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WHAT CONSTITUTES AN ADEQUATE BILLING SYSTEM

(Editor's Note. We are finding government auditors – the Defence Contract Audit Agency (DCAA), some Offices of Inspector General and even price and cost analysts at buying agencies – taking an increased interest in contractors' billing practices. We have applied our experience as consultants and used the DCAA Contract Audit Manual and DCAA audit program for reviewing a billing system as sources for this article.)

An assertion of significant deficiencies in a contractor's billing system can result in a range of problems: contractors can loose their privilege to direct bill, the government may suspend acceptance of invoices on flexible type contracts and progress billings and an adverse finding can contribute to an assertion that a contractor's accounting system is inadequate, resulting in failure to be awarded a contract.

Since their guidance is, by far, the most comprehensive, we will identify the criteria that DCAA considers to be an adequate billing system and suggest our readers use their judgement to determine what is appropriate for their business. For example, detailed written policies and procedures addressing each element below may be overkill for a small, low risk contractor whose government business is minor and has a sole $50,000 T&M contract. Contractors whose main business is cost type government contracts or large businesses with significant progress billings on fixed price contracts are considered higher risk and would likely need more controls. Unfortunately risk assessment of specific contractors and corresponding criteria of what is acceptable varies widely not only between audit offices but also between auditors and their supervisors within the same office. As consultants, we are constantly confronted by a lack of consistency on what auditors and contracting personnel consider adequate versus problematic.

Auditors are supposed to determine whether a contractor's billing system provides reasonable assurance that billings applicable to government contracts are prepared in accordance with laws, regulations and contract terms and that material misstatements are prevented or are detected in a timely manner. In order to make this determination the auditors will either conduct a separate billing system review or more commonly, examine the billing system as part of other audits such as accounting system reviews, forward pricing rates or incurred cost submittals. The scope of the audit is supposed to be dependent on the contractor's size, amount of government business and type of contracts they have. The source of inconsistency is that what is considered small versus large differs by office (e.g. for a branch office handling mostly smaller contractors a $500,000 contract can be substantial while at an office with a lot of large contractors the same contractor could be considered insignificant). The scope of audit can also be dependent on the overall work demands of the office and whether it is over (quite common today) or understaffed.

The substance of the audit will focus on "internal controls" over billing and the auditor will make a determination of whether they are adequate, deficient or inadequate. The review of internal controls will examine:

1. *Management Reviews*. The contractor should demonstrate it monitors its billing process. This should include (a) a regular compliance review to ensure its billings are made in accordance with both regulations and contract terms and (b) periodic reconciliation of contract costs identified in the cost records to costs billed.

2. *Written Policies and Procedures*. Several adequate practices along with written policies and procedures should be, when appropriate, in place in the following areas:

a. *Training of employees*. Ensure appropriate personnel are specifically trained to prepare and submit

government billing requests. Outside training courses, internal courses and on-the-job training are options. Programs might include an overview of the accounting system, information on specific billing procedures, an overview of written policies and procedures, instructions on briefing contracts (discussed below), understanding of the approval process, guidance on relevant contract clauses and knowledge about quick closeout procedures. If specific procedures are not followed the auditor will ask what type of training is provided and will likely follow it up with interviews of selected people.

b. *Contract briefings*. Government contracts often have unique requirements related to billings such as withhold criteria, cost exclusions, etc. We are seeing a significant increase of audit attention on how well contractors keep up-to-date briefings of contracts and the procedures should document the process (e.g. forms used, checkmarks for FAR clauses, contract type, billing rates for individuals or labor classes, ceiling indirect costing rates, project set up information, etc.).

c. *Management review and approval*. The contractor should have procedures in place, preferably written, to demonstrate that there is a management review and approval of billings before they are submitted. Progress billing requests require management certifications. Adequate procedures should demonstrate that contract briefing require management review, managers review billings prior to submission and even better, that certain items or elements in a billing receive specific review if certain thresholds are exceeded.

d. *Reconciliation of recorded and billed costs*. The contractor should be able to demonstrate that its billings are prepared directly from the cost accounting records or from other records (e.g. spreadsheets) that are reconciled to cost accounting records. If billings are prepared from subsidiary ledgers or memorandum reports then they should be reconciled to the general ledger. Periodically, contract costs as identified in the cost records should be reconciled to costs billed. This is a good idea not only to demonstrate good internal controls but will help prepare timely final vouchers detailing allowable costs by year.

e. For *electronic data systems* the contractor should have written procedures and/or flowcharts identifying the appropriate inputs, control points, ancillary EDP applications and related transactions. The automated system needs to have the capability to input billing ceilings, withhold requirements or automatically code items that are not billable and then identify these items included in cost records but excluded from billings in a separate attachment. For *manual systems*, the contractor may want to consider attaching the job cost ledger or verification to the billing record for management review before billings are sent.

f. *Adjustment of cost and rates*. We are also seeing increased audit attention on whether contractors adequately monitor interim indirect cost rates. Billings on cost type contracts are usually based on projected rates for the year which often change. Procedures should be in place for monitoring actual rates (required by FAR 52.216-7(e) and FAR 42.704)) and if billing rates differ significantly from actual rates, adjustments to the billing should be made either during or at year end to ensure amount reimbursed is close to that claimed. The contractor should have procedures in place to ensure yearly rate computations are easily identifiable, are made at least annually and that approval for changing billing rates are in place (and prevention from unauthorized changes to billing rates also exist).

g. *Exclusion of certain incurred costs from billings*. Examples of costs that may be reflected in books of account that should not be included in billings are (1) unallowable costs defined by the FAR, supplemental agency regulations, OMB circulars or contract terms (2) certain costs that may be considered incurred but for large business may not be included in billings because they have not been paid (3) withholding costs that are appropriate adjustments such as costs in excess of ceilings or liquidated progress payments (4) adjusting submissions for claimed or audited rates that differ from contractors' current applied rates and (5) certain costs that require contracting officer approval such as special purchases, overtime authorizations, etc. Appropriate written procedures should be in place to ensure these costs are excluded from billings (e.g. special coding) and what occurs when they are reclassified as billable (e.g. amounts were paid, CO authorized payments at a later date).

h. *Estimates to complete*. For progress payments, the amount on line 12b on the SF 1443 form, Contractors Request for Progress Billing, is critical for determining the reasonableness of the request and these estimates to complete must be current (not more than 6 months old). When using progress billing, the contractor should have in place procedures to ensure it keeps its estimates of cost to complete current and that these estimates reconcile with other reporting requirements

such as EVMS and status reports provided to upper management. The contractor should demonstrate it has EDP controls or tickler files identifying that estimates have not exceeded the 6 month requirement.

i. *Estimates of costs of delivered/invoiced items.* Because costs by delivered item are not generally available from cost accounting records, the contractor generally computes the costs of items delivered by applying the estimated cost/price ratio to the contract price of the item delivered. The contractor should have policies and procedures describing how the estimated cost for delivered items is computed.

j. *Title to assets.* When the CO has given the contractor consent to dispose of property under the progress billing clause (FAR 52.232-16(d)) procedures should assure the contractor disposes of the property systematically over the course of contract life so the government can receive the appropriate credit against the contract for the proceeds.

3. *EDP Controls.* DCAA has begun a major push to ensure contractors have adequate internal controls over its electronic data processing. Whereas they used to have special teams focusing only on major contractors, EDP audits have been pushed down to the local branch level causing audits spread to more and more contractors. Billing system is a likely place they will examine EDP controls. Both EDP general controls (i.e. controls affecting all system applications and operational elements of all EDP systems) and separate application systems (labor, billing in this instance) audits can be expected. The focus is generally on the control procedures in place to prevent or detect several types of errors in most phases of the application. For more information on DCAA's approach to EDP audits, see the new chapter recently added to the DCAM, 5-1400, Audit of EDP Systems Application Internal Controls.

DCMC'S "HIGH PRIORITY" ISSUES

(Editor's Note. Contract administrators either initiate questioned costs or resolve questioned cost disputes between auditors and contractors. The Defense Contract Management Command (DCMC) administers most contracts awarded by the military and it is usually their position on an issue that determines how a questioned cost issue will be resolved short of an appeal. The following discusses the topics being addressed by DCMC which is based on an article by Robert A. Burton, Associate General Council for the Defense Logistics Agency, in the Fall 1998 issue of The Procurement Lawyer. Though the publication informs its readers that Mr. Burton's views are his own and not those of DCMC – we think this is a pretty good indication of what DCMC thinks are important cost issues.)

DCMC

DCMC administers over 383,000 contracts valued at $927 billion and it plays a key role in the resolution of contract cost issues. In recent years it is taking an increased interest in making sure that proper accounting treatment of costs incurred under negotiated DOD contracts occurs. In 1994 DCMC created a unit at its headquarters to bring national focus on "high profile" cost issues arising primarily out of business combinations to ensure there was consistent treatment of cost allowability and allocability issues across DMCM. In August 1997, the DCMC commander issued a policy memorandum to require coordination of the Overhead Center and DCMC on certain actions related to resolving "high profile" cost issues. The memo, in effect, made the positions of the Overhead Center on the "high profile" issues dominant in most administrative matters including final ACO decisions, advanced agreements, administrative or court settlements and initiation of litigation against contractors. The memo made it clear the Overhead Center will address only these high profile issues, leaving local ACO actions involving routine costs alone.

Selected "High Profile" Issues

Those costs of most concern include:

◆ Environmental Costs

The allowability of environmental costs will continue to be a high profile issues due to the high dollar amounts involved. For a long time, DOD considered adopting a specific FAR cost principle but determined that the costs should be considered on a case-by-case basis because the nature and extent of the costs vary so much. Without such a cost principle, DCMC must apply reasonableness standards.

Environmental costs consists of costs to prevent contamination and costs to clean up prior contamination. They are generally considered to be normal costs of doing business and hence allowable

if they are reasonable and allocable to government contracts. Several factors complicate this general concept such as: (1) the simple fact of very high costs of environmental remediation (2) inadequate environmental standards in earlier years that resulted in extensive remediation efforts makes assignment of blame difficult (3) numerous parties contributing to the contamination of a site over a long period of time (4) does the government or contractor own the site (5) potential contractor insurance recoveries and the government's right to these recoveries and (6) contractor recoveries from potentially responsible parties (PRPs) under the Comprehensive Environmental Response, Compensation, and Liability Act.

The author cites DCAA guidance to its auditors as sound, especially when environmental costs should be questioned. For example, the costs should be questioned if they resulted from contamination caused by the contractor's wrongdoing and increased costs caused by a contractor's delay in responding to contamination. ACOs should ensure the government does not pay more than its "fair share" particularly when there are numerous parties responsible for the contamination over many years. Also ACOs must take care that the government receives its proportionate share of any recoveries a contractor obtains from any insurance policies that provide coverage for remediation.

(For a more detailed discussion of environmental costs see our analysis in the GCA DIGEST Vol. 1, No. 1)

◆ Pension Costs

DCMC is specially concerned with the treatment of "overfunded" pension plans when a business combination occurs. Overfunding occurs when the market value of the assets of a fund are greater than the actuary liabilities for its benefits. Under a sales agreement of a business or segment, it is quite common for the contractor to attempt to retain all or a disproportionate share of pension assets which include any overfunding. To the extent the Government contributed to the pension assets over the life of the plan through payment of fringe benefits, the Government may be entitled to a credit or refund for a portion of the excess assets in accordance with Cost Accounting Standard 413.

Many questions related to CAS 413 remain unanswered. CAS 413 requires a contractor to make an adjustment of its previously determined pension costs when a "segment is closed". A "segment closing" was never defined and it took a 1995 modification to CAS 413 to clarify that a "sale" of a company unit or division constitutes a "segment closing". An Armed Services Board of Contract Appeals case (Gould Inc., ASBCA 46759) ruled that the 1995 rule modification did not apply *retroactively* but only *prospectively* making contractors subject to different versions depending on the date of segment closing. In addition, the ASBCA reasoned that the pre-1995 version of CAS 413 did not mandate an adjustment to contract *prices* meaning the government was not entitled to an adjustment on fixed-price contracts but that the government was limited to *cost* adjustments to flexibly-priced contracts only.

Other problems related to the new version of CAS 413 DCMC will be addressing include: (1) some contractors claim that if a plan is underfunded they should be entitled to a recovery of additional costs from the Government (2) for overfunded contracts, many contractors argue that the government is not entitled to recover on fixed price contracts (3) with respect to underfunded contracts, many contractors have put forth the argument that the government is liable on both flexibly-priced and fixed-price contracts.

◆ Restructuring Costs

The allowability of restructuring costs associated with a business combination has received considerable attention from Congress. "Restructuring costs" is the term applied to costs incurred as the result of nonroutine, nonrecurring or extraordinary events (as opposed to normal efficiency and productivity enhancing acts) that include personnel relocations, severance pay, early retirement incentives, retraining, facility closings, lease terminations and system conversions. Most of the Defense Authorization Acts since 1995 allow contractors to charge these costs to their contacts provided contractors can demonstrate in a proposal that it will achieve a two-for-one savings in the future.

The Overhead Center is stressing two "lessons learned". First, ACOs should be seeking revised forward pricing proposals with these restructuring proposals so that the projected savings can be visible in its pricing. Secondly, the Overhead Center is in the forefront of efforts to have ACOs recommend to buying activities use of a "reopener" clause in firm, fixed price contacts awarded during the period between

the approval of a business combination and the time the contractor's forward pricing rates are adjusted to reflect the estimated savings.

◆ Taxes Associated with Divested Segments

When a contractor discontinues operations through the sale of a business segment or segments, it is assessed state and local taxes on the gain resulting from the sale. DCMC strongly supports attempts to approve a proposed rule that would add these tax increases to the list of unallowable costs.

Other matters being addressed by the Overhead Center are:

◆ Final Overhead Settlement Process

Recent changes to the FAR that streamline final settlement of indirect cost rates under cost type contracts will require attention. The Overhead Center will be stressing the following:

1. Strive to meet the "6-12-6" goal – six months after the end of its fiscal year for the contractor to submit its proposal, 12 months for DCAA to audit it and six months for the ACO to reach a final settlement

2. Use quick close-out rates whenever possible (FAR 42.708 addresses this)

3. Consider the materiality of costs when negotiating

4. Exert maximum effort to secure contractor submissions of overdue final overhead rate proposals

5. Negotiate several open years at the same time. If multiple years contain cost allowability/allocability issues, negotiate these simultaneously to save time and permit faster closure of open years.

6. Settle corporate division issues as soon as possible so that corporate allocations can be allocated downward to expedite closure at the lower levels.

◆ "Roll-Forward" Techniques

Many high profile cost issues are difficult to expedite either because some costs will not occur until future years (e.g. environmental and restructuring costs) or ACO determinations of unallowability may be appealed to boards and/or courts. Historically, one method of dealing with this issue is to set aside the disputed costs from a contractor's claim and roll these costs forward to a future year when their amount and allowability is conclusively determined. ACOs should coordinate the use of this technique with the Overhead Center.

The ACO will enter into an agreement with a contractor with the understanding that the roll forward will not result in any increased costs to the government. This should be implemented by the contractor agreeing that the actual overhead costs will be determined by applying the approximate government participation rate on flexibly-priced contracts for the year in which the contractor originally recorded the costs. The agreement should be limited to those contractors who have a continuing and consistent level of government business.

When a cost allowability determination is made, the costs should be allocated to the overhead year in which the costs were incurred. If that year is closed, the costs should be allocated to the open year closest to the year the costs were incurred.

◆ Cost Accounting Standards

The DCMC Overhead Center wants to expedite determinations of CAS noncompliance and quickly negotiate settlements. It is urging ACOs to work closely with DCAA during their CAS compliance audits and stresses that timely settlement of CAS issues require ACOs to (1) ensure the audit considers all evidentiary data (2) a timely response from the contractor is obtained and (3) and negotiation of the issues are commenced as soon as possible. If agreement cannot be reached in a reasonable time (usually six months) the CAS issue will be referred to the Overhead Center for review and coordination. The Overhead Center is planning to issue a CAS guidebook once the CAS Board issues final amendments to CAS on "cost accounting practice changes" and the cost impact process.

◆ Executive Compensation Caps

Statutory limits of $200,000 and $250,000 in earlier years and the 1998 rule that expands the scope of the limitation to all contractors (not just DOD) will require a great deal of DCMC's attention. The differing rules in different years will make implementation complex and will require a great deal of decisions (*Again, for an analysis of these changes as well as an examination of executive compensation in general see our three part article in the Digest, Vol. 1, Nos. 2-4).*

ELECTRONIC COMMERCE

(Editor's Note. It seems that as soon as we report on an electronic commerce development it quickly changes. In spite of new developments and new technologies, EC will be a permanent feature of contracting with the government and those who want to do business need to keep abreast. We have wanted to provide our readers with some basics as well as an indication of where EC is headed and found such an article in the July 1998 issue of Briefing Papers by Jean-Pierre Swennen and John McCarthy, Jr. of the law firm of Crowell & Moring.)

Definition

Electronic commerce is really a paperless process for accomplishing business transactions that rely on electronic mail, electronic bulletin boards, electronic funds transfer, electronic data interchange (EDI) and other technologies.

A Little History

Though used in the commercial sector since the late 1970s and early 1980s, the federal government did not take any unified efforts to implement EC until the early 1990s.

Although initial schedule goals were not met, substantial steps were taken toward implementing a standardized EC system in the establishment of FACNET. The Federal Acquisition Computer Network (FACNET) was to focus primarily on the acquisition of products and services with values between the micro-purchase threshold of $2,500 and the simplified acquisition threshold of $100,000. The system was designed to allow for electronic interchange of procurement information between government and contractors, where Government buyers were to provide widespread public notice of solicitations, receive responses to solicitations, provide public notice of contract award with price, receive questions, make payments through electronic means and archive data. Sellers were to access notice of the solicitations, respond to them, receive orders when awarded a contract, access information on contract awards to others and receive payment.

While FACNET was being implemented the Internet was rapidly becoming the universally recognized vehicle in the commercial world. Some agencies perceived this trend and began bypassing the FACNET, relying on the Internet and electronic bulletin boards for its procurements. A 1997 GAO report addressed numerous operating problems associated with FACNET (e.g. poor registration, high cost for small business) and pointed out the availability of simpler and faster electronic methods such as the Internet, on-line electronic catalogs and purchase cards (government issued credit cards). Under the 1998 DOD Authorization Act, Congress and the Administration repealed the need to use FACNET exclusively and called for more flexible EC methods.

Current Initiatives

There are numerous initiatives being pursued.

FACNET Integration. Though not widely implemented, FACNET has 320 DOD sites that are FACNET certified and these capabilities will be integrated with other EC technologies and purchasing methods.

Standard Procurement System. The Standard Procurement System (SPS) is an automated procurement tool being developed by DOD. It is intended to be the "next generation" of procurement software and is intended to incorporate the best practices of EC found in the commercial marketplace. SPS is in its very early stages and as of mid-1998, had completed installation at 184 buying sites covering over 7,000 vendors.

Central Contractor Registration. In 1996 the FAR was amended to require contractors to register with the Central Contractor Registration (CCR) database if they wish to conduct business with the federal government through EC. To register, they needed to submit identifying information including a Data Universal Numbering System (DUNS), Commercial and Government Entity (CAGE) code and electronic funds transfer data in prescribed EDI formats. On March, 31, 1998 the DOD issued a final rule requiring all contractors wishing to do business with the DOD (not just seeking EC participation) to register with the CCR database. The rule also implements the Debt Collection Improvement Act of 1996 that requires agencies to obtain contractor taxpayer identification numbers and to pay contractors only through electronic funds transfer. To remain registered, a contractor must annually confirm the accuracy and completeness of the information in the database. If the CO determines a contractor is not registered, it must wait for the contractor to register if a delay is

acceptable or will make the award to the next otherwise successful registered offeror.

Past Performance Information System. The purpose of the Past Performance Automated Information System (PPAIS) is to collect and provide access of information to procurement personnel about contractors' past performance. There are numerous systems being developed now that track objective information (e.g. ratings) and/or subjective appraisals (e.g. narratives).

Technical Data Information System. The purpose of the Technical Data Package Material Information System is to provide a central source for technical information for government procurements. The information will be available on the world wide net and will initially include (1) RFQ and RFPs (2) unclassified and unrestricted technical drawings (3) military specifications and standards and (4) commercial industry standards. Information to be added later includes commercial vendor drawings, DOD and military service instructions and directives.

Paperless Acquisition. In a memorandum dated May 21, 1997 the DOD Comptroller launched an initiative to create a totally paperless contract writing, administration, finance and auditing process by January 2000.

Purchase Cards. The government has implemented a system of Government wide credit cards for small purchases for most micropurchases (under $2,500) as well as larger purchases.

Electronic Catalogs. Agency electronic catalogs – Web-based electronic systems allowing buyers to browse, place orders and make payments – have proliferated since the growth of the internet, use of purchase cards and increased use of multiple award task and delivery order contracts. Examples of such electronic catalogs are: the Federal Supply Services' GSA Advantage! (http://www.unicor.gov/) that permits buyers to look for specific product information, review delivery options and instantly place orders with schedule contractors; the Defense Logistics Agency's Emall (http://www.supply.dla.mil/email/index.html) for "one stop shopping" that currently allows DOD buyers to select over 4 million DLA-managed items as well as hundreds of thousands of commercial items from vendor catalogs and to make payment with a purchase card; the National Institutes of Health through its Electronic Computer Store (http://nitaac.nih.gov/Nhpmr/ECS%2011/ecs2homeframe.html) has vendors update their own catalogs and provides links to sellers' contract pages. In addition, the government is working projects to link the various agency electronic catalogs to allow easy viewing and movements between catalogs.

FACNET Alternatives. Though FACNET remains a part of the current EC procurement arsenal, it has proven to be a poor technique for small purchases in the $2,500 to $25,000 range. Such purchases use either the traditional "three quote" process where buyers typically seek out three telephone quotes solicited from the local trade area or the increasing use of indefinite-delivery, indefinite-quantity (IDIQ) contracts for high volume buys. Web-based software and electronic catalogs rather than the cumbersome FACNET are proving to be the most accepted method for these purchases.

Federal Procurement Data System. A major source of procurement information on federal contract awards is the Federal Procurement Data System (http://fpds.gsa.gov/fpds/fpds.html). Its reports are available on the Internet which permits sellers to search agencies that are buying their products and services and to determine which vendors those agencies have used in the past.

CBDNet & CBDPlus. Notices of all open market contract opportunities above $25,000 that would otherwise be published in the paper version of the Commerce Business Daily are now published electronically and available free of charge on CBDNet (http://cbdnet.access.gpo.gov/index.html). The site also has three search engines for text searches, field searches, or searches by classification code. CBDPlus will be an enhanced version of CBDNet which in addition to notices of contracting opportunities will include copies of solicitations and other documents ready for downloading as well as automatic e-mail notification to vendors about contracting opportunities in specific categories.

Small Business Outreach. There are many outreach actions to increase opportunities for small businesses. For example, the Small Business Administration's Procurement Marketing and Access Network (PRONet whose internet address can be found at http://www.policyworks.gov/epic) is a free Internet database of vendors providing access to profiles of more than 170,000 small businesses including products and services, history, references and other assistance that helps both government and large businesses locate

small contractors and subcontractors. In addition, a particularly useful resource we have found are the 16 Electronic Commerce Resource Centers funded by the DLA and located in different areas of the country that provide free training and technical assistance to small and medium-sized businesses. Each center has a Web page.

MEASURING CLAIMS

(Editor's Note. An equitable adjustment to a contract is the most frequently used method of adjusting the price of a contract for occurrences of changes, changed conditions or delays. Though the government occasionally uses this to obtain lower prices from contractors, the opposite is most common - contractors seeking ways of increasing the original price. In this and subsequent articles, we intend to address ways the contractor can maximize their recovery from an equitable adjustment. In this article we will make some general comments about measuring an equitable adjustment while in subsequent articles we will address specific costs, proper presentation of a request for an equitable adjustment, what to expect from an audit and identify those events that qualify for a change in contract price. Our sources will vary – in this article we draw on our own experience as consultants in helping clients prepare requests for equitable adjustments and use one of our favorite texts written by Professor Lane Anderson, "Accounting for Government Contracts, Federal Acquisition Regulation".)

The basic rules are quite simple. An equitable adjustment (EA) is an increase or decrease in the contract price or time of performance. The FAR clause 52.243-1, Changes-Fixed Price (Aug 1987), found in most contracts entitles the contractor to an EA for the occurrence of a government-ordered change, a changed condition or some event specified in the contract. The basic rationale behind an EA is that it is intended to make the contractor whole when the government modifies a contract. In general, the price adjustment is the difference between the cost of the contractor's adjusted performance and the cost of performance as originally contemplated by the contract plus profit. If the cost of the adjusted performance is greater the contractor is entitled to an upward equitable adjustment; if the cost is less, the government is entitled to a downward adjustment. The problems occur when the EA is actually calculated.

There are really different types of EAs with different methods for calculating the adjustments:

Changes from Deletion of Contract Work

Changes involving deletion of work may occur when the government simply eliminates a portion of the original contract work or substitutes different work for it. When work that was separately priced as a distinct item of work is deleted, the original bid price is considered to be the proper measure of the downward adjustment. If the item was bid at a high profit level the contractor loses whereas if the item was in a lose position, he is relieved of the loss.

The government frequently attempts to apply this same method when there is not a separate price in the contract but numerous cases have rejected this approach indicating the adjustment should be based on cost estimates. Cost experience to base the price adjustment can not be used since the deleted work was not performed. Hence, cost estimates of the deleted work are used. When work is deleted, the adjustment in price to which the government is entitled equals the reasonable costs for the work as estimated by the contractor when the contract was entered into plus estimated profit. Numerous cases have placed the burden of proving the amount of the downward adjustment on the government. This principle has been softened in recent cases where the courts have stated they are reluctant to accept the original bid estimate as the sole source of a downward adjustment stating the reasonableness of the estimate should be independently supported so the risk of a bidding error is not passed from the contractor to the government. For minor amounts contractor estimates are used without verification.

Changes Involving Additional Work or Substitution of Work

◆ Prospective Pricing

Where the change calls for only added work, the EA should be priced prospectively (i.e. before the added work is performed). The amount should be based on estimates available at the time the estimate is submitted. Cost estimates can be based on actual costs of doing similar work taking into account special circumstances of the contract that may change the costs. An allowance for profit is added to any cost estimates even when the contract is otherwise in a loss position.

When there is a change to contract work, some part of the original contract is usually deleted and different

work is added. There can be actual cost experience for either the deleted or changed work and when this happens the EA is calculated by determining the difference between (1) an estimate of the total reasonable costs to perform the contract as changed and (2) the total reasonable costs the contractor would have estimated for performing the changed (rather than original) contract at the time the contract was awarded.

◆ Retrospective Pricing

When a change order involves added work and the EA is priced retrospectively, actual cost data for the changed work is used and the adjustment is based on actual costs plus an allowance for profit. For substituted work, actual cost data for the changed work should also be used and the EA is calculated by taking the difference between (1) actual costs of performing the contract as changed and (2) a reasonable estimate of total costs to perform the contract at the time the contract was entered into. For example, if performance of the original contract was estimated to cost $25,000 while performing the contract as changed (including the substituted work) actually cost $30,000 the EA would equal $5,000 plus profit even if the contract may otherwise be in a loss position.

When there is a change to a contract in a loss position, the government is still entitled to a downward price adjustment when it issues a change order to delete work or substitute work costing less than the original work contemplated. Such a downward adjustment (sometimes called a "deductive change") should neither increase nor reduce a contractor's expected loss on the remainder of the contractor, leaving the contractor in the same position it was in before the change.

Methods of Presenting Actual Costs

A contractor must prove that a government change order caused the costs for which it is claiming. Cases have stipulated that the contractor need not prove the costs with "absolute certainty or mathematical exactitude" but a "reasonable basis for computation, even though the result is approximate" is acceptable. Still, the contractor has the burden of establishing the basic facts of their claim when an upward adjustment is sought while the government has the burden for a downward adjustment.

The courts have established preferences for measuring an EA:

◆ Directly Related Costs Method

When a change order has been performed and actual costs incurred, the preferred method for establishing the amount due is actual cost data for the changed work. Ideally, contractors should establish separate work orders for the change and be able to segregate costs incurred as a result of the change. In practice, contractors' accounting records frequently do not segregate costs for the changes, especially when costs are cumulative and overlapping. When this is the case, the contractor should be prepared to show the basis of its estimates by a description of the method used, evidence of its validity and substantiation of its calculations. Expert advice may be advantageous.

◆ The Total Cost Method

The total cost method measures the difference between the contractor's bid price on the original contract and the actual cost of performing the contract as changed. The government has voiced significant objections to this method because it can allow for recovery of costs having nothing to do with the changes. For example, the original contract price might be distorted because the contractor underbid the contract or the adjustment may be excessive due to the contractor's inefficiencies. A case (WRB Corp. vs. US) has established four criteria that must be met to use the total cost method:

1. The nature of the losses make it impossible or highly impracticable to determine with a degree of accuracy. The total cost method is not to be used if there are available other methods of proof such as credible expert opinion on the actual cost impact of the change, the contractor has a basis to know what costs are being incurred along with the accounting tools to segregate the costs or when there is sufficient data available to allow a reasonable estimation.

2. The original bid is realistic. If it was too low, the contractor obtains a windfall profit. A contractor can demonstrate the bid was reasonable if it was similar to other bids received by the government, close to the government's preaward estimate or there is expert testimony the estimating technique was reasonable and accurate.

3. Actual costs for the changed work are reasonable

4. The contractor is not responsible for added expense. Both Nos. 3 and 4 may be satisfied by

demonstrating the work was accomplished in a normal, efficient manner and there were not unrelated events contributing to the cost incurred.

◆ "Jury Verdict"

Like the total cost approach, the jury method of measuring EAs is used only when more exact methods of calculation of actual costs cannot be made. On an appeal to the co's decision, the Board or arbitrator might, on an imprecise basis, decide the amount to be paid typically using averages or percentages of computed amounts and then use discount percentages or other offsets to arrive at a "fair" number. Cases have held (1) there must be proof of injury (2) no more reliable methods for computing damages exist and (3) there is sufficient evidence for a court to make a fair approximation. The jury method is not to be used when there is a failure of proof by the contractor that prevents a reasonable degree of accuracy. Absence of cost estimation data on the original bid has been held to void the jury verdict method resulting in no adjustment for the contractor.

◆ Modified Total Cost Method

This is the same as the total cost method except adjustments are made to the original contract price or to actual costs to overcome a contention they are understated or overstated. An underbid, for example, would be adjusted upwards and the total costs incurred would be reduced to adjust for costs not attributable to the change in question.

BETTER DEBRIEFINGS RULES

(Editor's Note. After spending so much time and money preparing a proposal then participating in a long selection process (e.g. presentations, discussions, BAFOs, etc.) it would be nice to find out why you did not win. Though unsuccessful offerors have long had the regulatory right to request and obtain a postaward debriefing, the experience was usually frustrating, where the explanations were not meaningful. There have been several changes to the regulations recently that are designed to significantly improve the debriefing process and we have found several instances of actual improvements in our experience with clients. We recently came across an article by Edward Williamson of the Office of the Chief Attorney in the Department of the Army in the May 1998 issue of Contract Management that presents many of the recent changes to debriefing rules.)

In the past, the purpose of debriefing was viewed simply as an opportunity to assist unsuccessful contractors to prepare better proposals. In its recent efforts to reduce protests, Congress cited the lack of meaningful debriefings as a major stimulus to protest an award. Recent changes to the regulations were intended to improve debriefing in order to lessen protests. The relevant debriefing legislation was included in the Federal Acquisition Streamlining Act, the Clinger-Cohen Act of 1996 and the Federal Acquisition Regulation Sections 15.505, 15.506 and 33.104(c).

Timing and Conduct of Debriefings

In its effort to discourage protests, an agency normally wants to convey sufficient information in its debriefing that instills confidence the decision was reasonably based. It seeks to impress upon the unsuccessful offeror that it was treated fairly and its proposal was evaluated properly.

Under the new rules, timing is an essential element. As an incentive to speed the process, protest timeliness rules and statutory automatic suspension of contract performance have become important. A debriefing is a procedure where an after-the-fact explanation of the award decision is presented. A debriefing may be conducted orally, in writing, or in any other method acceptable to the contracting officer. There is no specific legal requirement to hold a face-to-face meeting and in practice nothing precludes a CO from sending written debriefing materials by fax and or conducting a same day telephone conference responding to questions posed by the requestor.

Required Debriefings

Debriefing provisions are initiated by the written *preaward* notices to firms they have been excluded from the competitive range or written *postaward* notices to unsuccessful offerors that their proposal was not selected for award. The rules depend upon whether the debriefing is required or whether an agency is voluntarily providing it as an accommodation. If a debriefing is not required, a timely debriefing is not mandated and the protest timeliness rules and suspension of performance rules do not apply. When a debriefing is not required, a protest must be filed no later than 10 days from contract award in order to suspend contract performance; also, a protest must be filed not later than 10 days from when the protester knew or should have known the basis for the protest.

What is a Required Debriefing

A required debriefing results from the time of receipt of a written request for a debriefing from a firm that submitted a proposal. It is required only if the requester submits the request in writing to the agency within three days after receipt of the notice of exclusion from the competitive range or within three days after receiving the notice of award. For purposes of counting the days, the day the unsuccessful offeror receives the notice is not counted as one of the three days.

These provisions put a premium on maintaining evidence or proof that demonstrates when the requester actually receives notice of exclusion or notice of award and when the agency receives a written request for a debriefing. Since protest boards assume mail is received within one calendar week from the date it is sent, the parties should use other forms of proof for the shorter periods like fax transmission forms or return receipt requested forms of mailing. Also, a brief memorandum of telephone conversation is advisable for receipt of fax or mail.

When is a Required Debriefing Provided

For postaward debriefings the agency is directed to provided required debriefings to the "maximum extent practical" within five days of receiving written request of debriefing. The regulations suggest no express sanctions for failure to provide debriefing within this five day limit. The incentive for doing it quickly is to avoid prolonging the time to file a protest or to suspend contract performance – every day prolonged extends the opportunity to file a protest and potentially delay contract performance.

Once a required debriefing occurs, the unsuccessful offeror has no more than 10 days to file a timely protest. In addition, a protest filed within five days after receiving a required debriefing can result in the automatic suspension of contract performance even if the contract was awarded before the protester received the required debriefing.

If the debriefing is required and the requestor protests before receiving it, the GAO will dismiss the protest as premature. After debriefing, the protestor may resubmit its protest as long as its is within 10 days after the debriefing. In order to invoke the suspension of performance provisions, however, the protest must be resubmitted within five days after the debriefing.

Preaward Debriefings

The Clinger-Cohen Act authorizes preaward debriefings to firms that have been eliminated from award consideration. A short-lived regulation in FAC 90-44 initially required that preaward notices to firms being eliminated from the competitive range expressly advise them of the availability of debriefing. This regulation was not included in subsequent FAR Part 15 rewrites.

The required information for firms excluded from the competitive range should not be as extensive as that disclosed at postaward debriefings. In preaward debriefings the firm excluded from the competitive range is not informed of the number and identity of other firms nor of the content, evaluation and ranking of any proposals. All that must be disclosed is the agency's evaluation of significant elements of the proposal, a summary of the rationale for exclusion and responses to relevant questions on whether source selection procedures and regulations were followed.

The FAR provisions relating to postaward notices of award expressly requires the CO provide these notices of award no later than within three days of contract award. For preaward notices, the FAR does not set out a specific time line for preaward notices. Rather, the CO is instructed to "promptly" provide this notice. The preaward debriefing rules instruct an agency's CO to "make every effort" and provide "as soon as practical" the requested debriefing. The CO may delay providing required information if it is in the government's best interest. The GAO has ruled the CO has the discretion to delay the debriefing until after award. If it is delayed until after award, it must be provided not later than five days after the award date. The information disclosed at this delayed debriefing must be the same information disclosed to the postaward unsuccessful firms.

Postaward Debriefings

Any firm retained in the competitive range has a right to a postaward debriefing provided the firm submits a timely written request for a debriefing. If award is made on the initial proposal without discussions, any firm that submitted a proposal would have a right to a timely requested postaward debriefing. Once an agency receives the request, it must schedule a

debriefing by either sending the written debriefing information and/or conducting a telephone conference debriefing or expressly offering to hold a face-to-face debriefing on a specified date.

The date offered by the agency, not the subsequent accommodating debriefing date, controls the start of the suspension of contract performance and timeliness of protest clocks. Otherwise, requesters could stall. The date offered by the agency must be expressly conveyed to the requestor with some form of record in the contract file. In postaward debriefings, the agency must provide the firm with:

1. Its proposal's evaluated significant weaknesses or deficiencies

2. The overall evaluated price/costs (including unit prices) and the technical ratings of the debriefed firm and the awardee

3. If ranking was developed, the overall rankings of offerors

4. A summary of the rationale for award

5. For commercial items, the make and model of the item to be delivered and

6. Reasonable responses to relevant questions about whether source selection procedures and applicable regulations were followed.

The above is the minimum information required and the CO may provide additional information unless disclosure is specifically prohibited. There is some information the agency is precluded from disclosing such as that which reflects:

1. A point-by-point comparison between the debriefed firms proposal and those of other offerors

2. The names of individuals providing referenced past performance information

3. Information that is exempt from release under the Freedom of Information Act such as trade secrets, privileged or confidential manufacturing processes/ techniques, confidential commercial and financial information including cost breakdowns, profits, indirect cost rates and the like.

Accommodating Requesters

The FAR states that an offeror eliminated from the competitive range that fails to make a timely request is not entitled to a debriefing. In practice, these requests may be accommodated. Accommodations, however, do not automatically extend the deadlines for filing a timely protest nor extending the opportunity to suspend contract performance.

COST PRINCIPLES CHANGES CHART SINCE 1991

When cost allowability questions arise, the general rule is that the versions of the cost principles found in FAR 31.205 on the date of the contract governs. Because the cost principles undergo changes it is a good idea to know which version of the cost principles applied to a particular contract. The attached chart is a handy reference of changes to the cost principles since 1991. They are a copy of a periodic updated chart found in the Nash & Cibinic Report and duplication is not prohibited.

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