Cost Recovery in Commercial Item Contracts

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Discussion Topics

- Research Question
- Background
- FASB Concept Statement No. 7 approaches
- Net Present Value Clauses

Research Question and Background

- How is present value identified in commercial item contracts and what corresponding contract clause should be inserted into the contract?
- The FAR does not uniformly define what is fair and reasonable
- Existing literature on GAAP and FASB Concept Statement No. 7 reviewed to try and define what is fair and reasonable
- GAAP Principles are: Recognition, Measurement, Presentation, and Disclosure

FASB Concept Statement No. 7: Best Estimate Method

- Best estimate method: (1) compare to existing item in marketplace, (2) compare discounted cash flows, (3) Evaluate characteristics, and (4) evaluate market conditions
- Example: 100million, comparable supercomputers on the market are valued at $200million and $300million with probabilities of completion of actually completing the supercomputer at 10 percent, 60 percent, and 30 percent respectively. The expected cash flow is $220million using the following formula: ($100million x .1) + ($200million x .6) + ($300million x .30) =$220million. Therefore, contractor can expect to recover $220million on the contract to build a supercomputer.

FASB Concept Statement No. 7: Estimated Cash Flow

- Estimated cash flow based on probability of completing contract
- Example: 100million, comparable supercomputers on the market are valued at $200million and $300million with probabilities of completion of actually completing the supercomputer at 10 percent, 60 percent, and 30 percent respectively. The expected cash flow is $220million using the following formula: ($100million x .1) + ($200million x .6) + ($300million x .30) =$220million. Therefore, contractor can expect to recover $220million on the contract to build a supercomputer.

Recommendation: Net Present Value Clauses

- Alternative 1: The term “net present value” (NPV) shall mean present value of cash payments generated by a commercial item(s), calculated using a discount rate determined by an actuary selected by the government and determined in accordance with GAAP. Probability shall be determined by conducting an analysis of alternatives analysis. Contractors shall calculate cost recovery or charges from commercial item terminations based on NPV or fuzzy net cash flow.
- Alternative 2: The term “net present value” (NPV) shall mean present value of cash payments generated by a commercial item(s), due in the future reduced by a discount rate equal to 100% of the Applicable Federal Rate (as defined in Code Section 1274(d). Contractors shall calculate cost recovery or charges from commercial item terminations based on NPV. Probability shall be determined by conducting an analysis of alternatives analysis.