desirable to establish pay benchmarks for each position.

This, in turn, helps the employer determine the relationship to the marketplace its pay should take. It facilitates pay negotiation and communicates a clear picture of how the employer values each position in relationship to the marketplace. If the employer values a position at a rate higher than the market, the *compa ratio* is a benchmark for understanding how to determine appropriate pay.

As an attraction and retention tool, a *compa ratio* study provides empirical data on how well the employer pays in relationship to the marketplace. ■

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The agency that has released the solicitation refuses to request that DCAA perform a pre-award accounting system survey and DCAA refuses to perform such a survey at the request of a contractor (particularly if they have only subcontracts). The government has effectively made the prime contractor the cognizant agency. This is most likely appropriate when the government does not have privity of contract anyway. In many cases (e.g. incentive fee contracts), the government places responsibility for subcontract administrative oversight on the prime contract as well.

Another area where we see this issue is when a subcontractor has auditable cost reimbursable contracts. The prime contractor has flowed down the clause at FAR 52.216-7 "Allowable Cost and Payment" but the subcontractor does not have any auditable contracts directly with the government. Again, the government therefore does not have any privity of contract. Who is responsible for performing the incurred cost audit? The experience of many government contractors has been different here than in the case of the accounting system surveys. Many DCAA offices are more than willing to perform incurred cost audits of subcontractors even if the government does not have privity of the contracts to which the audits apply. Additionally, recent experience has shown that the government and the courts will disallow subcontractor costs incurred by a prime if they have not been audited. DCAA's typically does not have the resources to audit in a manner as timely as the prime may. However, getting DCAA (and therefore the cognizant contracting officer) to rely on an audit performed by a prime, or even an independent professional auditor may be difficult.

The bottom line is that it is the responsibility of the contractor (prime and / or sub) to assure that if the government does not take the appropriate responsibility, the contractor should. In some cases, even if the government does accept the responsibility, it may be in the best interest of all concerned for the prime to garner that responsibility as well. ■



13TH ANNUAL GOVERNMENT CONTRACTING UPDATE

DC Metro Seminar

Date

Thursday, October 23, 2008

Time

8:00 a.m. – 5 p.m.

Location

Sheraton Premiere at Tysons Corner
Conference Theater
8661 Leesburg Pike
Vienna, VA 22182

Hampton Roads Seminar

Date

Wednesday, November 5, 2008

Time

8:00 a.m. – 5 p.m.

Location

The Westin at Virginia Beach Town Center
4535 Commerce Street
Virginia Beach, VA 23462

CIRCULAR 230 DISCLOSURE

The following disclosure is required pursuant to IRS Circular 230 and applicable state and local tax provisions, the regulations that govern the practice of tax advisors. Any advice concerning Federal, state and local tax issues contained in this written communication (and any attachments) has not been written nor is it intended by the author or Goodman & Company, L.L.P. to be used, and cannot be used, for the purpose of (i) avoiding federal, state or local tax penalties that may be imposed by the Internal Revenue Service or applicable state or local tax provisions, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. If a formal covered opinion intended to provide such protection is desired, please contact us to discuss the issues and costs involved in preparation of such a covered opinion. ■



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LETTER FROM THE EDITOR

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health care, municipal and government, not for profits, real estate, human resources, pension plans and recruiting. I look forward to our continued growth and development of additional resources as we continue forward.

ANNUAL GOVERNMENT CONTRACTING UPDATE

Reserve October 23rd on your calendar for the 13th Annual Government Contracting Update which will be held at the Sheraton Premiere at Tysons Corner. We have outgrown our previous spot and will cap attendance at 100 for this year's seminar so sign up early! We are planning an additional Update in the Hampton Roads region on November 5th at The Westin at Virginia Beach Town Center. Details on both seminars will be in our next publication as well as in email reminders. If you know of someone who should be receiving this publication, please have them email jcalabrese@goodmanco.com to be added to our mailing list.

SUPER CPA'S

Thirty one of our partners were nominated and elected by their peers as Super CPA's in the state of Virginia, as noted in the November issue of *Virginia Business Magazine*, including four from the Government Contracting Industry Specialization Group. Myself, Scott Brezler, Ken Bricker and Sharon McMichael are proud to represent our Government Contracting Industry Specialization Group as Super CPA's.

GOVERNMENT CONTRACT RECRUITING

Our consulting practice has expanded to include assistance in hiring technical personnel for government contractors. Franchaun (see brief bio) has joined our consulting practice and brings experience in technical recruiting for government contracting clients. Franchaun recruits extensively for cleared positions. If you would like to have more information regarding our recruiting capabilities please contact Alan Luba at aluba@goodmanco.com. ■



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