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Knowing Your Cost Principles…
BID AND PROPOSAL COSTS

(Editor's Note. As part of our continuing series on exploring a FAR 31.205 cost principle, we have relied on numerous texts for this article especially Accounting for Government Contracts by Lane Anderson.)

Allowability

Bid and Proposal (B&P) costs are incurred in preparing, submitting and supporting bids and proposals (whether or not they were solicited) on potential government or non-government contracts. Although marketing and sales costs are similar to bid and proposal costs, basic B&P costs are incurred in preparing specific documents whereas selling and marketing costs are more general in nature. Costs incurred in deciding if a bid or a proposal should be prepared, for example, are not considered B&P but marketing.

Since 1997 all bid and proposal costs are allowable if reasonable and allocable to a contract. When the government used to impose ceilings on bid and proposal costs distinguishing between B&P and other costs were essential since recovery of other costs were not limited. Though less critical, making distinctions is still important. For example, in *General Dynamics (ASBCA Nos. 15394 and 15858)* the government contended the costs of building a mock-up of a product were improper B&P costs but should be considered development and test expenses. The Board disagreed ruling since the mock-up was needed to display the company's capabilities as well as to develop the products, the costs were properly classified as B&P. This was significant because had the costs not been B&P they would have been considered direct costs of the contract rather than indirect costs resulting in a cost overrun to the contract and hence non-recoverable.

Allocation

Bid and proposal costs should generally be treated as indirect costs unless the contract requires submission of a proposal for subsequent work and authorizes the costs be charged directly to that contract. Individual task orders on ID/IQ contracts frequently contain this stipulation. These are the only conditions under which B&P expenses may be charged directly to a contract and when these conditions are met, only bid and proposal costs covered by the contract clause must be direct charges.

This raises the question about whether all B&P costs incurred on one of these contracts must be charged direct to that contract even when, for example, the task order or contract may limit the amount of reimbursement (e.g. caps on B&P reimbursement). In *Boeing (ASBCA 29793)* the contractor treated some costs as direct in compliance with contract terms while other related costs were charged indirect. The contractor argued this treatment was appropriate because the costs charged indirect were for efforts above and beyond that required to submit the proposal since they were incurred before the government requested a submittal of a proposal. The Appeals Board rejected these arguments and classified the entire effort as direct costs to the contract but a higher Court (*Boeing Co. v. US, CA FC No 88-1298)* reversed this decision. The Court said the contractor's distinction was appropriate and the treatment of some costs as direct and others as indirect was warranted under the circumstances. The Court concluded the only costs required to be treated as direct in this case were those incurred after the government's go-ahead for preparing the proposal – costs incurred before and after this period were properly treated as indirect.

Many would think these B&P costs would have to be treated either direct or indirect in accordance with CAS 402 (consistency of treating like costs under like circumstances). To prevent such an interpretation in the light of the *Boeing* case, DCAA changed its guidance to auditors to permit direct charging of the cost of preparing task order price proposals under an ID/IQ contract as long as such costs are classified

as B&P, the contractor's policies provide for direct treatment and the contract terms require the contractor to submit such a bid.

♦ CAS Covered Contractors

Accumulation and allocation of bid and proposal costs are to be the same as IR&D costs. CAS 420, Allocating IR&D/B&P costs provide for similar treatment. The basic unit of accumulation is an individual B&P project or if immaterial in amount, a single account. For example, a contractor may decide to establish a separate account that would accumulate the costs of individual B&P projects whose expected costs are to exceed, say $10,000 while a separate account would be established to accumulate the costs of all other B&P expenses. CAS 420 requires costs allocated to B&P projects be treated as if they were final cost objectives or contracts (although G&A is not allocated) and treated as if they were G&A costs (e.g. allocated on the same base). B&P costs must include all the associated direct and overhead costs just as if they were another contract. The standard requires use of the same base used to allocate G&A costs and B&P costs are routinely included in the G&A pool.

Like IR&D costs, B&P can be accumulated at either the segment or group level. The proper accumulation point is determined by whether the costs benefit only one segment or several within a group. If a B&P project may benefit more than one segment then allocation of these costs must take this into account.

♦ Non-CAS Covered Contractors

FAR 31.205-18(b)(2) provides that non-CAS covered contracts and contracts subject to modified CAS coverage must still meet all provisions of CAS 420 except for CAS section 420.50(e)(2) and 420.50(f)(2) which have to do with allocation of costs between business units. Unlike the more restrictive requirement of CAS 420, the FAR permits use of an allocation base other than the G&A base if (1) the results of using the G&A allocation are "inequitable" and (2) the CO approves another base. The existence of two product lines within a single division having varying requirements for B&P costs would be an example of where another base may be desirable.

Does Clear Requirements for IR&D Apply to Less Clear B&P Costs?

There is some question by some commentators whether the rules that clearly apply to IR&D costs also apply to B&P expenses. First, DOD FAR Supplement 231.205-18, IR&D and B&P Costs, states these costs must have "potential interest to the Department of Defense" to be allocable to defense contracts. Though they are sufficiently broad to include just about all IR&D effort (we are unaware of any successful challenge) there is some question whether all B&P costs have similar "potential interest." Second, there is some question whether deferred B&P costs are allowable like its IR&D brethren. Offering an opportunity that neither generally accepted accounting procedures or the tax laws provide, the government allows contractors to recover deferred IR&D costs under certain limited circumstances. The FAR 31.205-18 cost principle addressing deferred IR&D costs includes "IR&D" and "B&P" in the title but only IR&D costs are actually referred. Though this raises the question whether deferred B&P costs are allowed, two ASBCA cases (*North Am Rockwell Corp. ASBCA No 13067* and *Channel Splicing Machine Co., ASBCA No 10209*) have supported the conclusion that B&P and IR&D costs should be treated the same.

CHALLENGING A DISALLOWANCE OF OVERTIME PREMIUM

(Editor's Note. We have selected this case study not only because it explores an interesting cost issue – overtime premium – but it also demonstrates how to effectively assemble and present arguments to challenge a DCAA position as well as illuminates certain key concepts such as equitable estoppel and misapplying certain contract clauses. The source of this article is a position paper prepared by one of our favorite colleagues, Len Birnbaum of Leonard Birnbaum & Company, in challenging a DCAA disallowance of costs claimed by his client. Len is a member of our "Ask the Experts" panel of consultants and attorneys who respond to our readers' questions on cost, pricing and contract issues at no charge.)

Background

Contractor (*we will omit the name of the company*) includes various fringe benefits as well as paid overtime premiums in its fringe benefit pool. Dividing the fringe benefit pool by total labor, a fringe benefit rate is computed. The overhead pool includes fringe benefit costs applied to both direct labor and overhead labor (fringe benefit rate times the labor) while the G&A pool includes fringe benefit costs of

G&A labor. This practice has been followed by the contractor for several years, the practice is disclosed in several written policies and DCAA has consistently approved the practice for purposes of developing forward pricing rates as well as historical purposes. The level of overtime premium is not unusually high when compared to other companies and since over half of its contracts are fixed price, there is a strong incentive to control its expenses including overtime payments.

♦ DCAA Position

In the course of auditing its last incurred cost submission, DCAA, for the first time, challenged the inclusion of the overtime premium in the fringe benefit rate because the FAR clause 52.222-2, Payment for Overtime Premiums, that was incorporated in its cost reimbursement contract had a zero amount in paragraph (a) that states "the use of overtime is authorized under this contract if the overtime premium cost does not exceed *……." Since there was no figure in the clause, DCAA questioned the amount of overtime premiums that were included in the fringe benefit pool. In addition, DCAA asserted use of overtime did not result in overall lower costs because it would have been less expensive for the company to have more full time employees.

♦ Relevant Regulations

FAR 22.103-1 provides general guidance concerning the government's policies, procedures, approval process and use of overtime. As a general policy, the government, to the extent practical, requires contractors to perform all contracts without using overtime. Accordingly, solicitations generally do not specify delivery or performance schedules that would require the use of overtime at government expense. Contracting officers should consider the extent and necessity of overtime when negotiating contracts and when they know in advance, the parties may negotiate the amount of overtime premium that can be paid without the need of obtaining further approval. Approval may be granted by the CO and the amount of overtime premium negotiated and authorized should be stated in the FAR clause 52.222-2 for cost reimbursement type contracts over $100,000 and the amount inserted in paragraph (a) of the clause. The limitation, however, does not apply to emergencies, indirect labor employees, operations of a continuous nature or if it will result in lower overall costs. Also, contracting officer approval is required for payment of overtime premiums under time and material and labor hour contracts.

Response

♦ DCAA cannot retroactively disapprove of an accounting practice that was previously approved and accepted.

It is a well established principle of contract law that the Boards of Appeal and Courts will not permit retroactive disallowances of costs when the contractor can show it reasonably relied on the government's prior consent. This principle is known as "equitable estoppel" or "estoppel." It applies when a contractor can show a history of acquiescence or approval over a particular accounting practice by the government. In order for the equitable estoppel doctrine to apply the following conditions must be present:

1. The government must have had actual notice of all relevant facts
2. The contractor must have reasonably relied upon the government's actions or inaction.
3. The government must have realized or should have realized the contractor's reliance.
4. The contractor would be prejudiced or suffer a loss as a consequence of the retroactive application.

All of the above conditions appear to be present. The existence of policies and procedures, forward pricing rates and indirect cost rate submissions identified the handling of overtime premium. In establishing the prices of both cost and fixed type work, Contractor reasonably relied on DCAA's prior acceptance. DCAA must have realized the Contractor's reliance in establishing contract prices. Any retroactive disallowance of overtime premium would be clearly prejudicial to Contractor since it would be unable to recoup such costs.

♦ FAR 52.222-2 payment for overtime premiums applies only to amounts charged to a particular contract.

DCAA contends that a zero amount entered in subparagraph (a) of that clause applies to both overtime premium costs charged direct and to overtime premiums costs included in the indirect cost pool. First, the clause that is inserted in the contract is unique to that contract and logically can only be applied with respect to the direct charges to the particular contract. Further, even if the FAR Clause

52.222-2(a) is construed in a manner so as to apply to indirect costs, the overtime premium costs are not automatically unallowable because such costs can be approved retroactively, if justified. Overtime premium that is included in the indirect expense pool is equitably distributed among all of Contractor's contracts. At the inception of a contract, it would be very difficult, if not impossible, to ascertain a proportionate share of indirect expense that could be reduced to a dollar amount and inserted in the clause. Moreover, its should be recognized that when the contracting officer accepts the indirect cost rate, which includes overtime premiums, the contracting officer has, in effect, approved the inclusion of overtime premiums as part of the indirect expense rate.

In addition, there is not a single case Len could find addressing application of FAR 52.222-2 to overtime premiums being charged indirect. Based on his extensive experience, FAR 52.222-2 has been interpreted as applying overtime premium that is charged directly to a particular contract. Thus it appears the auditor has made a determination that is not supported by the applicable regulations, case law or practical considerations.

♦ **Contractor's method of accounting for overtime premium results in lower overall costs to the government.**

DCAA contends that Contractor should have more full time employees rather than incur overtime premium costs. In order to prove its point, DCAA attempts to make a comparison of cost of hiring additional employees versus the use of overtime.

DCAA's analysis fails to consider the following. First, the requirement for overtime work depends upon scheduling and a combination of other factors. Contractor has a powerful incentive to carefully control overtime premium costs because half of the total amount is allocated to fixed price contracts. Second, DCAA did not consider the full extent of the variable costs related to direct labor (e.g. health and life insurance premiums, additional supervision, other variable indirect costs, and the costs of recruiting, training and severance pay). Third, it is inappropriate for DCAA to attempt to substitute its opinion for Contractor's management judgement concerning the number of personnel that should be employed.

ELEMENTS OF AN ADEQUATE COMPENSATION SYSTEM

(Editor's Note. Audit guidance on contractors' compensation practices has been extensively revised over the last year and a half. Areas receiving most revisions are what constitutes an adequate compensation system and how to assess the reasonableness of compensation for various categories of employees. The effect of these changes is to expand the scope of compensation reviews at large contractors and initiate various types of reviews at mid-sized and even smaller contractors. In the first two articles of this three part series we focused on recent changes to DCAA guidance on evaluating compensation levels of non-senior categories of labor and senior executives. In this article we address new guidance addressing what constitutes an "adequate compensation system," new areas of review and what audit steps auditors are instructed to take. We recognize this series of articles will be of interest to other functional areas of your organization (e.g. human resources, project management, business owners, etc.) so feel free to reproduce and distribute them to people you feel will benefit.)

What is an Adequate Compensation System

A compensation system is an inherent part of establishing reasonable compensation in accordance with FAR 31.205-6. In new sections of Chapter 5 of the DCAA Contract Audit Manual (DCAM) and its revised audit program (Audit Program for Reviewing and Reporting on Contractor Compensation System and Related Internal Controls, Version 2.6, January 2001), DCAA has elaborated on what it considers an adequate compensation system:

♦ Organization Structure

The contractor's pay administration function should be organized on the basis of a "definitive flow of authority". The contractor should define the lines of authority as well as the duties and responsibilities for administering the pay system and approving changes to cash and non-cash components of compensation. The guidance recognizes the compensation function can be organized very differently depending on the nature of products or services, size of organization, degree of centralization, management attitudes, etc.

♦ Management Reviews

Recent additions to the DCAM emphasize the need to adequately "monitor" the compensation system.

The audit program incorporating this new emphasis stresses Management should conduct compliance reviews to be reasonably assured that (a) qualified employees are working on the compensation system (b) periodic training of these employees are conducted (c) policies and procedures exist and they are consistently followed (d) pay actions are properly authorized and approved and (e) compensation paid to employees are reasonable.

♦ Policies and Procedures

The contractor should have written policies and procedures as opposed to less formal "established custom" to ensure compensation for employees working on government contracts is reasonable. These written policies and procedures should address (a) an established wage and salary structure (b) a system of "internal equity" which includes job analysis, job descriptions and job evaluation (c) a system of "external equity" such as pay policy, relevant market, external pay surveys and market comparisons (d) a description of fringe benefits (e) a system for determining pay increases and promotions and (f) operations of performance procedures. The auditor is instructed to verify policies and procedures exist in these areas.

♦ Training

Pay administration employees need to receive training to perform their pay administration tasks in conformity with the contractor's policies and procedures. Auditors are instructed to verify training has occurred.

Recent Emphasis on Areas for Review

The DCAM indicates audits of the compensation system should be conducted at major contractors, non-major contractors "where the system is considered significant" and contractors with substantial firm-fixed price contracts. The evaluation of the compensation system and internal controls will be assessed separately and the results will be used to determine the scope of further review. There have been extensive changes to auditing specific elements of compensation. In addition to the guidance we have discussed in the last two articles covering reasonableness by job class of employees and use of offsets as well as costs of owners, executives and other "high risk" employees in closely held companies new guidance includes the following:

♦ Executive Compensation

The new guidance recognizes executives may have enhanced or supplemental benefits not available to the majority of employees and their reasonableness should be evaluated against market surveys or other available data. The prevalence of such plans should also be considered. So, for example, just because a survey says long term incentive (LTI) pay is 10% of base salary, a 10% LTI plan would not necessarily be reasonable if only a small percentage of participating companies have LTI plans. The guidance also addresses specific types of supplemental benefit plans:

a. Supplemental executive retirement plans (SERPs). The guidance puts the burden on the contractor to document the reasonableness of SERPs (sometimes called ERISA excess plans) by using market data. If no measurable market data is provided, the auditor is to benchmark total pension compensation as a percent of base salary. If no data can be obtained, the auditor should question the costs.

b. Deferred compensation. This is defined as award given in a future accounting period(s) for services rendered in one or more prior accounting periods before receipt. Examples cited include split-dollar life insurance (a plan giving both the employer and employee an interest in a cash value life insurance on the employee's life) and rabbi trusts (a means to accumulate deferred compensation to usually fund a SERP).

c. Long term incentive (LTI) plans. These are compensation plans having award periods of two or more years that are typically based on achieving some long-term business goals and are used to retain key executive talent. The guidance reminds auditors that the most common types of LTI plans are based on stock options which are unallowable.

d. Executive severance. Whereas most severance policies are based on years of service executives are awarded severance in excess of normal policies. The guidance warns contractors will often allude to employment contracts as justification for their higher severance but the employment contract does not necessarily support the amount as reasonable. Rather, comparable market surveys or other data benchmarking comparable executives should be used.

In addition auditors are reminded (1) "golden parachute" benefits are expressly unallowable (2) executive pay (salary, bonus and deferred compensation) should be compared to prior years and the auditor should obtain explanations and justification

for significant increases, paying particular attention to whether the company's financial performance justifies the increases (3) executive pay components being evaluated should be consistent with that being reflected in surveys, noting that survey data usually combines base pay and cash bonuses and reflects long term incentive pay as a percent of base pay.

♦ Non-Executive, Non-Bargaining Unit Employee Compensation

Section 5-808 adds extensive guidance on how contractors should review pay for non-executives that are not covered by union contracts. Many of the changes are made to incorporate recent changes in FAR 31.205-6(b) that adds *job class* of employee to the previous measure of *grade level* to determine reasonableness of compensation. The new guidance addresses the necessary reviews a contractor should take and the steps auditors need to take to ascertain whether they are taking appropriate action. Some of the highlights include:

1. Market comparisons. The company benchmarks wages and salaries of employees by job class or grade level and takes "corrective action" when levels exceed 10% of survey data. Market based pay takes precedence over internal considerations when valuing a job.

2. Management Review. Management reviews for adjusting pay structure including assumptions about inflation, changes in the job market, pay increases and merit increases as well as how reassignments of job additions or reslotting are made.

3. Internal Equity. Internal equity – equal pay for jobs of equal worth and acceptable pay differentials for jobs of unequal worth - is maintained.

4. Job Analysis and Descriptions. The section adds considerable material indicating a contractor should provide adequate job analysis and job descriptions. Job analysis is the process of obtaining relevant information about a job that relates to the nature of work and the level of skills needed. Using the data from job analysis, the contractor also needs to have job descriptions that describe the most important features of a job including duties and responsibilities, level of skill, effort, accountability and working conditions. Use of trained personnel is stressed.

5. Job Evaluation. Alluding to almost limitless ways to evaluate jobs, five methods are identified: (a) ranking (by worth or value) (b) classification (number of grades or levels specified beforehand) (c) slotting (putting new job descriptions into existing ones) (d) factor comparison (key factors such as skills or responsibility are identified and each job benchmarked according to the factors) and (e) point factor (similar to factor comparison but used for exempt jobs).

6. External Equity. Almost three pages of new guidance covers general market comparisons and specific use of surveys to determine compensation reasonableness. Actual cash payments of compensation should be benchmarked against the labor market for the same job where practices of firms of the same size, industry, geographic area, primarily non-government work and comparable services are considered. In addition, supply and demand, competition for the skills and internal factors such as ability to pay, business strategy, productivity and skills of current work force are evaluated. The most important factors will vary depending on what is the relative importance in the relevant market.

External pay surveys provide the detailed data regarding market pay levels. The new guidance recognizes the validity of private and contractor self-conducted surveys in addition to the traditional public surveys. Guidance indicates these latter two type of surveys can be useful by focusing on specific companies contractors must compete with for labor but auditors need to make sure they are reliable and unbiased. Auditors are told that evaluation of choices of pay surveys should consider if (1) the survey provides specific job classification with corresponding job descriptions and duties (2) "maturity-curve" surveys are an acceptable alternative where surveys do not adequately measure professional, scientific or engineering jobs (3) well defined procedures detailing criteria to use (e.g. geographic location, company size, industry type) and (4) weighted average rates by job are provided that also should include minimum/maximum and/or percentile or quartile data.

♦ Review of Employee Benefit Programs

Common benefits include health and life insurance, pensions, worker's compensation, pay for time off, etc. Though each element should not be unreasonable, auditors will focus on the total benefits package. Policies should include (1) identifying contractors' objective in setting the package (2) eligibility requirements for various benefits (3) flexibility in plan coverage (e.g. "cafeteria-style" plans) and (4) the method of financing (e.g. contributory, employee financing). The new guidance adds that each element should comply with FAR 31.205-6(m) and the total compensation package including cash

compensation and fringe benefits must be reasonable in accordance with FAR 31.205-6(b).

When Deficiencies are Found

When the auditor has determined that there are sufficient internal control deficiencies to preclude an assessment that wages and salaries are reasonable the auditor must take other steps depending on the nature of the deficiencies. When there are system deficiencies that are not severe enough to prevent a demonstration of reasonableness then normal audit steps (e.g. comparison of wage and salary levels against surveys) will be taken to determine independently whether compensation is reasonable. In addition an action plan will be adopted. If the deficiencies are considered serious enough to prevent a demonstration of reasonableness the normal audit steps will not begin and the focus will be put on "fixing" the deficiencies. The contractor will be asked to prepare a time phased corrective action plan. Auditors are instructed to consult with the Administrative Contracting Officer to determine if other steps should be taken (e.g. contract billing withholds).

TASK ORDER CONTRACTING

(Editor's Note. We have reported in the GCA REPORT on several GAO and Inspector General reports criticizing the government's use of task order contracting. We found a recent article on task order contracting that addresses these recent developments and we have based this article on the June 2001 Briefing Papers written by Raymond Fioravanti of the law firm of Epstein Becker and Green, P.C.)

Basics

Since Congress in the Federal Acquisition Streamlining Act (FASA) of 1994 explicitly authorized federal agencies to make multiple award of task and delivery order contracts they have gained in popularity and scope. This contract vehicle allows an agency to award a contract to many and even all offerors competing under a single solicitation. The contracts themselves offer contractors only an opportunity to compete against each other for task orders for services or delivery orders for supplies under the contract (we will collectively refer to the orders as task orders or TOs). The frequency and scope of multiple task order contracting for services was increased even further since Congress passed the Clinger-Cohen Act of 1996 that introduced the Government-wide agency contracts (GWACs) that allow any federal agency to acquire information technology services through the awarding agency.

FAR Part 16.5 is the regulation implementing the FASA directive. Generally, the FAR provision on indefinite delivery/indefinite quantity (i.e. task and delivery order contracts) contracts instructs contracting officers, to the "maximum extent possible", to give preference to ID/IQ contracts under a single solicitation for the same or similar supplies and services to two or more sources. The FAR requires task order contracts for "advisory and assistance services" that include management and professional support services for providing studies, analysis, evaluation, engineering or technical services if they will exceed $10 million (including options) and three years.

Soliciting and Awarding the ID/IQ Contract

Whether it is for an agency or the broader GWACs, the purpose of the award is to have contractors compete with each other through the contract process. This is achieved through two steps: First, an umbrella task order contract is awarded where there is no limitation on the number of awardees that may be selected. Second, is the issuance of solicitations for individual task orders where the individual orders may be made on an informal basis using "streamlined" selection processes. Several issues arise:

Umbrella Statement of Work. The initial statement of work in the basic contract is intended to be fairly broad where it provides a definition of the work to be performed under which each order must fall. If a subsequent task order does not fit, it must be processed through another contract. Both FASA and FAR 16.5 provide for broad – some say even vague – statements of work. The limits on how broad a statement can be has not been reached. For example, a recent GWAC for the Federal Aviation Administration contracted a statement of work that included every possible service associated with information technology. Guidance by the Office of Federal Procurement (OFPP) in its "Best Practices for Multiple Award Task and Delivery Order Contracting" states agencies should have flexible broad statements. One of the only areas of successful protest of task orders is when it exceeds the original scope of work. The OFPP guidelines encourage COs, program managers and industry to work together to develop a clear statement of work.

Bundling. "Bundling" is the practice of consolidating two or more previously smaller contracts into a single, larger contract. The advantages of economies of scale, reduced administrative costs and increased reliability is offset by limiting competition to fewer contractors capable of meeting a broad range of demands which is especially harmful to small contractors. Agencies are instructed to conduct market research and carefully identify the benefits before bundling contracts.

Number of Awardees. Agencies have wide discretion in determining the number of awards it will make under the umbrella solicitation. The FAR instructs COs to avoid situations where particular awardees specialize in one or a few areas of the statement of work that will result in award of task orders to those firms on a virtual sole-source basis. The OFPP recommends an agency make a reasonable number of awards to ensure competition but that keeps the ordering process from becoming burdensome.

Competitive Range Determination. Selection of ID/IQ awardees receive less scrutiny than single award selection decisions. The FAR allows the agency to reduce the competitive range of offers to an "efficient" number where the agency has broad discretion in setting the competitive range and delivering what is an efficient number. If an agency, for example, decides that of 150 offerors, the competitive range will be set at 40, it may then decide to make awards to all 40 offerors.

Evaluation Factors. Multiple award contracts are subject to the same evaluation requirement as other negotiated procurements. Agencies must consider price (or cost) along with quality. Quality may be measured on the basis of an offeror's past performance record where in a procurement over $100,000 past performance *must* be considered.

Issuing Orders

Competition for task orders begins only after the umbrella contract is in place. After that, contract awardees are entitled only to minimum quantities specified in their contract and a CO may select awardees for task orders using "streamlined" procedures.

Task Order Statement of Work. Unlike the umbrella contract, Task Order SOWs must be fairly detailed, all orders must be within the scope of the umbrella contract (again, this is the only grounds to protest a specific TO) and orders must include, at least, descriptions of services or supplies, quantity and unit or estimated price.

Streamlined Selection Process. COs have broad discretion in determining the process for selecting recipients for individual TOs and the FAR encourages "streamlined" approaches. The procedures and selection criteria must be identified in the umbrella contract. "Full and open competition" is not required but rather a "fair opportunity to be considered" for each order over $2,500 unless a sole source award is justified. Essentially, the CO can contact two or more contractors and ask them to compete.

The FAR directs COs to keep the requirements for submission to a minimum. Though written proposals may be required, the FAR allows and the OFPP encourages oral presentations. For selection criteria, the FAR requires only price or cost be considered but adds the CO should consider (1) past performance on earlier orders under the contract (e.g. quality, timeliness and cost control) (2) potential impact on other orders placed with the contractor and (3) minimum order requirements. The OFPP recommends past performance be used as an "initial screen" to determine which offerors will be considered.

In practice, competition is often no more than a formality. Umbrella contract awardees are not required to be notified of an order opportunity. Many may be eliminated from further consideration (i.e. competitive range) because they did not pass the "initial screen". Under GWACs, ordinary agencies may state a preference for a contractor and request they receive a solicitation for an order.

Sole Source Orders. Compared to strict impediments to sole sourcing under normal contracting (e.g. approval by head of contracting agency, protests by others), an agency has significant discretion to award TOs on a sole source basis. Though the FAR directs COs to avoid situations where awardees specialize in only one or a few areas to avoid likelihood of sole-source awards, sole source awards over $2,500 are allowed when (1) the agency's needs are urgent (2) only one awardee is capable of providing the quantity of service because it is unique or highly specialized (3) a follow on contract is justified for reasons of economy and efficiency as long as the original TO was fairly competed and (4) a minimum quantity must be met.

Pricing Orders. The FAR specifies that contracts for TOs can provide for a wide range of cost or pricing

arrangements including cost-reimbursement, time and material, labor hour/level of effort and fixed price. If the task can be specified in sufficient detail to permit reasonable estimates and fair price competition, fixed prices should be used; if not, then other pricing methods may be used. When the umbrella contract does not establish an overall price, the CO is to establish prices for individual TOs using methods established in FAR 15.4 for pricing negotiated contracts.

Contractors' Obligation to Compete. Depending on terms of the umbrella contract, contractors are obligated to submit a good faith proposal if the agency requests one. Otherwise, the agency may simply issue the order at a price found to be reasonable. The OFPP encourages agencies to minimize the requirement for contractors to submit bids to provide them the flexibility to determine when to prepare bids.

Use of Blanket Purchase Agreements (BPAs). Further circumstances to lessen competition even more is use of BPAs. The FAR defines a BPA as a means of filling anticipated repetitive needs for supplies and services by establishing a "charge account" with qualified sources. BPAs are an acceptable contracting method under the FAR 15 simplified acquisition procedures for purchases under $100,000. The FAR, and most recently the General Accounting Office, allows agencies to establish BLAs with Federal Supply Schedule (FSS) suppliers where the FSS program gives established ID/IQ contracts with commercial firms to allow agencies to buy supplies and services at stated prices and time periods.

Duration of Contract. Whereas ordinary contracts contain specific dates by which the work must be completed, TO contracts specify a "period of performance" where orders may be placed but not a term of performance under the orders. The only time limit applies to advisory and assistance services where a 5 year time limit applies to placing orders (though not for performance of those orders).

Implications for Contractors

The authors identify some lessons for contractors:

1. Awardees of umbrella contracts will need to actively market their supplies and services to agency officials more. Since officials may specify preferred vendors and follow-on orders may be sole source, more marketing activity is called for to take advantage of COs buying discretion.

2. You cannot protest awards of individual TOs except on grounds they exceed the scope, period or maximum value of the contract.

3. When placing individual TOs the agency is not required to notify you of an opportunity so intelligence gathering become more important.

4. Become very familiar with the TO selection procedures and evaluation criteria set in the umbrella contract. Also, develop skills in oral presentations to meet agencies' desires to streamline procurement procedures.

5. Be aware that agencies may use past performance as an "initial screening" device to eliminate you from further consideration.

6. The umbrella contract may require you to submit a proposal for TOs or, at least, indicate why you are not submitting an offer.

NEW GUIDANCE ON WHAT IS AN ACCOUNTING CHANGE

(Editor's Note. We often find confusion by both contractor personnel and government representatives on what constitutes an accounting change. This confusion often leads to unfortunate results. For example, a contractor may not adopt a desirable practice for fear it is an accounting change requiring extensive justification when it really is not a change. Or conversely, a contractor may adopt a change and not realize it is a change requiring a justification or demonstration the government is not harmed. The new guidance represents the most current ideas on what constitutes an accounting change. It is presented in clearer terms than found in the cost accounting standards and includes new examples intended to illustrate the concepts.)

On January 17, 2002 the Director, Defense Procurement issued guidance to assist administrative contracting officers and auditors to determine when a change occurs in cost accounting practice under the cost accounting standards. The guidance, found at www.acq.osd.mil/dp, follows an unsuccessful seven year effort by the CAS Board to extensively redefine what constitutes a change in a cost accounting practices. Though the guidance formally addresses accounting changes for fully and modified CAS covered contractors, in practice, the guidance affects cost accounting changes for all contractors, whether CAS covered or not.

In summary form, the guidance states ACOs and auditors should use the following to determine if a change occurs:

1. An accounting change occurs when there is a change in the method or technique for determining (a) whether a cost is direct or indirectly allocated (b) the composition of the cost pools (c) the selection of the allocation base or (d) the composition of the allocation base.
2. A change has not occurred when there is the initial adoption of a cost accounting practice for the first time a cost is incurred or a function is created.
3. A change has not occurred when there is a transfer of contract work from one segment to another provided the cost accounting practices at the segments remain unchanged.
4. When there is a change in cost accounting practice, only affected CAS-covered contracts are subject to price or cost adjustments.

What is a Cost Allocation Practice

The definition of a cost accounting practice has not changed and the guidance cites 48 CFR 9903.302-1(c):

> Allocation of cost to cost objectives, as used in this part, includes both direct and indirect allocation of cost. Examples of cost accounting practices …are the accounting methods and techniques used to accumulate cost, to determine whether a cost is to be directly or indirectly allocated, to determine the composition of cost pools and to determine the selection and composition of the appropriate allocation base.

Since changes in cost accumulation practices generally occur when there is a change in the composition of the pool or base, auditors should focus on the following:

♦ Direct vs. Indirect

Specific identification of a cost to a final cost objective or to a business segment is a direct allocation method. Accumulating a cost in a specified indirect pool or home office pool for purposes of allocating to multiple cost objectives or segments is an indirect allocation method. A change in direct vs. indirect allocation can occur within a business segment, within a home office, between two segments, between two or more home offices or between a segment and home office.

New examples of changes in the method of allocating costs direct versus indirect include: (1) if company reorganizes its engineering group within a business segment and first line supervisor costs formerly charged to the engineering overhead pool are now charged directly to cost objectives and (2) payroll function was formally performed at Segment A and B but is now performed at the home office level – this is a change for Segments A and B if the home office indirectly allocates the costs of the payroll functions to Segments A and B but is not a change if the home office directly identifies the costs of the payroll functions to A and B.

♦ Determining the composition of cost pools

Functions and activities. Indirect cost pools are composed of "activities" (e.g. machining supervision, purchasing, security, inspection, insurance administration) and functions that are defined as "an activity or group of activities that are identifiable in scope and has a purpose or end to be accomplished." A change to the composition of a cost pool occurs when a contractor changes the functions or activities that compose the indirect cost pool.

Combining indirect cost pools. When two or more pools are combined, there is a change in the composition if the functions or activities of the previously separate pool(s) are not generally the same as the functions or activities of the new combined pool.

For example, Segment A of Company 1 has an assembly overhead pool where functions and activities consist of assembly supervision, materials inspection and machine maintenance. Company 1 purchases Company 2 which becomes Segment B. Company 2, which used to perform fabrication for Company 1, has a fabrication pool including fabrication supervision and tool calibration. After the sale, the fabrication pool of Segment B is combined with the assembly pool of Segment A. This is a change for both segments – the functions and activities of the two prior pools have been substantially changed with the combination.

Dividing indirect cost pools. When a company divides a single indirect cost pool into two or more pools, a change occurs in pool composition because the functions and activities in the divided pool(s) are not generally the same as the functions and activities of the former single pool. For example, an accounting change has occurred when a single overhead pool includes two functions, building maintenance and

security and then divides the single overhead pool into two separate cost pools consisting of maintenance and security functions.

Transfer of functions. A transfer of a function or activity from one pool to another is not considered a change in pool composition if the transferring pool (i.e. the pool from which the function or activity is transferred) receives an allocable cost of the function or activity from the receiving pool. Otherwise, the transfer represents a change for the transferring pool. If the receiving pool contained that function or activity prior to the transfer then a change has not occurred.

For example, the engineering overhead pool contains a production engineering supervision function while its production overhead pool does not. If the production engineering function is moved from the engineering overhead pool to the production pool a change to both pools has occurred because the engineering overhead pool no longer contains the supervision costs while the production overhead pool now contains the supervision costs.

Disclosed and established practices. When determining whether a change has occurred, the ACO and auditor are instructed to focus on the disclosed and established practices that define and describe the significant functions and activities of the indirect cost pools. They are warned that the disclosed practices, whether in the form of a disclosure statement or other policies, may not identify all functions and activities.

Variations in costs. Costs that are associated with a function of a pool may vary, even significantly, from one point in time to another. These variations do not result in an accounting change as long as the defined pool functions do not change. For example, if a contractor buys a building and the maintenance costs fall within the defined building maintenance function of the pool the increase in size of the pool does not affect its composition and hence no change has occurred.

♦ Determining the selection of the allocation base

The selection of the allocation base refers to the base measure (e.g. direct labor dollars, direct labor hours, direct material costs, total cost input or a resource consumption measure like computer usage or square footage). A change in the selection of the allocation base is a change in accounting practice.

♦ Determining the composition of the allocation base

A change in the composition of the allocation base occurs when (a) the elements of the base change or (b) the activities that are included in the base change. However, a volume change in the base (e.g. addition or deletion of a contract or a business segment) does not, in itself, represent a change. The elements include not only the type of base (e.g. direct labor) but the composition of that type (e.g. direct labor dollars plus overtime premium or fringe benefits). A change in the elements making up the base is an accounting change. For example, a change from a direct labor dollar to a direct labor dollar plus overtime premium is a change in the composition of the allocation base.

The composition of the base also encompasses the activities of the base (e.g. systems engineering, design engineering, fabrication) that are in some way related to the activities in the pool. A change in the activities is a change in the composition of the base. For example, a change from a machining direct labor dollar allocation base to an assembly direct labor dollar base is a change. However, as we have seen, volume fluctuations do not represent the change so, for example, a contractor that purchases a new segment and adds it to its home office allocation base does not change the composition of the home office allocation base.

Initial Adoption of an Accounting Practice or Elimination of a Cost or Cost of a Function is Not an Accounting Change

CFR 9903.302-2(a) states the initial adoption of a cost accounting practice is the first time a cost is incurred or a function is created. *(Editor's Note. We have often been successful in asserting a change in treatment of a cost that was immaterial in the past and then becomes material is tantamount to adopting a new incurred cost and hence is not an accounting change.)* Alluding to the controversy over whether an organization change represents an accounting change, when a function is transferred between segments, between home offices or between a segment and home office this does not constitute the creation or elimination of a function for either the segments or home offices. Similarly, the merger of two or more segments does not constitute the creation or elimination of a function.

For example, if a contractor establishes a new security function then this would be a creation of a new

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function. However, if the security function was transferred from one segment to another this would not be creation of a new function for the one segment nor the elimination of the function from the other segment.

Transfer of Contract Work

The transfer of work on a contract from one existing business segment to another is not a change in accounting practice or a noncompliance with CAS 401 (consistent treatment of estimated and actual costs) as long as the cost accounting practices at the segments do not change.

Often when work is transferred from one segment to another, the contract often will not incur the same costs as originally estimated. Instead the contract will incur costs in accordance with the cost accounting practices of the segment where work was transferred. The contract may incur the costs of the transferred work under a different indirect cost pool (e.g. Segment A's overhead pool instead of Segment B's overhead pool) or a different cost element (e.g. intra-company transfers). This is considered a business decision in how the work will be performed (similar to a make or buy decision), not a change in the cost accounting practices of either segment. As long as the cost accounting practices of the segments remain the same no change or noncompliance with CAS 401 has occurred. After all, the established cost accounting practices of the two segments were consistently used to estimate and accumulate each segment's costs.

Affected CAS-Covered Contracts

Affected CAS-covered contracts are those contracts on which the cost accounting practice change occurred. Affected contracts are only those that are subject to contract price or cost adjustments. Contracts may be impacted by events other than cost accounting practice changes (e.g. volume changes or contract performance changes). When the practices do not change for these contracts, they are not subject to contract price or cost adjustments.

For example, a contractor merges two indirect cost pools containing basically similar functions and activities. Pool A uses a direct labor dollar allocation base and Pool B uses a direct labor hour base and the combined pools uses a direct labor dollar base. Yes, there is a change in the selection of the allocation base for those contracts in the allocation base for Pool B but no change for those in the base of Pool A. Hence the affected CAS covered contracts are those only in the allocation base of Pool B and they are the only ones subject to a price adjustment.

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