GCA DIGEST

(A publication of Government Contract Associates)

Second Quarter 2001 Vol 4, No. 2

Knowing Your Cost Principles... IDLE FACILITIES AND IDLE CAPACITY

(Editor's Note. Whether motivated by reduced workload or desire to create economies and efficiencies, many contractors are doing more with less. However, when they are unable to dispose of the assets they originally acquired, contractors are often quite surprised to find the costs of the assets are being disallowed while if they did not attempt to streamline operations the same costs might not be questioned. Since many contractors have or will be confronted with these issues we thought it would be a good time to closely examine (1) the cost principle related to idle facilities (2) how board decisions clarify the principles (3) guidance auditors are asked to follow and (4) suggest some ways to handle the costs to maximize recovery of them for the longest period. We have used a classic article by Frank Knapp in the discontinued Government Contract Costs, Pricing & Accounting Report (May 1993) with updates from Mathew Bender's Accounting for Government Contracts as well as the Defense Contract Audit Agency's Contract Audit Manual.)

Definition. FAR 31.205-17 defines "facilities" as land, plant, equipment or other tangible assets owned or leased by the contractor. "Capacity" refers to the unused capacity of partially used facilities where "unused" is the difference between what was used in an accounting period versus what a facility would use under 100 percent operating time on one shift less normal operation disruptions (e.g. set-up, repair, rework, etc.). A multiple shift basis could be substituted if it could be shown to be normal usage for the facility.

Types of cost. Before discussing questions of allowability and allocability, FAR 31.205-17 identifies the type of cost attributable to idle facilities or capacity as rent, depreciation, repair, maintenance, property taxes and insurance costs. In *General Dynamics (ASBCA 19607)*, other costs under appropriate circumstances can qualify such as salaries, wages and fringe benefits of maintenance and security personnel as well as travel and communication expenses related to managing activities associated with idle facilities.

♦ Allowability

Costs that arise from idle facilities are unallowable unless they meet one of the following criteria:

1. The facilities were necessary when acquired but are now idle because of changes that could not be forseen (because, for example, of unforseen changes in government requirements, production economics, reorganization or terminations).

2. The facilities are necessary to meet workload fluctuations.

If these conditions are met the costs of idle facilities are not allowable indefinitely but only for a reasonable time – usually one year – depending on the actions taken to avoid them. We will look at a few of these considerations in more detail.

"Necessary When Acquired." The Appeals Boards have interpreted "necessary" as a "reasonable expenditure" which is appropriate for conducting business (*Boeing Co. ASBCA 13625*). Thus allowability hinges on whether the contractor can demonstrate it made a reasonable business decision at the time the facility was bought or leased. Board decisions have ruled that the business decisions may be based on (1) anticipated increases in business *(Vare Industries, ASBCA 12126)* (2) need to expand facilities to produce at a rate to provide economies of scale to compete in a particular market *(Raytheon ASBCA 32419)* and (3) the unique characteristics of a product preclude use of its other facilities *(Aerojet-General, ASBCA 15703)*. However, another case – *Hercules Inc., ASBCA 18382* – ruled that the costs of idle facilities were unallowable when they were not needed when obtained (they were acquired to enter a new market but the new business could have been handled by existing facilities) and hence the new facilities were considered a calculated business risk the contractor chose to take rather than a necessary action.

Length of Time. After determining the costs were necessary, how long the costs are to be allowed must be addressed. This is the most contentious issue we encounter. FAR 31.205-17(b)(2) suggests the period "generally" should not exceed one year. As a practical matter, when left to its own judgment, DCAA

interprets the one year as a maximum period while Board Decisions offer opportunities to go beyond one year. For example, in *General Dynamics*, the Board ruled a showing of "diligent or reasonable efforts" to dispose of facilities "permits recovery of costs for a longer period." The Board went further recognizing that diligent efforts to mitigate the costs may be unsuccessful for several years resulting in extending the period of allowability. The board has not decided what constitutes "reasonable effort" though the authors indicate the "prudent business person" standard should apply and be decided on a case-by-case basis.

Workload Fluctuations. FAR 31.205-17(b)(1) permits contracts to treat idle facilities costs as allowable if they are necessary to meet fluctuations in workload. Board decisions provide little guidance to when this condition is met, leaving such determinations to be made on an individual basis. The discussion above related to "necessary" can be used and in one case – *Aeroject-General Corp.* – has validated the principle that facilities need not be used continuously for them to be allowable. Facilities used intermittently for research and development or to store unused equipment and machinery meet the non-continuous principle (*Cook Electric Co. ASBCA 17100*).

To better ensure recovery of idle facilities costs, the authors recommend contractors maintain detailed records of all efforts taken to use, lease or dispose of those facilities. The records should document unique circumstances such as environmental problems, the local real estate market (e.g. preventing subleasing or only partial recovery of lease costs). Also, market projections, production schedules or other information useful to justify a decision to retain facilities to meet expected fluctuations in workload should be kept.

Idle Capacity

Under FAR 31.205-17(c), the costs of idle capacity are viewed as normal costs of doing business and are considered a factor in the normal fluctuations of usage or overhead. Like idle facilities, they are allowable provided the capacity (a) "is necessary" or (b) "was originally reasonable and not subject to reduction or elimination by subletting, renting or sale." The cost principle does advise that widespread idle capacity in a plant or group of assets may be considered idle facilities, subject to the same rules as idle facilities.

There have been some cases ruling on when capacity is considered idle but there is no clear guidance. In *AVCO Construction (ASBCA 10858)*, 13 percent of the company's capacity was considered idle and hence unallowable. In *Cook Electric*, the Appeals Board ruled that buildings with less than 25 percent idle capacity did not give rise to unallowable costs but higher amounts did. When the government suggested idle capacity existed due to excessively high overhead rates, the Board ruled in *Stanley Aviation Corp. (ASBCA 12292)* that high overhead rates, in themselves, did not establish the existence of idle capacity.

Standby Costs. Standby costs, which are costs incurred to maintain a facility at a capacity higher than currently needed, are usually allowable if reasonable. In *Big Three Industries, Inc. (ASBCA 16949)*, the Board allowed standby costs when the government reduced its contract needs but failed to notify the contractor who presumably could have taken action to either reduce costs or obtain other business with better notification. In *Fred D. Wright Co. (ASBCA 7200*), the board ruled reasonable standby costs were allowed, because the standby costs were for the government's convenience.

♦ Allocability

Once a facility become idle the basis for allocating the facility's continuing costs becomes an issue. The *Aerojet-General* decision established that consistency with past practices should be seriously considered. The case established other criteria to be considered when establishing an appropriate allocation base: (1) the relationship of the work previously performed at the idle facility to the contractor's other work (2) historical relationship of the idle facility with other business units within the company and (3) the effect of reactivating the facility would have on the contractor's other work.

In *General Dynamics*, the Appeals Board endorsed the principle that idle facility costs can be likened to independent research and development/bid and proposal costs characterized as normal costs of an ongoing business and hence allocated on a broad base (e.g. G&A base). The Board rejected the government's attempt to restrict allocation of the costs to only those contracts directly related to the closed facility, reasoning such an approach would systematically deny recovery of otherwise allowable costs. The Board said the criteria for allocations should be what is "equitable", indicating "burdening

small firms with large extraneous sums" was inappropriate.

The authors say that DCAA guidance on how to treat environmental cleanup costs incurred at contractors' previous sites constitutes sound guidance on how to allocate idle facilities costs. In that guidance (*DCAA MRD No. 92-PAD163IR, October 14, 1992*), DCAA suggests that continuing cleanup costs from closed sites be assigned to the business unit where the remaining work of the closed site was transferred and included in that unit's G&A expense pool. If no work remains from the site that was closed then the guidance suggests the site costs be transferred to the next higher group or home office and be included in the residual expense pool of the office and then be allocated just like any other residual pool expense.

♦ DCAA Guidance

DCAA audit guidance in Chapter 7-1906.3a of the Contract Audit Manual addresses only the length of time issue. Other references related to idle facilities (e.g. depreciation costs of idle facilities) reference the FAR cost principle only. In our experience, we have never seen DCAA allow a period longer than one year for otherwise allowable idle facilities costs unless there was a prior agreement with the ACO. Interestingly, the guidance explicitly recognizes the validity of extending the period beyond one year and provides some detailed conditions and criteria for extending this period. It states the regulation provides the CO with flexibility to accept a longer period. It urges auditors to recommend the CO obtain justification for a longer period when the facilities are expected to be idle for more than one year. The guidance specifies, at a minimum, the proper justification to extend the period should document: (1) whether the facility will be needed in the future and why (2) if not needed, what actions are being taken to lease or dispose of the facility and (3) an estimate of time to lease or dispose of the facility based on current market conditions, surveys of real estate prices, public record of real estate sales for similar facilities, etc.

The guidance states the auditor should assist the CO in determining a reasonable period but stresses both the CO and contractor should seek an advance agreement specifying the maximum period for which idle facility costs will be reimbursed. Without such an agreement, DCAA will question any amount over one year.

LESSENING THE IMPACT OF A NEGATIVE DCAA FINDING

(Editor's Note. We recently helped teach a two day Federal Publications seminar entitled "Government Contract Audits and Resolving Audit Disputes" with Len Birnbaum and David Sakofs of Leonard Birnbaum & Associates. One of the interesting topics covered, where instructors and students put forth examples from their experiences, was how to mitigate the impact of a negative audit position short of litigation. The following article discusses some of the insights we brought back from the seminar though they are not necessarily shared by the other instructors.)

A negative finding by the Defense Contract Audit Agency is rarely good. Questioned costs, whether it follows audits of forward pricing action, incurred cost, post award reviews or claims/terminations costs you money. A finding of inadequate accounting practices can include costly fixes, payment delays and prevention of future contract and subcontract awards.

Ways Negative Findings Surface

Though auditors sometimes play it close to the vest and do not show their hand, awareness of negative findings are usually quite visible throughout the audit process – during question and answer sessions, requests for data, informal discussions, more formalized communications of preliminary findings, distribution of draft reports, exit conferences, discussions with contracting officials and issuance of a Form 1.

No matter when the finding surfaces audit positions generally become more hardened as the process continues so the "earlier the better" is the best advice to reverse an adverse audit position. Once a problem surfaces, it will be much easier to persuade the auditor to accept your point of view before they have expended a lot of effort developing their adverse position. You will also want to have as much time as possible to ascertain the facts and review the appropriate regulations, opinions and decisions and decide how and when to present your position.

Findings During the Exit Conference. If problem areas have not surfaced beforehand, the Audit Exit Conference is the last best time to identify audit positions. The level of detail divulged depends on the type of audit. For audits of *incurred costs*, the results should be discussed in detail. Also, if needed to understand their position, the contractor is entitled

to receive copies of the audit workpapers (e.g. *Allied Materials and Equip. Co., ASBCA No 17318* established DCAA audit workpapers are not privileged) but, in practice, certain auditors may be uncertain of their authority so judgement about pressing the issue if refused needs to be made. For *initial pricing* proposals auditors will generally not disclose results of audit on the rationale the government negotiator does not want to "tip their hand." The auditor should be willing to disclose what factual data they relied on and discuss in general terms the areas of questioned costs. For example, they should be able to tell you they disagree with your proposed labor hours or rates without disclosing their specific recommendations. For *defective pricing* audits the auditor should discuss any factual indication that cost or pricing data was defective and a draft copy of the report with exhibits and footnotes should be supplied and the contractor given the opportunity to review the matter and provide any additional information. Results of audits of *termination settlement* proposals should be provided to the contractor. *For equitable adjustment claims*, the ACO frequently instructs auditors to not disclose audit results - they are, in effect treated like initial pricing proposals – but when historical data is used to price the price adjustment the contractor should request the ACO to authorize DCAA to openly discuss cost issues. Most other reviews (e.g. CAS Compliance, Estimating, Billing, Budgeting, etc.) require full disclosure by DCAA. Sometimes auditors will try to avoid an exit conference but this should be adamantly rejected since some audit reports can wind up as fraud investigations and it is quite common for last minute problem areas to emerge when the auditor is compiling their workpapers and writing their report. (An exit conference by phone is acceptable if there are no major cost disallowances or all issues have been surfaced and they are clearly understood.)

Deciding What Course of Action to Take

Once the finding becomes apparent the next question is to decide on the most effective course of action. Should you go up the DCAA chain or is their position unlikely to change? This most often depends on how firm their guidance is on the issue and their history on the issue. Should you, instead, focus your effort on preparing a formal response to be included in the "Contractor's Comments" section of the audit report? Will you also seek to have the CO reverse the decision or find an acceptable compromise? Or, does it make more sense to accept DCAA's position and do nothing? Though emotions often cloud the issue, if the impact of the negative position is not significant this may be the most prudent course so more significant battles can be fought later. (*Editor's Note. This phase is an excellent time to use our new "Ask the Experts" service to subscribers – you can email or call us with an explanation of your situation and we can put the question to one of our accounting or legal experts to help you decide how best to proceed at no charge.)*

Window of Opportunity Within DCAA

If your position has merit and the issue is one DCAA is likely to be flexible about then you have an option before formally responding to the audit position or negotiating with the CO. There is an informal "window of opportunity" to challenge the auditor's position between the time an audit issue surfaces and negotiations with the CO commence. *(The incentive to reach a settlement with DCAA is particular strong when the negotiators often say "don't convince me, convince the auditors".*) There is no formal appeals process within DCAA but the opportunities for informal agreements are significant. It is an often repeated truism that, especially at the branch level, supervisors will simply rubberstamp the auditor's position. In our experience, this sometimes occurrence is overstated. We are constantly surprised at how often the original audit position is either reversed or some other mutually-agreed to position is found following discussions with a supervisor or branch manager.

Of course, it cannot be stressed too much to prepare your position before you approach the audit supervisor or go higher. Address the audit position completely, be able to present your counter position clearly and succinctly and make sure your authorities are clearly identified (e.g. board and court decisions, cost principles, authoritative interpretations, cost accounting standards and preambles whether you are CAS covered or not, DCAA guidance, etc.).

Within the branch office there are usually two distinct avenues of informal appeal. The first is the audit supervisor. Though the supervisor often develops the audit position with the auditor it is far from always so. The supervisor may have had other administrative duties, training, sickness or is "hands-off" and if properly approached with a request for an open mind, will give a fair hearing to your position. Even if involved in the original position, they may have relied more on the auditor's judgment and the presentation of a strong counter argument may be sufficient to change their mind. There may be other motives to

change the finding such as hesitancy to fight a weak position, other priorities, etc.

Opportunities to receive an open-minded reevaluation of the original audit position is even greater with the branch manager. Unless the issue impacts large dollars from a large contractor, the branch manager is unlikely to have been deeply involved in the original position. Recent cutbacks and greater span-of-control between supervisors and auditors result in more time spent in administration and less participation in audit issues. However, their promotion to branch manager is usually based on their technical competency over contract costing issues and their interpersonal skills at resolving problems. In our experience, most branch managers are quite intelligent and predisposed to resolving issues to everyone's satisfaction. They are often a fair "appeals board" and if the contractor's position is strong and the audit position relatively weak they will sometimes reverse the original position or seek a reasonable compromise (e.g. give in on this issue if another issue is not challenged, find ways of lessening the financial impact).

The third window of opportunity within DCAA is at the regional level with the Regional Audit Manager (they usually have 4-6 branch offices they supervise). The RAM is unlikely to be involved in formulating the original audit position so they have even less of a stake in supporting the original position. Since an audit report is issued under the branch manager's signature, your chance of resolving the issue to your satisfaction is best at the RAM level if you do not succeed at the branch office. RAMs are usually quite experienced in handling a variety of issues, are technically competent and often quite personable (*we have a couple of former RAMs on our staff*).

The next window of opportunity is at the regional office where either the Deputy Regional Director or Regional Director can hear your case. Though we have seen considerable success going to the audit supervisor, branch manager and RAM you will need a very strong position and be very clear that an important point was not adequately considered by the other three if you expect to prevail at either the Regional Office or Headquarter level. It is quite common for the branch manager and RAM to have obtained expert legal and accounting advice within the agency before rendering their opinion so it is unlikely that you will change any minds higher up.

Next Step – The CO

Once DCAA has taken a formal position relative to the unallowability of a particular cost (whether it be an allowability issue per FAR cost principles or an allocation issue) it is supposed to issue a Formal Notice of Disallowability – commonly known as a Form 1. The Form 1 serves as a notice of suspension or disallowance of costs under cost reimbursement contracts and after DCAA receives notice of the contractor's acknowledgement of receipt, the form is distributed to buying offices (for more detail on Form 1, see DCAA Contract Audit Manual, Chapter 6-900).

Once DCAA is ready to issue a Form 1 you can be assured that it is DCAA's final position and further effort to change their mind is fruitless. Though it used to issue Form 1s more frequently, DCAA will now commonly consult with the ACO before issuing one. Though the ACO will often defer to DCAA since they are the authorized representative of the CO for purposes of issuing a Form 1, we find the ACO usually takes an active interest in hearing out the contractor when approached and we have repeatedly seen the CO either take a different position or find a mutually satisfactory solution. The CO can learn the contractor's position either through reading the Contractor's Comment sections of the audit report or by the contractor preparing a separate position paper. Both approaches are recommended.

Without a comprehensive written rebuttal, the contractor may find itself faced with a CO that does not budge from DCAA's position. In order to write an effective rebuttal you should have a clear understanding of the basis upon which DCAA has formulated its opinion and the results of any negotiation largely depends on how well you have done your homework beforehand. Do not go to the negotiation with just general statements; be prepared to discuss specifics, regulations and board/court decisions when applicable. Assume the DCAA auditor will be equally prepared. Be prepared to answer questions, know the facts and understand the weaknesses and merits of your position. Be prepared to question the auditor and do not hesitate to tactfully put them on the defensive – remember, you are trying to persuade the CO to adopt your position so you must demonstrate it makes more sense than the auditor's.

If a good argument is put forth by the contractor, the CO will often obtain advice in-house from their price

analysts and legal counsel. If the dollar value is significant, the issue may even be elevated to the special Overhead Center in the Defense Contract Management Agency tasked with resolving high priority cost issues. If the contractor's position has merit, the ACO commonly seeks a position to satisfy both DCAA and the contractor rather than go through the disputes process and avoid issuance of a Form 1.

BILLING PURCHASED LABOR USING DIRECT LABOR HOURLY RATES

(Editor's Note. Use of purchased labor – temporary labor, outside consultants, subcontractors – are increasingly being used in place of full time employees. After we discussed various methods of accounting for such labor in a prior article in GCA DIGEST Vol. 3, No. 2, Len Birnbaum of the law firm Birnbaum & Umeda LLP sent us a case he litigated defending his client's practice of treating outside consultants as employees for purposes of billing contracted hourly billing rates rather than as an Other Direct Cost (ODC). We thought we would summarize the case because (1) many of our readers want to do the same and (2) the case explores some interesting cost and contracting issues of interest to our subscribers. By the way, Len has agreed to be a member of our "Ask the Experts" panel where subscribers can send questions and our panel of experts provide you their opinion at no charge.)

Though the case included questions related to total billing in excess of the original contract amount we focus only on the following issue: Should the government pay the contractor for services of consultants at the direct labor hourly rates specified in the contract for "employees" or reimburse the contractor for these services as "other direct costs."

Undisputed Facts

Contract Definitions. "Engineering services" was defined as "those functions normally performed by qualified engineers or technicians in accomplishing" a set of functions set out in the contract. "Direct labor" was defined as "all effort expended in performance of orders under this BOA by personnel/equipment in the categories listed" below. "Direct Parts/Materials/ Subcontracts" was defined as "those parts and/or materials and/or subcontracted items or services which the contractor must furnish incidental to the accomplishment of the engineering services." Provided the contractor's accounting system did not consider these items indirect they would be charged as other direct costs (ODCs) where the negotiated 7% G&A rate and 5% profit rate would be applied. "Contractor personnel" are "employees of the contractor and under its administrative control and supervision" and the contractor "shall select, supervise and exercise control and direction over its employees under this contract." "Employees" was not defined.

Billing Rates. The Air Force awarded a time and material contract, a Basic Ordering Agreement (BOA), for engineering services to support a radar warning system. The contractor would be paid for direct labor hours worked times hourly rates for the following labor categories: Senior Technical Direct - $77.75; Technical Direct – $62.19; Senior Technical Specialist - $47.51 and Technical Specialist - $42.87. These billing rates were agreed to after a DCAA audit of the original proposal and negotiations with the CO resulted in average raw labor costs for each labor category where a 107.5 percent overhead rate, G&A rate of 7 percent and profit rates of 8.2 and 5 percent for various labor categories were applied.

Use of Consultants. In addition to its regular employees, the contractor used three professionals hired at hourly rates established under consulting agreements. Two out of three of the consultants worked at the contractor's office. The consulting agreement stipulated they would be free to exercise their discretion as to method and means of performing their duties and they would "in no sense be considered an employee" entitled to benefits or privileges given to the contractor's employees. (*Editor's Note. These conditions were, no doubt, stipulated to firmly establish their non-employee status for purposes of not paying payroll taxes.*) Set rates were established for each consultant and like employees, they were required to obtain necessary security clearances. The contractor did not notify the CO it would have some of the work performed by individuals who were not regular employees nor did it seek approval for the arrangement.

Billings. The contractor submitted monthly invoices and progress reports which listed, by name, the individuals who worked on the project, their hours and applicable hourly rate for each individual corresponding to the labor category they were assigned. The three consultants were included in the monthly invoices and were not specifically identified as consultants.

Government's Position

The Defense Contract Audit Agency conducted a review of the final invoice after it was forwarded by the ACO. In its report, it disputed the right to charge the consultants' services at direct labor rates and stated they should have been charged as ODCs resulting in a $59,000 overcharge. In response to DCAA's preliminary findings, the contractor asserted it was proper to charge at direct labor rates because (1) the consultants were "common law employees" in as much as they were under the control and supervision of the contract and two of the individuals performed work at the contractor's office and (2) the project manager had approved all earlier invoices. DCAA responded in its audit report that it was improper to charge the individuals at direct labor rates and in response to the contractor's comments (1) "common law employee" status was not confirmed since one of the individuals did not work at the office (2) the project manager's approval related to the individual's competence not their cost accounting treatment and (3) to charge the consultants' time as if they were employees *could* result in a "windfall profit" for the contractor. DCAA concluded the contractor was entitled to only amounts paid to the consultants plus 7 percent G&A (the contractor used a total cost input base for calculating and applying G&A) and 5 percent profit.

The ACO sided with DCAA's position and issued a final check representing amount outstanding after deducting the $59,000 "overcharge". The contractor cashed the check and appealed the decision as a claim. In its arguments to the appeals board, the government asserted the propriety of reimbursing the consultants as ODCs because (1) the contractor did not consider the use of consultants when its determined the direct labor hourly rates (2) the CO was never advised nor was his approval sought (3) the consultants did not receive employee benefits but were paid more than employees so they could supply their own benefits and (4) the consultants are part of the "parts/material/subcontractor" category and their services should be considered ODCs incidental to contract performance and hence the contractor is entitled only to the amount paid plus applicable G&A and profit.

Decision

The Armed Service Appeals Board addressed the issue of whether the government should pay for the consultants as direct hourly rates specified in the contract for "employees" or whether those services should be reimbursed as ODCs. The Board restated the government positions stated above and concluded though the government's position may be "technically acceptable" it ignores the "realities under which contract work was performed with the participation of the consultants."

In its rejection of the government's position the Board made the following points:

1. The Board alluded to the definition of "engineering services" and indicates this part of the contract clearly defines what is being purchased in terms of the work to be performed. The only restriction on the type of personnel to be used to perform the work is they be "qualified." It is undisputed that the individuals in question were qualified.

2. There was also no question that the work the consultants performed was of the nature and quality expected of the individuals in the four labor categories. There is also no indication in the record that the consultants were treated differently from the contractor's regular employees (e.g. provided security clearances, administrative support from the contractor, at least two individuals worked at the facility while the third replaced an employee who previously worked on the project).

3. The contract documents refer to contractor personnel repeatedly as "employees."

4. The services rendered by the three individuals were essential to contract performance and was not just incidental to the contract performance. Consequently it does not come under the category of "parts/material/subcontract."

5. There is no merit in the government's assertion that the contractor receives a "windfall" profit. There was no attempt to calculate what this windfall was or any other showing that it existed other than a mere assertion that it "may" exist.

The Board concluded there is no "logical reason" to have the contractor compensated for the consultants' work on a basis different from that of its regular employees. With respect to the services performed on the project, the three individuals were "indistinguishable" from their "employee counterparts" and hence the contractor should be compensated for their services on the same basis as their employees i.e. at the direct labor hourly rates (Software Research Associates, ASBCA 33478).

IMPORTANT PROCUREMENT DESCISIONS IN THE LAST YEAR

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and the Comptroller General rule we thought we would present some of the decisions in the last year or so that affect successful grounds for protests, best value procurements, past performance information, grounds for adjusting contract price and some cost issues not previously reported. This article is based on the January 2001 issue of Briefing Papers written by Miki Shager of the Department of Agriculture Board of Contract Appeals. We have decided to reference the cases for further research.)

Protests

A timely protest on winnable grounds is an effective tool to increase chances of winning contracts. The following decisions should be considered to identify the best opportunities to win a protest.

Grounds. Usually modifications to a contract after an award is made is not reviewed because it is considered to be contract administration which is beyond the GAO's protest jurisdiction. An exception to this rule applies when it is alleged the modification is beyond the scope of the original contract where the work covered by the mod should be subject to competition requirements absent a valid justification for sole-source award *(Paragon Sys. Inc., Comp. Gen Dec. b-28494.2*). Similarly under indefinite-delivery/ indefinite quantify (IDIQ) contracts, task orders orders are usually not protestable unless the protest alleges the task order increased the scope, duration or maximum value of the underlying contract. In *Floro & Assocs., Comp. Gen. Dec. B-285451*, the GAO found the award of a task order for management support services was beyond the scope for hardware/software integration services. The GAO said its scope analysis should compare the task order to the original contract not to any modification of the contract.

The GAO also established it usually does not want to settle matters related to subcontracts (unless it is established the government's involvement is so extensive as to make the subcontract, in effect, a prime contract), allegations of violating antitrust laws (*CHE Consulting Inc., Comp. Gen. Dec B-284110*) or disputes between private parties.

Timeliness. Several cases have established the need to file protests promptly. Protests must be filed within 10 days of an agency's report (*SDS Intl., Comp. Gen. Dec. B-285821*), within 10 days of a preaward debriefing following elimination from the competitive range (*United Intl. Investigative Svcs., Comp. Gen. Dec. B-286327*) and within 10 days of learning an agency will not address past performance issues in a reopened solicitation (*Oregon Iron Works, Comp. Gen. Dec. B-284088.2*). Also, don't wait to file a preaward debriefing until after award since a failure to file a protest against not being included in the competitive range until after debriefing on the contract award was ruled untimely (*United Intl.*).

Review of Record Not Reevaluation of Proposal. When reviewing protests of an agency's technical evaluation of proposals the GAO will not reevaluate proposals but will examine the record to determine whether the evaluation was reasonable and consistent with the stated evaluation criteria. In a solicitation making price twice as important as past performance a protest was sustained because the record did not provide a basis for how the tradeoff was made in an award made to a higher priced, outstanding past performance over a lower priced, satisfactory past performance offeror (*Si-Nor Inc. Comp. Gen. Dec. B282064*). Similarly in *J&J Maint., Inc. Comp. Gen. Dec. B-284708.2*, the GAO sustained a protest because the record of the evaluation of an offeror's oral presentation was "so sketchy" it had no means to determine the reasonableness of the award.

Must Show Prejudice. The GAO will not sustain a protest unless the protester demonstrates "competitive prejudice." To establish prejudice, the record must show the protester had a "reasonable possibility" or "substantial chance" of receiving the award absent the agency's actions (*McDonalds Const. Inc., Comp. Gen. Dec. B-288980*).

Competition Under FSS Contracts. Though competition is not required on all task or delivery orders under Federal Service Schedule contracts, if competition is held then a decision is protestable. If a FSS contract contains services priced at hourly rates, merely comparing competing vendors' hourly rates without considering number of hours or labor categories is an inadequate indicator of which vendor offers the lowest price (*Computer Pdts., Inc., Comp. Gen. Dec. B-284702*). If an agency relies on FSS competition, then virtually all items orderd must be on the schedule contract unless the items are below the $2,500 threshold (*SMS Sys. Maint Serv., Inc., Comp. Gen. Dec. B-284550.2*). In addition, an agency may be forced to use full and open competition for the entire requirement of those items not on the schedule (*T-L-C- Sys., Comp. Gen. Dec. B-285687.2*).

Submission of Offers. There is no prohibition against submitting a *below-cost* bid for a fixed price contract. Protesters frequently argue the selected contractor cannot perform at the low price but these allegations concern a contractor's *responsibility* which the GAO cannot review absent bad faith. Though agencies may conduct a price realism analysis a fixed price offer that is below cost is quite legal and cannot be rated lower or downgraded in the price evaluation section simply by virtue of a low price (*Arctic Slope World Servs., Inc., Comp. Gen. Dec. B-284481*).

Best Value

Negotiated Contracts. The government's ability to use a variety of evaluation factors when considering proposals provides flexibility in contracting decisions. FAR 15-203(a((4) provides the RFP must describe the factors and significant subfactors to be used in evaluating proposals as well as their relative importance. *In Brown & Root, Inc. & Perini Corp., Joint Venture, Comp. Gen. Dec. B-270505.2* the GAO held an agency need not disclose its evaluation guidelines as long as it uses a rational evaluation method that is consistent with the stated criteria.

Price Versus Technical Tradeoff. In *Beneco Enters., Comp. Gen. Dec. B-283154* the GAO sustained a protest where the agency's unwillingness to accept a 26% price premium on a proposal scored 36% higher than the awardee's without any evidence of consideration of technical merit or tradeoff analysis demonstrated the selection was price driven which was contrary to the stated evaluation scheme. In *Kathpal Techs., Inc. Comp. Gen. Dec.* the GAO ruled the agency improperly excluded the protester's technically acceptable offer from consideration without considering price. It stated an agency may not eliminate a technically acceptable proposal from the competitive range without taking into account the cost of the proposal, particularly where the protestor's cost advantage is significant and its technical rating is close to the other proposals in the competitive range.

Organizational Conflict of Interest (OCI). In *DSD Labs., Inc. VS US Cl. 467* the Court upheld the CO decision to exclude the protester from competition because they had been engaged as a subcontractor to provide the agency with recommendations that formed the basis of the statement of work. The GAO ruled there was no OCI in *LeBouef, Lamb Greene & MacRae, Comp. Gen. Dec. B-283825* where a DOE contract for legal services was awarded to a law firm that previously performed similar services as a subcontractor to a DOE management and operations contractor. The GAO ruled there was no OCI in spite of a teaming agreement between the agency's software integration contractor and awardee software vendor because the teaming agreement did not apply to the protested procurement and there were no other connections between the integrator and software vendor (*American Mgmt., Sys., Inc., Comp. Gen. Dec. B-285645*). Finally, the GAO ruled in *Global Readiness Enters., Comp. Gen. Dec. B-284714* that there was no OCI in spite of the fact two members of a team submitted separate prime contractor proposals where each relied on the other as a subcontractor.

Past Performance

Discussions and Past Performance. FAR 15.306(b)(1)(I) and 15.306(d)(3) provide for discussions in negotiated procurements and gives offerors the opportunity to clarify adverse past performance information. For awards without discussions, FAR 15.306(a)(2) provides that offerors *may* be given the opportunity to clarify adverse past performance information. In A.G. Cullen Const., Comp. Gen. Dec. B-284049.2 the GAO held that under FAR 15.306(a) the agency, absent bad faith, was not required to provide the offeror an opportunity to response to adverse past performance information unless there was a "clear reason" to question the validity of the past performance evaluation (for example, if the narrative comments from the reference were not consistent with the actual rating).

Challenging Past Performance Evaluations. In *OneSource Energy Servs., Inc. Comp. Gen. Dec. B-283445* the protester and agency had frequently disagreed during a prior contract on who was contractually liable for certain repairs and as a result received a low past performance rating. The GAO sustained the protest ruling the past performance downgrade was improper because it was inappropriately based on the protestor's exercising its valid contractual rights.

Because a trucking contractor's past performance rating was based on the actual number of late or problem shipments rather than the proportion of such shipments in comparison to total deliveries the GAO ruled in *Green Valley Trans., Inc., Comp. Gen. Dec. B-285283* the past performance evaluation was "irrational." In *Oregon Iron Works, Inc.* the GAO ruled though FAR 42.1503(e) directs agencies not to retain past performance for more than three years the provision is not a blanket prohibition against considering offerors' performance on contracts completed over three years earlier. In a case underlying the need to notify references and have them agree to

provide timely information the GAO denied a protest where the RFP required offerors to submit at least three references and the protestor challenged a past performance rating based on only one reference because others could not be contacted by the agency. The GAO justified its ruling because the RFP expressly placed the risk of failure to reach a reference on the offeror (*North American Aerodynamics, Inc., Comp. Gen. Dec. B-285651*).

In *Beneco Enters., Comp. Gen. Dec B-283512* the GAO rejected the awardee's "excellent" past performance rating in negating the award ruling the awardee's corporate experience was not comparable to the work required in the solicitation. Absent a solicitation provision authorizing agencies to consider a key employee's experience in its evaluation of an offeror's corporate past performance there is no general requirement the agency credit the corporation with the experience of its key personnel (*Project Mgmt Group, Inc., Comp. Gen. Dec. B-284445*). If the solicitation allows source selection officials to consider experience of key personnel in assessing corporate past performance experience there must be a commitment by the key personnel to work on the contract (*SWR, Inc., Comp. Gen. Dec. B-286044.2*). In *Menendez-Donnell Assocs., Comp. Gen. Dec. B286599* the GAO ruled an agency reasonably rated a proposal unacceptable based on the offeror's failure to establish adequate experience and performance for its subcontractors and key employees. In *SDS Intl., Comp. Gen. Dec. B-285822* a high past performance evaluation based on the experience of a single employee was considered reasonable where the employee possessed recent unique experience and would be directly and extensively involved in the project. In *Universal Fabric Structures, Inc. Comp. Gen. Dec. B-284032* the GAO ruled there was nothing unreasonable about considering the past performance information of the awardee's predecessor company where the awardee had the same management and employees and operated out of the same location. In *AJT & Assocs., Comp. Gen. Dec. B-284305* the GAO found nothing unreasonable for an agency to consider a large subcontractor's past performance information in a small set-aside procurement where the solicitation expressly provided for subcontractors' past performance.

Changes

Constructive Changes. A change to a contract entitles the contractor to an adjustment in price. A constructive change to a contract occurs when a contractor must perform work without a formal "order" to do so under the "Changes' clause (either by informal order or by the fault of the government). In *T&M Distib., Inc. ASBCA 51404* despite the absence of contract terms limiting the types of orders the government could place, the ASBCA ruled the parties "course of dealing" under prior contracts supplemented the current contract. Consequently, the government's decision to place orders in excess of the parties'prior dealing constituted a constructive change to the existing contract and entitled the contractor to monetary relief. In *Unarco Material Handling, PSBCA 4100*, the contract provided delays had to be agreed to by both parties and when the Postal Service unilaterally set a later start date but insisted on its original completion deadline the Postal Board ruled the Postal Service constructively accelerated performance and entitled the contractor to relief.

Equitable Adjustments. A contractor generally carries a burden of proving the amount by which a change increased its cost of performing the contract. In *Clark Constr. Group, Inc., VABCA 5674*, the Board upheld the use of percentage estimates for calculating the loss of labor efficiency due to the change. In *Delta Const. Intl, Inc. ASBCA 52162* a contractor may be entitled to recover the difference between guaranteed minimum payment under an IDIQ contract and actual orders if the contractor was required to be on standby for the entire contract period. In *Golden West Envtl. Servs.*, DOTBCA 2895 when the government shortened the performance period due to delays before award and lowered the contract price without lowering the amount of waste contracted to be disposed, the Board ruled a unilateral change to the bid price occurred and the contractor was entitled to a price adjustment to the extent it could demonstrate the change increased its cost of performance.

Termination Settlement Costs

A termination for the convenience of the government essentially converts a fixed price contract to a cost-reimbursement contract entitling the contractor to recover allowable costs incurred in the performance of the terminated work, a reasonable profit on work performed and certain additional costs associated with the termination (*See our article on Maximizing Termination Cost Recovery in the GCA DIGEST, Vol. 2, No. 1).* Where a default termination is converted to a termination for convenience (T of C) because of impossible specifications, the contractor's recovery is not limited to the contract price nor is recovery subject to the T of C loss formula (*D.E.W., Inc. & D.E. Wurzback, ASBCA 50796*). The same case also

established that, as a general rule, the government is not entitled to reduce the termination settlement by the costs of defective or noncompliant work except when the costs are a result of "gross disregard" of contract obligations. However, in *Defense Sys. Corp., ASBCA 44131R*, the Board held the contractor was not entitled to recover costs in excess of the contract price when the contractor failed to demonstrate the government was responsible for the specified costs. Cost of special equipment to be used for developing technology in anticipation of the government's exercise of an option but not necessary for performing the existing contract were unallowable as well as the costs of renting and adapting rental premises to house the equipment (*Compression Research Corp., ASBCA 46566*). Bid and proposal preparation costs are not allowable as part of a termination settlement (*Barsh Co., PSBCA 4481*). A contractor was not entitled to collect interest on its termination settlement proposal following a settlement because the resulting settlement agreement was conclusive proof that negotiations had not reach an impasse which are grounds for the interest clock to start (*Rex Sys. Inc. v Cohen, 224 F.3d 1367*).

SOME CONSIDERATIONS FOR TEAMING

(Editor's Note. When we asked our colleague Kathy Szymkovicz, a former contracting officer and source selection official and one of our favorite guest authors, what she has been doing lately we heard she has been working with several firms putting together a variety of teaming arrangements. We asked her to provide some practical insights into how to avoid common problems she is encountering as well as some useful pointers on how to help present the team to the government in order to win contracts. This article is not intended to cover all the legal aspects of team arrangements (you will need to work with an experienced attorney) or cost and pricing issues since this was covered in a prior article in the GCA DIGEST, Vol. 1, NO. 2. Kathy is a consultant with The Acquisition Network that provides acquisition assistance and training to federal contractors and can be emailed at TANetwork@hotmail.com or called at 415-861-0556. Kathy is also a member of our "Ask the Experts" panel.)

Common Problems

Whether you are a large business looking for a small business to partner with or a small business looking for a large business to help you grow, teaming can be a tricky business. Knowing some of the pitfalls and making wise decisions up front can avoid many of the catastrophes that happen everyday as a result of teaming gone wrong.

Occasionally teaming disasters are a result of actual intent to mislead the other party. For example, a business might hide an affiliate from its teaming partner, representing itself as small, to have a teaming arrangement for bidding as a small business. When the Small Business Administration investigates and learns the business is large, both members suffer damage to their reputations and pocketbooks. In this situation, the intent to mislead the Government sticks to both firms.

Much more common are simple misunderstandings that occur as the result of differing assumptions by the teaming partners. Too often, short bid periods and unanticipated opportunities that look too good to miss lead firms to jump into teaming arrangements with other firms who are not sufficiently checked out. For example, if your "partner" fails to pay Davis Bacon rates to its employees, the Department of Labor will look at both of you and while only your partner will suffer the monetary consequences imposed by DOL, the damage to your reputation will stick to you both.

Often the agreements are verbal or if written are quite sketchy. Things such as proposal costs, profit and loss sharing, and management control are often not specifically discussed, with both firms thinking the arrangements are obvious. Unfortunately, what is a logical assumption to one firm may not be to another. For example:

- Who pays for the preparation of the Proposal. This sounds obvious, and often it is the obvious nature of this item that leads to failure to spell out the specific terms. The cost sharing terms for this item should be stated in the written Agreement. More than one small firm has been shocked to receive a substantial five figure bill from a large business that offered to prepare the proposal. The smaller company assumed preparation included covering the costs and never verbalized this assumption for confirmation.

- Profit/Loss sharing and a clear statement of financial responsibility. A small firm may assume limited liability (since the larger firm can more easily incur a greater loss without disastrous consequences) and at the same time expect 50% profit. Obviously the sharing arrangements should be discussed and

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documented. Many a firm has ended up in court by assuming this type of "obvious" arrangement.

- Responsibly for any space (such as offices or warehouses) or equipment that was leased or purchased prior to submitting the bid. Clarify who will be responsible for lease payments, including if one firm or the other uses the leased location or property.

Presentations to the Government

Once a Teaming Agreement is firmly in place, the presentation of the Team to the Government needs to be considered.

It is vital that the Team is presented as an entity in itself. Presenting two firms who plan to work together may appear to be an attractive arrangement but will not be to the Government. To represent the Team as two firms working together invites Government fears of finger pointing and failure to take responsibility. What the Government wants to see is a single entity comprised of the strengths of the Team members, but with a single management point of contact that can commit the joint venture.

If the firms have worked together in the past, this is an important element to the Government and one that should be emphasized. Once again, the Government is looking for a seamless arrangement with a minimum of impact on contract administration. If you can show that you have accomplished this with your teaming partner on a previous contract, the Government will view the arrangement favorably. Whether you have this past experience or not, it is vital to show your management plan for integrating the Team into a single entity.

Know the Common Rules

Joint ventures are subject to most of the same acquisition rules as individual contractors (e.g. small business classification, past performance criteria, cost allowability, etc.). For example, since a Teaming arrangement is a Joint Venture the gross annual receipts of both firms together must total an amount under the size requirement for the appropriate NAICS in order to qualify as a small business. Or an 8(a) set aside requires that both firms be 8(a) to qualify the Joint Venture as an 8(a).

Knowing the rules gives you the flexibility to create the best arrangement for a particular procurement. An 8(a) firm that wants to work with a small business on an 8(a) set aside would need to show the small business as a subcontractor, meeting the subcontracting rules as they apply to the specific procurement. Or, since past performance information can be considered in various ways under a given award scheme to maximize past performance evaluation the prime team member can choose to portray the past performance of the subordinate member as a full team partner, subcontractor or even employee of another firm.

Most often, it is assumptions and an unfamiliar partner that get the teaming arrangement into trouble. If you want to create a joint venture, do your market planning now, deciding what type of procurements you want to pursue and what type of partner you need. Create the team in advance of a specific opportunity so that your planning is well thought out, thoroughly investigated and not rushed. As in most situations, it is far better to plan than to react.

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