All this writing about possible impacts of sequestration cuts got us thinking about the recent penchant of DCAA auditors to question the costs of contractors' facilities. Let's take a sec to explain our thought process, and to walk through how we get from sequestration to unallowable facilities costs.

If The Powers That Be don't get their acts together soon, we may have to deal with "reductions in force" (RIFs)—also known as layoffs. Program stretch-outs and delays and terminations are going to lead, inevitably, to workforce "adjustments". Naturally, everyone's focus has been on that obvious and most immediate impact. For those who are laid-off, it's a tragedy. It's still stressful even for those who survive. We don't want to gloss over the employment situation; we just don't want to focus on it.

Instead, we want to focus on another, less obvious, impact from sequestration cuts: *contractor s will need less facility space*
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As funding cuts impact programs, there will be a reduced need for manufacturing and assembly space. Expect less need for warehouse space. Clean room and SCIF needs will come down, as well. But we suspect the biggest impact will be seen in the need for office space. As indirect heads are cut, we expect contractors will experience floors of abandoned cubicle warrens and corridors of uninhabited executive office suites. We predict contractors will have lots and lots of empty office space to deal with.

It's almost inevitable, really. Regardless of whether or not sequestration cuts take place, the fact of the matter is that the United States is coming off of a decade-long defense and homeland security spending spree. Cut-backs are destined to happen; sequestration only accelerates the process. So no matter what happens, contractors will need to manage—*and downsize*—their facilities as they downsize their workforces.

If the affected buildings are owned, then there's not much to do except to try to sublease or sell. But if the affected buildings are leased, then there are more options to consider. The point is that contractors need to do something. A failure to address excess facility space may very well lead to DCAA auditors questioning a large amount of costs as being unallowable.

Unallowable? Whatever might we mean? How can facility costs be questioned as being unallowable? Well, let's start with the Cost Principle at 31.205-17, which discusses the cost of "idle facilities and idle capacity."

The first thing we noticed is that the definition of facilities costs encompasses more than just the costs of paying the lease or the mortgage. The Cost Principle states that the term includes such costs as "maintenance, repair, housing, rent, and other related costs; *e.g.,* property taxes, insurance, and depreciation." So if DCAA auditors question facility costs, then (potentially) there is a large pot of dollars at stake.

We were surprised to read that the term "facilities" is also broadly defined by the Cost Principle. "Facilities" means "plant or any portion thereof (including land integral to the operation), equipment, individually or collectively, *or any other tangible capital asset*, wherever located, and whether owned or leased by the contractor." See that part we italicized? That's scary, isn't it? Your facilities include your tangible capital assets, such as test equipment, tooling, dies, and all that expensive machinery.

Did we say that there was a large pot at stake? Yeah, now we're saying it's a *huge* pot at stake. *Huge.*

But what will lead DCAA auditors to question costs in this area? Let's dig a bit deeper.

The first thing we'll look at is "idle capacity"—which is defined as—

… the unused capacity of partially used facilities. It is the difference between that which a facility could achieve under 100 percent operating time on a one-shift basis, less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays, and the extent to which the facility was actually used to meet demands during the accounting period. A multiple-shift basis may be used in the calculation instead of a one-shift basis if it can be shown that this amount of usage could normally be expected for the type of facility involved.

So "idle capacity" is the difference between using a facility at max capacity and what you actually use it at. To the extent you have empty cubicles and empty offices, and empty warehouses and empty program areas—you have idle capacity.

The Cost Principle states that the costs of idle capacity are "costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period." Thus, "such costs are allowable provided the capacity is necessary or was originally reasonable and is not subject to reduction or elimination by subletting, renting, or sale, in accordance with sound business, economics, or security practices." So if you are managing your facilities, and seeking to reduce your footprint as your workforce declines, you should be fine in this area.

However, the Cost Principle also states, "widespread idle capacity throughout an entire plant or among a group of assets having substantially the same function may be idle facilities." Thus, if you are failing to manage your facilities, and do not seek to reduce your footprint as your workforce declines, then a DCAA auditor may assert you have "idle facilities"—which is bad news.

The Cost Principle defines "idle facilities" as "completely unused facilities that are excess to the contractor's current needs." The costs of idle facilities are unallowable. However, if the contractor can show that the unused facilities are necessary to meet expected workload fluctuations then the costs are allowable (because they now meet the definition of "idle capacity"). In addition, if the facilities "were necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen," then the costs may be allowable—up to a point. The Cost Principle states that "costs of idle facilities are allowable for a reasonable period, ordinarily not to exceed 1 year, depending upon the initiative taken to use, lease, or dispose of the idle facilities."

The audit guidance in this area is remarkably sparse, considering how many indirect dollars may be tied up in contractor facilities. What little guidance there is, shows up in unexpected areas.

We found some interesting guidance in the audit program related to assuring CAS 414 compliance (Standard Audit Program 19414, dated June 2012). This audit program guides auditors in evaluating a contractor's compliance with Cost Accounting Standard 404 in calculating the proper Facilities Capital Cost of Money Factors. When assessing the distribution of Net Book Values (NBV) of capital assets, the audit program directs the auditor to evaluate "risk" in certain areas. The audit program states—

Existence of idle facilities, potential idle facilities, or assets not in use may increase risk. Restructuring activities or other reorganizations may result in unutilized assets that may indicate increased risk. Determine that the asset base includes only those assets used in the regular course of business. Perform analysis to determine if unutilized or underutilized assets are an integral part of the regular operations of the business. Land should be included if the contractor can support is purchase as an integral part of its operations. The following assets should not be included:

1. Land held for speculation or expansion.
2. Idle facilities or capacity in accordance with FAR 31.205-17.
3. Assets under construction and not in use.

We also found some interesting guidance in the Contract Audit Manual related to evaluating contractors' "make-or-buy" programs. At 6-309.3, the CAM states—

a. FAR Subpart 15.407.2 generally requires contractors to submit make or buy programs for negotiated acquisitions requiring certified cost or pricing data with an estimated value of $12.5 million or more (see exception at FAR 15.407-2(c)). It also allows, for monitoring purposes, the incorporation of the program in negotiated cost-reimbursable contracts, some cost sharing contracts and major systems contracts and subcontracts for monitoring purposes. The contract clause at 52.215-9 requires notification of any changes in the program as incorporated in the contract. Alternates 1 and 2 requires adjustment of incentive fees if during performance the contractor reverses a make or buy categorization which initially was economically detrimental to the Government. Determine the effect of and compliance with any agreements resulting from these requirements.

b. The contractor has the basic responsibility for make-or-buy decisions. Therefore, its recommendations should be accepted unless they are inconsistent with Government interests or policy. *Evaluate the contractor's decisions in the make or buy area which may have been motivated by considerations other than economies or efficiencies for the Government operation. For example, the contractor may desire to gain experience in a particular manufacturing or fabricating process. Another consideration which may influence a contractor's make or buy decisions involves the extent of available idle facilities. The contractor's decision to manufacture in lieu of purchase may be in the best interests of the company, but not in the best interests of the Government. When a contractor decides to manufacture a part or component not normally within its experience or production capabilities or which had been purchased in the past, determine whether the decision results in additional costs to the Government.*

[Emphasis added. We assume any “additional costs” so identified will be questioned.]

From the foregoing, we conclude that contractors with idle facilities run the risk of being accused of violating the requirements of CAS 414, and that they may also run the risk of having their Purchasing System deemed inadequate, based on a perceived biased make-or-buy program that puts the contractor’s self-interest ahead of the government’s interests.

In sum, we think this is a surprisingly risky area, one that will become more so as contractors deal with the impacts of DOD budget cuts—whether or not those cuts stem from sequestration. We are advising our clients to closely manage their facility footprint so as to avoid DCAA problems in this area. If a contractor fails to manage its facility footprint, and reduce its facilities along with workforce cuts, it may find itself dealing with a large amount of questioned costs—and in some surprising areas, as well.

But best efforts may not be sufficient.

We have learned that some contractors are still having problems with DCAA auditors, despite their best efforts to manage their facilities. Because there is so little audit guidance in this area, auditors have more individual discretion to use their imaginations in order to generate questioned costs. We have heard that some auditors are starting with 90% facility utilization as the baseline, and questioning costs as being “idle facilities” when a contractor dips below that utilization rate. Clearly, that’s not the bar contemplated by the FAR Cost Principle. But until DCAA issues more prescriptive guidance to assist its auditors in applying the Cost Principle, we suspect the application will be … *inconsistent*.

Whether or not more prescriptive audit guidance is issued from Fort Belvoir, we suspect the subject of contractors' facilities costs is going to be perceived by DCAA auditors as being "low-hanging fruit" that can be used to generate lots of questioned costs. You have been warned.