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Knowing Your Cost Principles… DEPRECIATION COSTS

Depreciation costs are often significant and government regulations provide considerable latitude on how and when to recognize the expenses for pricing and costing government contracts. Whether firms want to maximize or minimize cost recovery, several ways of flexibly treating depreciation expenses come to mind:

1. Asset cost – various initial costs may be capitalized or expensed
2. Asset life – e.g. IRS guidelines, "economic life", contract period
3. Method of depreciation – straight line, various accelerated methods
4. Direct versus indirect charging
5. Where to assign the expense - cost center, plant, company, which indirect cost pool
6. Differentiating assets – dedicated assets for different types of contracts versus pooled assets for all work
7. Method of ownership - capital versus operating lease, related party versus non-related parties
8. Treatment of fully depreciated assets – e.g. charge out rates
9. Estimates for salvage value
10. Improvements – capitalized as betterments or expensed as patchwork repairs

Some of the rules and guidance auditors follow are intended to somewhat limit so-called "inequitable" cost and pricing actions but still considerable latitude exists. We will discuss the basic rules for depreciation and allude to those significant areas auditors can be expected to look at. We have drawn on numerous texts, the Defense Contract Audit Manual and our experience as consultants to government contractors.

General Rules

FAR 31.205-11 governs the allowability of depreciation costs. Contractors subject to cost accounting standards must comply with CAS 409, Depreciation of Tangible Capital Assets and CAS 404, Capitalization of Tangible Assets. In the few cases where CAS conflicts with FAR (e.g. demonstration of economic or useful lives, valuation of assets after a business combination), CAS will supercede a conflict with FAR for CAS covered contracts only. We will focus on the FAR rather than CAS because there are not that many conflicts and most contractors are not subject to the more detailed requirements of CAS 409 and 404.

Normal depreciation is generally considered allowable contract costs if they are reasonable and allocable. When depreciation expenses are treated the same for financial and income tax purposes, costs are considered reasonable under FAR 31.205-11(d) if the contractor follows its policies and procedures which must be (1) consistent with those followed in the same cost center for non-government businesses (2) are reflected in the contractor's books of accounts for financial reporting and (3) used for federal income tax purposes. Even when these conditions are met, DCAA reminds its auditors that "inequitable charges to the government" may still occur and certain depreciation costs may need to be questioned.

Since 1986, the Internal Revenue Code has been periodically revised to allow use of accelerated methods of depreciation to defer payment of taxes and improve cash flow. When contractors choose to take advantage of these IRS changes, the amount of depreciation charged may differ for financial reporting and income tax purposes. Where book and tax methods differ, FAR 31.205-11(e) allows contractors to follow IRS methods of depreciation as long as the resulting expense does not exceed the amount recognized for book/financial statements. If a dispute occurs, auditors will tell you that the mere fact the IRS does not specifically reject use of a particular depreciation method does not establish the acceptability of that method for government costing purposes.

Allocation Requirements. CAS generally covers cost allocation issues and even when not CAS covered, the standards provide contractors a level of legitimacy if they follow CAS allocation prescriptions. CAS 409

does provide for direct charging of depreciation costs as long as the charges are made on a usage basis (e.g. units-of-production method) and the depreciation costs of similar assets used for similar purposes are charged in the same manner. The standard also recognizes that depreciation charges not only may but must be included in service center costs. That is, when tangible capital assets are part of a function or an organizational unit whose costs are charged directly to cost objectives on the basis of services provided, then the depreciation costs of those assets must be included in the service center costs. When not direct charged or part of a service center, the standard recognizes that the "normal procedure" is to include depreciation costs in appropriate indirect cost pools. FAR does not conflict with CAS but it recognizes that depreciation expenses are usually allocated to contracts as an indirect cost.

DCAA audit guidance in DCAM 7-404.1 states that depreciation is usually an indirect expense and states it is preferable to have depreciation recorded at the lowest organization level as possible such as the department or cost center level so that the cost is identifiable as closely as possible with the benefiting work or activity. Auditors are advised that plant or company-wide rates may not be equitable because, for example, government work may be performed in only a part of the facilities or the contractor may be replacing assets faster in a part of the plant performing primarily commercial work than where government work is performed. When plant or company rates are used, auditors are advised to make sufficient tests to determine that the end results are substantially the same as those achieved by more refined methods.

Other Considerations

Life of asset. The depreciation expense of an asset should be based on the estimated useful life of an asset. Though the government has traditionally preferred the use of physical lives of assets for computing depreciation, *American Electronics Laboratories* (ASBCA No. 9879) established that economic life of assets is acceptable. The physical life, economic life and technical life have all been held to be acceptable for measuring the service life of an asset. The FAR has established that useful lives should be assigned as provided in the IRS's asset depreciation range (ADR) guidelines. Even though the IRS has switched to the Accelerated Cost Recovery System (ACRS), which are usually shorter periods, ADR is preferred for government cost and pricing. ACRS is acceptable for contract costing purposes if it is also used for non-government work in the same cost center and is used for both financial accounting and income tax purposes. If ACRS is not used for both financial accounting and tax purposes it can be used for contract costing if (1) the ACRS recovery period is the same as the useful life and (2) ACRS is used for non-government work. In any case, allowable depreciation cannot exceed amounts used for financial accounting. It should also be recognized that it is not uncommon to have a contract that limits depreciation to, for example, common practices established in a particular industry.

Acceptable depreciation methods. With the general proviso that "inequities" can still occur, DCAA considers both asset lives and methods of depreciation that are consistent with the ADR system to be compatible with FAR 31.205-11(d). If ADR is not followed, only the straight line, declining balance or the sum-of-the-years digits methods are considered reasonable within certain limitations (e.g. only the straight-line method can be used if the depreciation period is less than three years, IRS guidelines for using the 200 percent declining balance must be followed, etc.).

Residual values. In computing depreciable assets, government auditors follow IRS guidelines in allowing the residual value of an asset to be ignored if it is less than 10 percent of the original amount capitalized (this provision has been accepted as part of the CAS and there is currently an outstanding proposal to amend the FAR to be consistent with CAS).

Government provided assets. No depreciation, rental or use charge is allowed on property obtained from the government at no cost to the contractor or obtained at no cost from an organization under common control.

Depreciation at other than cost. Depreciation based on the price paid for assets acquired from an organization under common control is permitted if the practice is consistently applied and if the price is based on established prices or adequate price competition. This does not apply if the price paid exceeds the price the seller would have charged its most favored customer or if the contracting officer determines the price is unreasonable.

Fully depreciated assets. Use charges for fully depreciated assets are allowable provided the charges are negotiated and documented in an advance agreement. In computing a reasonable use charge consideration should be given to: (1) the replacement cost and

estimated useful life at the time of negotiation (2) the effect of increased maintenance costs and decreased efficiency because of the age of the asset and (3) the amount of previous depreciation charges made to the government contracts and subcontracts. In practice, established commercial practices of setting charge out rates are commonly accepted. Board decisions have established that use charges need not be recorded in the contractor's books and records to be allowable on government contracts.

Asset valuations. As a result of a merger or acquisition contractors may be required to value their assets at fair market value in accordance with Accounting Principles Board Option No. 16, "Business Combinations." However, the new and usually higher valuations may not create depreciation charges greater than what would have been incurred had no merger or acquisition taken place. In 1996, CAS 404 was revised to preclude any write-up or write-down of assets based on a business combination. This created a conflict between the FAR and CAS because the FAR required a write-down of assets where the CAS did not permit such a write-down. The conflict was resolved in 1998 when the FAR was revised to match the CAS. DCAA, however, has taken the position that if an asset write-down occurs allowable depreciation is based on the written-down value of the acquired asset.

Sale leasebacks and related party transactions. Depreciation under sale-leaseback arrangements is limited to constructive ownership costs meaning allowable costs are limited to what would have been incurred had the asset been purchased. Similarly, the costs of leases between related parties are also limited to the constructive costs of the assets unless leasing of similar assets to non-related parties is part of their business.

Foreign exchange rates. Depreciation costs initially recorded in a foreign currency will be required to be converted to US dollars if the contract is payable in US dollars. The question of what is the appropriate currency exchange rates was addressed in *General Electric Company* (ASBCA 44646) where the Board denied use of the historical exchange rate and required use of the current rate. This decision was reversed by a higher court that ruled depreciation charges had to be based on average historic exchange rates. The Court stated both the FAR and CAS were silent on the matter but that Financial Accounting Standard 52 required use of the historic exchange rates.

Investment tax credits. As a matter of policy, the Department of Defense does not deduct the amount of any investment tax credit from the depreciable value of assets or require that such credits be used to offset contract costs.

WAYS FOR GOVERNMENT CONTRACTORS TO IMPROVE CASH FLOW

(Editor's Note. As all firms know, the ability to generate cash is a critical key to success. All successful businesses have found their own unique ways to expedite cash generation. Our work with a wide variety of government contractors has led us to the conclusion there are common factors that are fairly unique to government contractors' efforts to improve cash flow no matter what type of product or service the firm sells to the government. We had been considering putting our experiences to paper on this topic when we came across a recent article by Glenn Sweatt, general counsel for Environmental Chemical Corp., in the May issue of Contract Management that sets forth some of the unique considerations government contractors face when they want to improve their cash flow. This article is based on Mr. Sweatt's insights and our experience.)

Collections

While most contracts contain the prompt payment clauses prescribed by FAR 32.9 each government activity proceeds at its own speed. Time for reviewing invoices can vary widely and reasons for rejecting invoicing can challenge the imagination. Client A may review and approve invoices in 14 days while Client B may take 60 days. The Prompt Payment Act requires government to pay interest on late payments at a rate set every six months but the current 4.25% rate may offer little help on a 90 day receivable. Consequently, contractors need to work with their clients up front to ensure invoices are processed quickly. The terms of the contract need to be well known and requirements of 52.232-25, Prompt Payment memorized.

If invoicing is based on delivery, attach evidence of the government's acceptance. If invoicing is based on percent of completion, ensure both parties are in agreement about what the percentage is. Even a 1% disagreement will result in delay. When submitting a cost reimbursable invoice, be prepared to have every backup document clearly marked, coded and attached to the invoice such as timecards, expense reports, subcontractors' invoices, materials reports, etc. If it

is the client's practice to request only an invoice, have back up documents handy. Have the invoice formats and required information established well in advance – contractor kick-off meeting should address invoice requirements or a short pre-invoice meeting is recommended. At these meetings, find out if bi-weekly or even weekly billings are allowed rather than the customary 30 days. Strive to work on the basis of electronic invoicing and electronic payments to save the several "in the mail" days.

Paying Vendors

Speeding up collections are half the battle – timing of contract payment is equally essential whether you are a prime contractor/upper tier subcontractor or are the lower tier subcontractor/vendor. Helping subcontractors get paid is important on all types of contracts but is critical on cost-type contracts. The subcontractor's invoices must be consistent with contract terms and sufficiently detailed to satisfy the client as well as government auditors. It must be clear with enough detail what was purchased, delivered and accepted, unit prices with backup and any other relevant information. Subcontractors and vendors need to know when invoices will be submitted by the prime contractor – if they submit an invoice the day after the prime contractor invoices its client, their invoice will not be sent to the government for another 29 days. To eliminate this time, establish a fixed date each month (or more often) in subcontracts and purchase orders. Let vendors know, for example, if the invoice to the client goes out on the 15th of each month, their invoices need to be received no later than the 10th, providing time to review and approve the invoice, request additional backup and submit the invoice with that month's voucher.

Timing of Payment. The question of when do I pay a vendor can depend on what state you are in, the agency you are working for and the type of contract. While "Net 30" or "Net 60" is clear certain terms may be "Pay When Paid" (vendor will receive payment when payment is received from prime contractor). The recent changes to the Paid Cost Rule has simplified matters – large businesses under cost type contracts used to have to certify that vendor invoices had been paid before they were entitled to payments but the change has eliminated this requirement allowing large businesses to bill the government for invoiced goods and services when the cost is "incurred" rather than having to be physically paid.

Similar to non-government contractors, prime and subcontractors need to consider prompt payment discounts. Such discounts are stated in the purchase order or vendor's proposal and should be carried over to the resulting subcontract. Early payments are usually expressed as a percentage with a time period – e.g. "2 percent/10" meaning a 2% discount if invoice is fully paid within 10 days. The decisions on whether to offer discounts are similar with all companies but government contractors need to be especially sensitive to the efforts to review subcontractors' work. While discounts may make sense for commodity supply contracts which are easy to administer contractors may not want to put on additional time burdens on top of the normal review cycle of complicated cost type contracts.

Tax Exemptions. On many government projects the issue of tax exemptions arise, particularly state and local sales tax exemptions. The prime or upper tier subcontractor must clearly address the issue with their subcontractors and vendors. Subcontractors may assume the exemption and provide quotes and bids based on the assumption. If the exemption does not go through, the subcontractor will seek reimbursement sometimes up to 8 or 9 percent of the price. The contractor will either bear the cost or seek a change order from the client. The increased cost can also call into question the contractor's purchasing processes – for example, if the vendor was evaluated assuming the tax exemption, would they still be the lowest responsible bidder if the exemption does not apply. When seeking bids from vendors, the contractor should state in the solicitation whether the price quote will include taxes, fees, permits, etc. so bids can be evaluated equally. Contractors need to let their vendors know how to obtain tax exemptions - just because the last contract they worked on had an exemption does not mean the new one will. Also, contractors need to clarify in the subcontract documents that in the event an exemption form any tax is obtained, a change order or other mechanism will be issued requesting a credit. Be aware that under non-competitive circumstances, FAR 52.229-4 may apply which allows contractors to recover any after-imposed federal, state or local taxes if they exempt them from the proposals or similarly, require them to provide the government a credit if the contractor did not have to pay the tax or received a refund.

Relations with Subcontractors. Though the government does not have a legal relationship with a subcontractor (lacks "privity") normal disputes between the contractor and subcontractor may result in subcontractors calling the government representatives

directly with complaints of not being paid. Since such actions can provide big headaches to the contractor, they need to minimize these occurrences. If a subcontractor wants to contact the client, the contractor should not react negatively but should educate the subcontractor on the likely outcome of such a call. If it believes a subcontractor is likely to make a call, it should contact the CO first and explain the situation to avoid surprises and one-sided accounts told by the subcontractor. Prime contractors should also ensure their subcontract agreement and purchase order terms and conditions restrict the subcontractor's ability to communicate directly with the client. Though it may not prevent the subcontractor from breaching those terms, it will provide some ammunition if the dispute ends in litigation. There is usually no better means to avoid escalating problems than to communicate frequently with the subcontractor.

Second Tier Contractors

Sometimes the prime contractor may receive inquiries from one of its subcontractor's vendors (know as second tier subcontractors). While the prime may have more options than subcontractors they are still essentially in the same position and need to follow the guidance in FAR 32.112, Payment of Subcontractors. When it comes to money, things don't tend to get better with age so there is a need to act quickly before the party's next call is to the client, bank, congressman, news media, etc. The prime should gather enough information to have a reasoned discussion with the first subcontractor but do not take sides or give the second tier subcontractor reason to have unrealistic expectations. There are things that can minimize the effect of second-tier subcontractors not being paid:

1. Have the first-tier subcontractor provide payment bonds. Under the Miller Act, a payment bond will provide protection in the event a subcontractor does not pay their subcontractors, employees or certain vendors. While the Miller Act applies to government-prime relationships, the prime can require its subcontractors to provide payment bonds anytime – the principles are the same. Though payment bonds are required on fixed price construction projects, clients will often be happy to pay for bonds of second-tier subcontractors on cost type prime contracts of any scope due to the benefits of decreased project risk.

2. Run a pre-award credit check. Dun and Bradstreet and other sources will provide invaluable information about a subcontractor's current financial status and payment history so eliminating non-responsible subcontractors can preempt future payment problems.

3. Require interim releases and payment certifications. These documents should accompany all invoices submitted by the first tier subcontractor and they should certify that all vendor, employees and subcontractors have been paid or will be paid. Though a prime cannot prevent false certifications, such documents should limit potential liability.

4. Have a dispute outlet for subcontractors before a situation escalates.

Finally, prime contractors should not pay second-tier subcontractors. In certain circumstances a subcontractor will ask for an assignment of debt and this is acceptable with properly legal review or an agency like the Labor Department or the IRS may direct the contractor to garnish or withhold payments. But direct payments to a second tier subcontractor can put contractors in jeopardy of paying twice – if the first tier-subcontractor files for bankruptcy the prime will be at risk for any "offset" receivable.

FINANCIAL DATA COMPARING PROFESSIONAL SERVICES CONTRACTORS

(Editor's Note. Most firms want to know how they compare with others. Unfortunately, most useful information is proprietary and almost all surveys we encounter are limited to generally useless financial data extracted from annual reports of publicly traded companies. The exception to this rule is an annual survey published by Wind2Software, Inc. Wind2 Software is a software development company providing accounting and information systems to government contractors. The survey is unique because it surveys actual firms of varying sizes and offers very relevant data for government contractors. Though it surveys engineering and architectural firms, we find the results closely mirror those of most professional service organizations. This is not surprising since most labor intensive businesses, particularly in professional services, incur similar costs. For a copy of the survey, contact Nick Bettis of Wind2 Software at 970-482-7145.)

The Wind2 Software survey presents a wide range of useful information: comparison of data for each year from 1978-2002, profit and loss statements, key financial ratios (e.g. current ratio, average collection

periods), identification of key overhead cost elements (e.g. all fringe benefits, insurance, indirect labor, depreciation, marketing costs etc.), key measures of productivity, and other financial measures (e.g. work-in-process incurred but not billed, number of firms that charge interest on late accounts). The following table and explanations represents a selection of measurements for 2002 we chose that will provide interesting comparisons for our government contractor readers. For those who (like us) forget statistics terms, "mean" refers to an average while "median" refers to a midpoint.

	Mean	Median
1. Net Profit on Total Revenue Before Tax & Distribution	10.8	9.6
2. Net Profit On Net Revenue Before Tax & distribution	13.2	11.2
3. Contribution Rate	61.2	63.6
4. Overhead Rate (Before Distribution)	140.6	137.8
5. Overhead Rate (After Distribution)	158.6	154.6
6. Net Multiplier	2.92	2.82
7. Unallowable Overhead as a Percentage of Direct Labor	16.7	12.3
8. Unallowable Overhead as a Percentage of Total Overhead		
-Before Distribution	12.6	8.9
-After Distribution	10.4	8.0
9. Allowable Overhead as a Percentage of Direct Labor -Before Distribution	127.5	123.6
10. Net Revenue Per Total Staff	$86,702	84,556
11. Net Revenue Per Technical Staff	$106,262	103,166
12. Chargeable Ratio	63.5	63.2
13. Marketing Per Total Revenue	2.7	2.1
14. Marketing Per Net Revenue	3.4	2.5
15. Errors and Omissions (E&O) Insurance as a Percent of Total Revenue	0.8	0.7
16. Health Insurance as a Percent of Net Revenues	3.2	3.0

1. Net Profit on *Total* Revenue before Tax and Distribution. Total revenue includes revenue generated from in-house labor (representing 85-90% of total revenue) as well as consultants or subcontractors and billable reimbursable expenses. Before distribution is before bonuses and profit distribution – since these items vary widely, the survey compares results before and after such distributions.

2. Net Profit on *Net* Revenue Before Tax Distribution. Net revenue refers to revenue generated only by employees and may be more relevant for firms having unusually high outside consultants and/or large reimbursable expenses.

3. Contribution Rate. This measures the portion of each dollar of net revenue remaining after all direct project costs (both labor and expenses) are covered.

4. Overhead Rate (before distribution). This is the percentage of total office overhead to direct labor. What the survey calls "office overhead" is really what many contractors call overhead and G&A including the portion of employees labor not direct charged to projects. Adjustments for unallowable costs are addressed below.

5. Overhead Rate (after distribution). Same as above but the overhead includes bonuses, employee profit sharing and other distributions but not distribution of profit.

6. Net Multiplier. This is the effective multiplier achieved on direct labor and is calculated by dividing net revenue by direct labor. Consultants and reimbursables are excluded in order to determine an actual multiplier achieved by the firm's own efforts. The figure indicates participating firms received $2.92 for each $1.00 of direct labor spent.

7. Unallowable Overhead as a Percentage of Direct Labor. This consists of total overhead that contractors either voluntarily delete or government auditors disallow as a percentage of direct labor.

8. Unallowable Overhead as a Percent of Total Overhead Before and After Distributions. Looking at unallowable costs from a different vantage.

9. Allowable Overhead as a Percent of Direct Labor. This is actual overhead applied to direct labor after unallowables have been removed. If your firm uses multiple overhead rates, you would have to adjust them to measure oranges and oranges.

10. Net Revenue for Total Staff. This rough productivity index measures net revenue for each employee or part-time equivalent. It is calculated by dividing net revenue by average total staff, including principles and part time equivalents.

11. Net revenue Per Technical Staff. This is probably more relevant because it measures revenue by those directly responsible for generating it.

12. Chargeable Ratio. Measures the percent of total staff time charged to projects (whether billed or not) and is calculated by dividing total direct labor by total firm labor (direct labor plus indirect labor, vacation, sick leave and holidays actually paid).

The Survey seeks to identify key overhead cost components expressed in numerous ways such as percent of direct labor, gross revenue, net revenue. A few examples are:

13. Marketing Costs Per Total Revenues. Takes all marketing expenses (principal and staff salaries plus expenses) divided by total revenue.

14. Marketing Costs Per Net Revenues. Net revenue is the denominator.

15. Errors and Omissions (E&O) Insurance as a Percent of Total Revenues.

16. Health Insurance as a Percent of Net Revenues. This new measurement reflects the relative increase of this significant insurance cost that now far exceeds E&O insurance.

IMPORTANT PROCUREMENT DECISIONS IN 2002

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and Comptroller General say they are, we are continuing our annual practice of summarizing some of the significant decisions last year affecting grounds for successful protests of award decisions, important contracting requirements, grounds for claims and cost and pricing issues. Since we are currently working on an article addressing recent decisions on evaluating past performance evaluations we will include relevant cases in that article. This article is based on the January 2003 issue of Briefing Papers written by Miki Shager, Counsel to the Department of Agriculture Board of Contract Appeals and Marshall Doke of the law firm of Gardere Wynee Sewell L.L.P. We have referenced the cases in the event our readers want to study the cases.)

Protests

Interested Party. To have standing in a protest a protestor must be an interested party – an actual or prospective offeror whose direct economic interest would be affected by the award or failure to receive a contract. A protester is not an interested party where it would not be in line for contract award if its protest were sustained but another offeror would be in line for award (*Easter Colorado Builders*, Inc Comp. Gen. Dec. B-291332. *Unless otherwise specified, protest decisions are Comptroller General decisions and we will abbreviate the reference by alluding only to the case number*). The GAO established it would not sustain a protest unless the protester demonstrates a reasonable possibility of prejudice – unless the protester demonstrates that but for the agency's actions it would have had a substantial chance for receiving the award (*Bath Iron Works Corp.* B-290470). Where a protester did not submit a bid because of certain testing requirements and later learned the requirements were lifted the protester was not an interested party *(McRae Industries, Inc*., 53 Fed. Cl. 177). The protester of a sole source award was not an interested party who did not make an effort to establish it was a qualified, responsible bidder capable of performing (*Mers Investigative and Security Services*, 275 F.3d 1366). But a prospective bidder who challenged an improper change to terms of a solicitation that deterred it from competing was an interested party (*Ceres Environmental Services*, 52 Fed. Cl. 23). A protester alleging the issuance of a task order beyond the scope of an existing contract is an interested party even where the protester is potentially incapable of performing on the task (*Symetrics Industries, Inc* B-289606).

Evaluating Proposals. In protests of an agency's technical evaluation of proposals, the GAO made clear it would not reevaluate proposals but rather would examine the record to determine if the evaluation was reasonable and consistent with the evaluation criteria of the solicitation and applicable statutes and regulations (*Yoosung T&S, Ltd.* B-291407). A best value award was ruled improper that was based on considerations not included in the solicitation's evaluation scheme (*Tennier Indus. Inc.* B-286706.2). A protest was sustained on the grounds the record contained insufficient information and analysis supporting the decision – it used an "overly mechanistic methodology" to compare proposals while failing to consider qualitative differences or ignore certain risks (*Johnson Controls World Services, Inc.* B-289942). Similarly, a protest of a best value award was sustained where the agency mechanically applied the solicitation evaluation methodology and the record did not establish a valid rationale for award to a higher-priced, higher technically rated proposal (*Shumaker Trucking,* B-290732).

Federal Supply Schedule. Under FSS, competition for task order awards are not required but if competition is held, the GAO will consider a protest. The award of a blanket purchase agreement under an FSS contract was ruled improper because the agency could not demonstrate the services to be provided were included in either the awardee's or its subcontractors' FSS contracts (*Omniplex World Services* B-291105). FSS delivery orders were invalid without considering the fact the protester offered the same services under a

different schedule for a lower price – consideration of this reasonably available information was required by the FAR to ensure orders be awarded to the vendor providing the best value (e.g. the lowest overall cost) to the government (*REEP, Inc.* B-290665).

OMB Circular A-76. The GAO is defining agency discretion in the growing area of public versus private competitions. The GAO determined that an A-76 cost comparison was flawed because the agency failed to adequately notify commercial offers the government's plan was to rely heavily on a category of workers typically receiving lower wages and benefits than government employees (*Sodexho Management* B-289605.2). A protest was sustained where the agency underestimated its in-house costs and inflated the administrative costs applied to a private sector offeror (*Del-Jen, Inc.* B-287273.2).

Bundling. The Small Business Act requires agencies to avoid unnecessary and unjustified bundling of contract requirements that precludes small business participation as prime contractors. An agency's consolidation of requirements previously provided to small businesses under separate contracts was appropriate where the consolidation requirements were likely to be unsuitable for small businesses *(TRS Research.* B290644). Combining latrine rental services with waste removal services, each with their own NAICS code, that was generally performed by separate contractors was improper under the FAR because the agency had not shown that combining the two services was necessary to meet the government's needs (*Vantex Services Corp.* B-290415).

Timeliness of Submissions. An agency properly may eliminate from the competition an offer having significant informational deficiencies (*Safety-Kleen.* B-290838). It was proper for an agency to accept a late bid where the bidder had hand carried the bid and it had been received at the government installation and was under government control before the scheduled bid opening (*J.L. Malone & Assocs.* B-290282). But a protest was denied where the agency had timely received a quote but lost it due to its own negligence where the GAO stated "while this is unfortunate…the occasional negligent loss of an offer by an agency does not entitle the firm submitting it to any relief" (*Safety & Health Consulting Svcs* B-290412). Increased use of electronic submissions has generated many protests. The GAO ruled that FAR 52.215-1, Competitive acquisitions, does not apply to proposals sent electronically (*Sea Box* B-291056) and the contractor assumes the risk of non-receipt of faxes when the agency denies receipt even when a contractor has evidence of transmission (*Brickwood Construction* B-290444).

Unbalanced Bids. A bid is unbalanced if it is based on prices significantly less than cost for some work and overstated in relation to cost for other work and there is a reasonable doubt the bid will result in the lowest overall cost. Acceptance of an unbalanced bid is not in itself improper for an agency may lawfully award a contract based on unbalanced pricing if it has concluded the pricing does not pose an unacceptable level of risk and the prices the agency is likely to pay are not unreasonably high (*Semont Travel Inc.* B-291179). No unbalanced pricing was shown to exist when the protester provided no facts to show the prices were significantly overstated and the Comptroller ruled the risk of low prices (or even below cost prices) is not the issue because the risk of loss falls on the contractor not the government (*Selrice Svcs.* B-286664.4).

Poor Analysis of Cost. For a cost type contract, agencies are usually required to conduct a cost realism analysis and develop a probable cost estimate based on the technical approaches. Merely comparing cost elements of each proposal without making any probable cost adjustments up or down was insufficient and justified the protest (*Priority One Services* B-288835). A protest was sustained where the agency had accepted, without any analysis, the awardee's revised proposed rates which were significantly lower than its proposed initial rates, its history and its proposed ceiling rates (*PADCO Inc.* B-289096). Also a protest was sustained where the agency's cost realism analysis of awardee's staffing costs was not supported where there was no meaningful explanation in the record of the basis for accepting the awardee's proposed reduced staffing levels *(Nat'l City Bank of Indiana* B-287608).

Adequate Record Documentation. An agency must provide adequate documentation of its evaluations. The source selection board's disagreement with the agency's evaluation was not adequately explained and hence the agency's award was considered unreasonable (*DynCorp International LLC* B-289863). A protest of an A-76 competition was sustained when the record failed to demonstrate why the only commercial offeror on a public-private competition was eliminated as technically unacceptable (*Consolidated Engineering Svcs.* B-291345). An award to a contractor whose proposed price was 65% higher in spite of equal technical scores

was sustained because the source selection board adequately detailed why the higher price was justified (*KPMG Consulting* B-290716)

Conflict of Interest. The protester asserted the awardee's proposed program manager was a Naval Officer who had unfair access to proprietary information. The GAO denied the protest holding though an *appearance* of conflict may be grounds for sustaining an organizational conflict of interest (COI) where the alleged conflict involves an *individual*, actual unfair access must be proven *(Perini/Jones Joint Venture* B-285206). The GAO ruled that organizational COI existed because of the work a proposed subcontractor had performed on a predecessor contract (e.g. obtained protester's confidential information used to improve its proposal) and the agency had failed to consider the COI and establish a mitigation plan (*Ktech Corp*. B-285330). The GAO ruled the incumbent did not have an organizational COI because the government, not the incumbent, drafted the statement of work and any unfair advantage was mitigated by providing all offerors "as built " drawings (*M&W Construction* B-288649). In its reconsideration of an earlier decision, the GAO admitted an organizational COI existed in having the same employees and consultants both draft the solicitation and help prepare the government's in-house management plan for an A-76 competition. However, since the practice was so widespread, resulting in cancellation of numerous A-76 competitions, the GAO made the decision on a prospective basis only (*Dept. of the Navy* – Reconsideration B-286194).

Discussions. The FAR requires that COs discuss with each offeror being considered for award significant weaknesses, deficiencies and other aspects of its proposal that could be altered or explained to enhance the proposal's potential for award (FAR 15.306). Prior year decisions ruled there is no requirement that all areas of a proposal be discussed but only significant weaknesses be discussed. The Court upheld the agency's decision not to discuss the protester's cost proposal since it was not considered inadequate and though it always must be evaluated, it was considered the least significant evaluation factor leading the Court to rule that cost is not always a material factor and hence need not be automatically discussed (*JWK International* 279 F3d. 985). The GAO established that technical leveling is no longer specifically prohibited stating that an agency's questions intended to provide an offeror the opportunity to correct aspects of its proposal that may not have met requirements are now "totally appropriate" (*Imagine One Technology& Management* B-289334). Though a defect in a cost proposal was not revealed until best and final offers were submitted, the agency still treated offerors unequally by holding discussions with the awardee on the same issue but not with the protester earlier in the process (*Metcalf Construction* 53 Fed. Cl. 617). An agency is not required to conduct discussions in a FSS procurement even if the solicitation stated discussions were contemplated (*Avalon Integrated Svcs* B-290185).

Mistakes. A request to correct a bid before award is made is allowable only when there is (1) clear and convincing evidence of the mistake and the intended bid and (2) if the correction would result in displacing one or more of the lower bids the mistake must be ascertainable from the bid invitation and the bid itself (*Mideastern Builders* B-290717). A contractor seeking a post award reformation of the contract on the grounds a unilateral mistake was made must provide convincing evidence in five elements: (1) a mistake in fact occurred before contract award (2) the mistake was a clear-cut clerical or mathematical error or a misreading of the specification and not a judgmental error (3) before award the government knew or should have known a mistake had been made and should have requested a bid verification (4) the government did not request bid verification or its request was inadequate and (5) proof of the intended bid is established (*Holmes & Narver Constructors* ASBCA 52439). The contractor's bid included a subcontract price that mistakenly did not include certain items. In its attempt to obtain a contract price increase for the mistake the government asserted it was not a mistake but a judgmental error. The Board disagreed stating though it was not a clerical or math error it was the type of inadvertent error that was correctable. Nonetheless the price was not adjusted because the contractor failed to provide clear and convincing evidence of the mistake and of its intended bid (*Will H Hall & Son*, 54 Fed Cl. 436).

Changes and Claims

If a contract is changed the contractor or the government are entitled to a price adjustment in the contract price. What constitutes a change and how to quantify the entitlement is subject to numerous decisions.

Constructive Change. A constructive change occurs when a contractor must perform work beyond the contract requirements without a formal "order." A contractor was entitled to an equitable adjustment as

a constructive change when it was required to perform more and different work as a result of a government inspector's misinterpretation of specifications (*A&D Fire Protection* ASBCA 53105). When a contractor intended to use material for forms required by the contract but an inspector prohibited its use it sought an equitable adjustment. The Board denied it saying the contractor must show the direction not to use the material came from the CO or one with authority to change the contract and the failure to notify the CO it considered the inspector's direction a change (who did not have authority to change the contract) meant there was no compensable constructive change (*Jerry Dodds*, ASBCA 51682).

Government Interference and Delay. The contractor asserted it was impossible to complete a contract for playground installation because the government did not furnish proper equipment but the Board held the government's failure did not provide an excuse for nonperformance, stating it did not take all reasonable steps to perform despite the absent equipment (*Southeast Technical Svcs.* ASBCA 52319). Claims based on delay of approving change orders were denied because the contractor used the wrong forms but claims for delays in the first article testing were sustained because the government's comments rejecting the contractor's first article inspections were untimely (*Essex Electro Engrs* ASBCA 49915).

Impossibility of Performance. Contractor claimed a radical change in the economy made it impossible to buy certain items at a reasonable price where the Board rejected the claim saying market fluctuations did not make performance impossible but only unprofitable. It said to demonstrate impossibility, it was not enough to show the contractor is incapable of performing but that no similarly situated contractor could have performed (*Seaboard Lumber* 308 F.3d 1283).

Defective Specifications. *Design specs* describe precise detail of materials to be used and the manner the work will be performed leaving no discretion to the contractor while *performance specs* set forth a standard to be achieved and the contractor is left to its own devices in how to achieve the standard (*U.S. vs Spearin, U.S.* 132). The Court rejected the Army's contention that a contract clause requiring inspection of specs before bidding shifted the burden of design defects to the contractor because such a requirement did not alert the contractor to substantive flaws in the design and hence did not waive the government's design warranty (*White v. Edsall* 96 F.3d 1081). If provision of older versions of specs and drawings did not result in an increase in costs the contractor was not entitled to a price adjustment (*Franklin Pavkov vs. Roche* , 279 F.3d 989). When a contractor followed the design specs for paint and material and subsequent soldering resulted in destruction of the paint finish the Board ruled for the contractor affirming that when the government specifies materials and procedures to be used to perform the contract an implied warranty arises that those materials and procedures are capable of meeting contract requirements (*Jimenez*, LBCA 02-2).

Superior Knowledge. In a claim based on the assertion the government had superior knowledge the contractor must demonstrate (1) it undertook to perform without vital knowledge of a fact affecting performance cost or duration (2) the government was aware the contractor had no knowledge of and no reason to obtain such knowledge (3) any spec supplied misled the contractor or did not put it on notice to inquire and (4) the government failed to provide the relevant information (*Henry Norman vs. GSA*, GSBCA 15070). Contractor failed in its superior knowledge claim where the agency did not intend to send half-size drawings but did so by mistake and the contractor did not establish the responsible procurement officials knew that half-size drawings were distributed (*Staffco Contr.* ASBCA 51754).

Liability for Subcontractors. Recent cases have lessened the incidents of when prime contractors are liable for their subcontractors' actions. The government sought a price reduction when a subcontractor illegally used an Iranian carrier to transport supplies. The Court ruled the illegality did not per se render the contact unenforceable, stating a contractor is not strictly liable for all the acts and omissions of its subcontractors. Rather first a determination of whether the prime was responsible under the circumstances had to be made and then applying a balance test, whether the nature of the illegality was such as to warrant the forfeiture of compensation (*Transfair International* 54 Fed. Cl. 78). Where the government alleged a contractor's claims were forfeited because its subcontractor's fraud infected the entire contract, the Court held there must be an inquiry into the prime contractor's knowledge or involvement with the fraud and that a subcontractor's fraud, standing alone, is not tied to the prime contractor (*N.R. Acquisition*, 52 Fed. Cl. 490).

Poor Estimates of Contract Work Scope. The Board found the government had breached its requirements

contract when it failed to exercise reasonable care in preparing estimates of orders to be placed in accordance with the FAR Part 16.5 requirement to include "a realistic estimated total quantity" based "on the most current information available." The Board stated while it need not be "clairvoyant to meet this standard" it is not "free to carelessly guess at its needs" (*S.P.L. Spare Parts* ASBCA 51acd118). Also when actual spare part orders were 12% of estimates the Court found the government negligently failed to consider unserviceable returns and spare parts on hand and was liable for any shortfall attributable to it negligence (*Hi-Shear* 53 Fed. Cl. 420). It is still not clear how to quantify damages a contractor is entitled to for poor estimates. A higher court overturned a ruling that provided a damage payment equal to what the government actually ordered and the total amount the ID/IQ contract obligated the government to order stating the contractor would have been in a better position with the government breaching the contract. Rather, it ruled the proper basis for damage should be the loss the contractor suffered as a result of the breach, not the total amount it would have received without the breach (*White vs. Delta* 285 F.3d 1040). But another Board ruled the minimum guaranteed price was the consideration for the contractor to be on call for the work so it was entitled to the total minimum amount of revenue minus what it had been paid (*Mid-Eastern Industries*, ASBCA 53016). However, a contractor's recovery for negligent estimates should not include anticipated profits (*Rumsfeld* 318 F.3d 1317).

Software Rights. The Court established a stringent rule for those who submit unsolicited proposals containing proprietary information when it ruled a submitter's failure to place a notice on each page relinquished its software rights pertaining to information in the unmarked pages even though it placed the required legend on the cover page (*Xerxe* Group 278 F.3d 1357). The Board rejected a claim for licensing fees because the contractor failed to mark the software with a "restricted rights legend" that complied with the DFARS and did not incorporate restrictions in a licensing agreement (*General Atomics* ASBCA 49196).

Quantifying the Equitable Adjustment. The government unilaterally eliminated a line item of the contract and sought a contract price reduction. The contractor asserted the government did not save "much of anything" for the deletion because it did not include "much of anything" for the deleted item from its original bid but the board ruled because there was no evidence of the amount the contractor had bid for the deleted work the government was entitled to a credit for the amount it would have cost (*Fire Systems Security* ASBCA 53498). Rather than quantifying the cost of the change the Board ruled that use of the total cost method of quantifying an equitable adjustment the contractor has the burden of establishing (1) the impracticality of proving losses directly (2) the reasonableness of its bid (3) reasonableness of its actual costs and (4) the lack of responsibility for the added costs (*Propellex Corp.* ASBCA 50203). The Board rejected contractor's attempt to quantify its claim based on lost revenue stating the proper measurement is the difference between what the work would have cost but for the change and the actual cost to perform the work (*Schleicher Community Corrections* DOTBCA 3046). The Court denied a claim for standby costs applying the Eichleay formula for recovering G&A and overhead costs because the contractor failed to demonstrate there was suspended work, idle time or uncertain period of delay *(Pete Varcari*, 53 Fed. Cl 357). The Eichleay based claimed costs for standby costs was also rejected where the contractor performed extensive work during the alleged suspension period (*Charles G. Williams Construction* ASBCA 49775). Where it was confirmed that many contracts severely limit recovery of field and home office overhead and profit on changes due to *delays* it may be advantageous to classify change claims as *suspensions of work* rather than delays. Four tests were put forth to meet the "Suspension of Work" conditions: (1) there must be a delay of unreasonable length extending the completion date (2) the delay must be caused by the agency (3) the delay must result in some injury and (4) there was no delay concurrent with the suspension that was the fault of the contractor (*Bay Construction Co.* VABCA 5594).

Accrual of Interest. In spite of submitting several revisions following its initial claim submission in 1997, the Appeals Board ruled there was no evidence the contractor intended to withdraw and resubmit its earlier claim but rather wanted to modify it and hence the interest clock started in 1997 (*Lockheed Martin Corp.*, ASBCA 53226).

Costs

Allowability. The Board rejected the contractor's claim it had properly distinguished between costs of developing a new product (charged to IR&D) and cost of developing capital equipment required for testing and manufacturing (charged to a capital account as manufacturing and production

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engineering) ruling the contractor had not carried its burden of proving the capitalized costs qualified as manufacturing and production engineering (*TRW Inc.* ASBCA 51172). The Board disallowed direct consultant fees on the grounds they were nothing more than the equivalent of an employee whose costs should have been charged to G&A and citing as one of the reasons that the FAR requires consulting costs "promote contract administration" while the consultant "ghost wrote" letters that hurt the parties' relationship (*Fire Security Systems, Inc.* VABCA 5559-63). A California state court ruled a contractor was not subject to an Orange County *ad valorem* tax on equipment whose costs were included in overhead on the grounds the government paid for, and thus obtained title to the equipment (*Hughes Aircraft* 96 Cal. App. 4th 540). The board ruled that contractor's "settling-in allowance" paid to employees who relocated overseas constituted relocation costs subject to the $1,000 per employee cap for miscellaneous costs rather than employee compensation. However, since the government had accepted "settling-in" costs for many years the Board ruled the government was "estopped" from disallowing the costs prior to the time DCAA had questioned the costs (*Lockheed Martin Western Dev.*, ASBCA 51452). The Court held that the contractor's direct labor costs and deferred compensation were allowable because the day-timer records with handwritten notes were sufficient evidence of direct labor costs and a promissory note to the owner was sufficient to establish the deferred compensation (*Thermalon Industries Ltd.* 51 Fed. Cl. 464).

Allocability. The Board disallowed costs for legal fees paid in defense of four members of its Board because they did not "benefit" the government. In its appeal the court ruled the board could not disallow the costs because they did not "benefit" the government but did say that the costs would be allowable only if the contractor could establish the allegations in the shareholder action had "very little likelihood of success." (*Boeing North American, Inc.* F.3d1320). The contractor could not recover expenses it incurred to prepare a proposal under a teaming agreement because the FAR definition of bid and proposal costs does not include obligations arising from joint ventures and teaming arrangements (though independent research and development costs do). The Board ruled the costs prepared under a "memorandum of agreement" to commercialize certain of the contractor's technology were required in performing the contract and thus could not be allowable indirect B&P costs (*TRW Inc.* ASBCA

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51530). Contractor received a refund in 1995 of state income taxes for which the contractor had received reimbursement from the government in 1987 as a contract costs. The court held the contractor was required to calculate the government's share of the refund based on the ratio of government/commercial work in effect in 1987 rather than 1995 since the refund was a deduction of a 1987 contract cost. The Court rejected the contractor's contention it was bound by CAS 406 to recognize the refund in the year received stating CAS did not require any particular period but the FAR clauses the government found relevant controlled the issue (*Hercules Inc.* 292 F.3d 1378).

Limitation of Costs. In its claim to be reimbursed for cost overruns on a cost plus contract due to the fact its actual indirect costs were higher than its provisional billing rates during contract performance, the Board sided with the contractor stating that under the "Limitation of Cost" clause it must look to see whether the overrun was "reasonably foreseeable." The board ruled in this case the overrun caused by the higher indirect rates was caused by an unexpected decrease in total business volume thus could not be reasonably foreseen (*Moshman Assocs.* ASBCA 52868).

Cost or Pricing Data Under TINA. The Truth in Negotiations Act defines cost or pricing data as all facts that as of the date of agreement on price, a prudent buyer or seller would reasonably expect to affect price negotiations. What is and is not cost or pricing data is a source of considerable review by Courts and Boards. Where the contractor's practice is to place all subcontract bids in a locked box until the date a bid is opened the government argued the contractor's failure to disclose the existence of unopened bids was defective pricing. The Board held the contractor was not required to open the quotes and advise the government of their contents because they were not cost or pricing data but the contractor was required to disclose the existence of the unopened bids because the government could have negotiated a lower price based on the unopened bids (*Aeroject* ASBCA 44568). Though the contractor argued that an important design improvement in a prototype unit developed several months before price negotiation was not cost or pricing data because it was not complete the Board ruled the design improvement was a fact constituting cost or pricing data and its disclosure would have reduced the contract price (*Lockheed Martin Corp.* ASBCA 50566). The Board held the contractor and government were on an "equal footing" with regard to the significance of certain labor hour data and rejected the government's argument the contractor had violated TINA by failing to provide additional explanation of the significance of the data (*Lockheed* ASBCA 50464).

Termination Settlement Costs. Entitlement to reimbursement of certain costs when the government terminates a contract for convenience basically converts a fixed price contract into a cost-reimbursement contract where allowability of costs are often greater than under the FAR cost principles. Because the government was at fault for not divulging certain information to the contractor resulting in significant performance inefficiencies the Court tended to be quite generous in allowing termination costs including (1) cost of facilities capital on the initial value of special equipment rather than the value as depreciated during performance (2) rental rates on pre-owned equipment based on "Blue Book" rates enhanced by 39% to reflect harsh operating conditions (3) unabsorbed overhead applied to increases in the direct labor base at contractor's historical rates of 10% rather than the lower actual 5% incurred during performance (4) a 30% profit based on the contractor's "truly remarkable production rate" (*Marshall Associated Contractors* IBCA 1901). The Court held that (1) the contract price limitation (settlements can't exceed the contract price) covers both the pre-termination and post termination costs except for settlement expenses which are outside the limitation (2) in establishing the limitation, the contractor has the burden of showing the government improperly determined adjustments to the contract price (3) the Associated General Contractors equipment rates are applicable only in the absence of actual cost information (4) rental costs for equipment owned by family members is limited to ownership costs (5) unsubstantiated salary costs of contractor owners would be compensated in the overhead allowed on contractor's other costs and (6) though the FAR precludes profit on settlement expenses, the court is free to grant it (*White Buffalo Construction* 52 Fed. Cl. 1). Since a "constructive change" in the contract had, in effect, increased the contract price the limitation of recovery was also raised and the contractor was entitled to (1) lost volume discounts from vendors (2) increased markup on equipment purchases (3) unexpired portion of communication circuit lease and (4) the cost of undelivered equipment (*Information Systems & Network Corp.* ASBCA 46119). The Board ruled the contractor was entitled to labor, material

and travel expenses that were substantiated by records but not presented on standard forms and allowed a 10% profit, rejecting application of a loss formula where it appeared the contractor would have made a profit and where the government contributed to the loss (*Swanson Group Inc.* ASBCA 52109).