GCA DIGEST

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Knowing Your Cost Principles and Cost Accounting Standards…

COST ACCOUNTING STANDARD 402

(Editor's Note. As part of our on-going series on cost principles, we have addressed not only allowability issues but have also confronted cost allocability problems. Generally, the FAR cost principles in section 31.205 cover whether a cost is to be allowed or not while the cost accounting standards address how a cost can be assigned or allocated to a particular government contract or task order. Consequently, we have decided to expand our coverage of cost principles to include cost accounting standards, particularly those relevant to all government contractors, whether they are CAS covered or not. The source of information we have used is the actual cost accounting standards including preambles, several texts such as Mathew Bender's Accounting for Government Contracts Cost Accounting Standards and the Defense Contract Audit Agency Manual (DCAM)

FAR Coverage

Though many contractors believe CAS 402 becomes an issue only if a contract is CAS covered, the intent of government was to have CAS 402 apply to all contractors, whether or not contracts were CAS covered. Like it has done with several other cost accounting standards, the government included the essence of CAS 402 in FAR. The consistency requirements of CAS 402 is clearly included in the definitions of direct and indirect costs. For example, in the FAR definition of direct costs "…No final cost objective shall have allocated to its as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool…" Similar verbiage is included in the definition of an indirect cost. So the following discussion will apply whether your contracts are fully CAS covered, modified CAS covered or subject to the Federal Acquisition Regulation.

Basic Requirement

The fundamental requirement of CAS 402 is that all costs incurred for the same purpose in like circumstances be treated as either direct costs only or indirect costs only, with respect to the final cost objectives. The standard drives home this point by saying (1) a cost cannot be an indirect cost if other costs incurred for the same purpose, in like circumstances, are treated as direct costs and vice versa. Although these requirements are stated in terms of costs incurred, they apply equally to estimates of costs for contract proposals. The consistency requirement addresses only those costs that cross the boundary of direct and indirect – hence, inconsistent treat of costs that remain direct costs or indirect costs is not an issue in CAS 402.

The CAS Board (CASB) required a contractor to (1) disclose its cost accounting practices (2) establish criteria, appropriate to its own situation, for selecting alternative accounting practices and (3) adhere consistently to its choices. If a contractor is required to submit a Disclosure Statement then that is the vehicle by which a contractor describes its criteria for selecting cost accounting practices and the circumstances that determine whether or not types of costs are incurred for the same purpose. If a Disclosure Statement is not required the determination of direct and indirect costs "shall be based upon the contractor's cost accounting practices used at the time of contract proposal."

A contractor should carefully consider its criteria for selecting alternative cost accounting practices and for distinguishing between direct and indirect costs. Once these criteria are established, any changes to them are considered changes in accounting practices that are subject to contract price adjustments. Generally contractors make decisions about direct or indirect treatment for costs of categories, activities or functions and to the elements that compose those costs. For example, they should consider under what circumstances are the following costs to be treated as direct or indirect – material, labor, supplies, tooling, equipment rental, depreciation, fringe benefits, travel, contract administration, service and support centers, research and development and bid and proposal. There are no inherent characteristics that exists whether these and other costs should be treated as direct or indirect. Also, once a decision is made, then the contractor must decide how to treat associated costs. For example, if material is to be a direct cost it

must decide how to treat the other associated cost elements such as insurance, freight, receiving costs, storeroom, etc. Or for direct labor, are fringe benefits to be direct or indirect.

Definitions

CAS 402 defines six terms – "allocate," "cost objective," "direct cost," "final cost objective," "indirect cost," and "indirect cost pool." Though we will not discuss each definition, a few interesting points emerge.

1. Whereas accounting texts address "allocate" primarily with indirect costs, the CAS Board expanded the meaning to both direct and indirect costs.

2. Since contractors recover direct costs dollar-for-dollar while they recover only a portion of indirect costs on contracts, they are often motivated to charge as much costs as possible directly to the contract, especially if it is government work. In addressing what makes a cost direct, the CASB said neither the nature of the cost (e.g. material, labor, etc.) nor the person performing the work (e.g. indirect person performing direct work) should determine whether a cost is direct or indirect. Rather, the essential relationship must be a "causal/beneficial" one, regardless of the goods or services used. So, for example, if a labor task is specifically identified with a particular final cost objective, the costs are direct, regardless of who performs the task.

3. A significant difference in terminology exists in the first sentence of the CASB and FAR definitions of direct costs. The FAR reads "A direct cost is any cost that can be identified specifically with a specific final cost objective" while the CASB substitutes "can be" with "is." Though the writers of the FAR said no difference of meaning was intended, as the years have gone by auditors are finding a difference in the terminology and are implementing the "can be" aspect of the FAR definition. Whereas the CASB version basically states a direct cost is any cost that the contractor calls direct if it meets the characteristic "identified specifically" criterion, the FAR "can be" terminology has been interpreted to mean if you can make a cost direct, you must do so. This "can be" interpretation has, in practice, been used to provide less flexibility to contractors and greater bases to challenge contractors' decisions on how to treat costs.

What are "Like Circumstances"

The words in CAS 402 are "costs incurred for the same purposes in like circumstances" but it is not always easy to distinguish like from unlike circumstances. It should be kept in mind that contracting officers and auditors do not look favorably on the use of the following criteria to distinguish "like" from "unlike: (1) government work occurs under circumstances unlike those for commercial work (2) fixed-price contract costs are incurred under circumstances unlike those for cost-reimbursable contracts and (3) costs on government work are treated as direct while costs on commercial work are treated indirect. Though these criteria are not specifically forbidden, contractors can expect to have auditors challenge costs allocated by procedures based on these criteria.

An associated problem is when a new circumstance is a like circumstance. For example, whereas a contractor charged test costs, which were not significant, indirectly and now receives a new contract requiring extensive testing with new equipment having no other foreseeable use. Must these costs be charged indirectly or may they be treated as a direct cost? If direct, is this a change or is it a new cost accounting practice for a situation not covered before?

Keep in mind the contractor needs to package the supporting rationale for identifying unlike circumstances. For example, a common rationale for unlike circumstances is if costs are over and above those had there been no contract. In assessing whether costs are incurred in like circumstances, you can expect the auditor to review the contract requirements and determine if the effort is different from or in greater scope than the effort might have been absent the new contract.

Materiality

Immaterial direct costs may be treated as indirect costs. CAS puts three conditions for treating immaterial direct costs as indirect: (1) the cost is a minor dollar amount (2) the accounting treatment for the cost is consistently applied for all final cost objectives and (3) the treatment produces results that are substantially the same as those obtained had the cost been treated as a direct cost. Neither the standard nor DCAA audit guidance establishes what is considered "immaterial" but in practice we usually see DCAA accept as immaterial amounts representing less than 2% of total indirect costs and they will rarely accepts as immaterial anything greater than 5% of total indirect costs. Between 2-5 percent, it will largely depend on the individual auditor's judgment.

Contract Terminations

Though CAS 402 requires a contractor to classify consistently all costs in like circumstances as either direct or indirect, termination regulations permit contractors to treat otherwise indirect costs as direct for purposes of computing allowable termination costs. To resolve this obvious inconsistency, the government has maintained that terminations result in circumstances that are not "like circumstances." However, if treatment of costs between different termination claims are different, then the contractor will be cited for a CAS 402 violation.

Use of Advance Agreements

When inconsistent practices and inequitable allocations exist, it would seem that contractors need to change their cost accounting practices. However, there is an alternative. Though CAS 402 does not address it, certain standards (e.g. 403, 410, 418 and 420) provide for special allocations under unique situations and FAR 31.109 recognizes that special treatments under advance agreement are permissible which can apply to CAS 402. An advance agreement would apply only in those situations which are unique to one contract. If the most equitable way to deal with a costing issue for a specific contract is to treat a particular cost as direct for this contract but to treat those costs as indirect for all other contracts an advance agreement can be used. However, the agreement must give assurance that it does not permit double counting (discussed below).

Sometimes Direct, Sometimes Indirect

When addressing whether specific costs are treated direct or indirect, the CAS Disclosure Statement has a classification of "sometimes direct/sometimes indirect." It is clear the CASB did not favor continual changing of cost treatment with each new contract so it established this category. Generally it depends upon how the contractor defines the structure of its cost accounting system. For example, a contractor has a computer center charged out based on usage. When a contract requires computer services, it is charged for those services as a direct cost of the contract; when the computer service center performs work for the finance function, the charges for the services flow to the G&A pool and become an indirect cost. Likewise, a contractor might define all material and supplies in an undifferentiated category where those that are identified with a contract are direct while those that are immaterial in amount or used for overhead or G&A activities are included in those pools as an indirect cost. The requirement of consistency is achieved not by whether the cost flows as a direct cost to a contract or to an indirect cost pool but in the manner of charging work performed. In the case of the computer service, a charge was determined for all work performed and that charge was assessed against the customer for work – if the customer is direct the cost is direct and if the customer is indirect, the cost is indirect. The underlying essential ingredient is the beneficial/causal relationship existing between the activity/task and the cost objective to which the cost flows.

Proposal Costs – Interpretation No. 1

The CAS Board clarified conditions under which a contractor can charge proposal costs, both direct and indirect, without violating CAS 402. The interpretation concluded that not all proposal costs are incurred in like circumstances – costs of preparing a proposal pursuant to a specific requirement of an existing contract, which can be charged specifically to that contract, was considered to be different circumstances from those which are not required by that contract, which can be charged indirect. Interestingly, the interpretation does not preclude the indirect allocation of costs incurred in preparing all proposals, thus permitting contractors to allocate indirectly those proposal costs that are permitted to be charged direct.

Examples

♦ Examples from the Standard

1. Contractor normally allocates all travel as an indirect cost and for a new proposal, contractor intends to allocate travel costs of direct labor directly to the contract. *Answer.* Since travel cost of direct labor working on other contracts are charged indirectly, their costs must no longer be charged indirect since the costs are incurred for the same purpose.

2. Special tooling costs are allocated directly to contracts while costs of general purpose tooling costs are normally included in the indirect cost pool. *Answer.* This is considered compliant since both types of costs were not incurred for the same purpose.

3. Contractor proposes to perform a contract requiring three fireman on a 24-hour duty at a fixed post to provide protection for flammable materials used on the contract. Contractor also maintains a

firefighting force of 10 for general protection of the plant. Contractor wants to charge the three firemen direct to the contract and the 10 indirect. *Answer*. This is compliant providing in its disclosed practices the contractor indicates that the costs of the three special firemen serve different purposes than the general firefighting force charged indirect. (*Editor's Note. One might argue that the purposes are the same but the circumstances are different but the CAS Board chose to call attention to different purposes so this should be remembered as the basis for distinguishing the difference when justifying different treatment.*)

♦ Examples from the DCAA Contract Audit Manual

1. A contract requires extra effort for planning and cost management where it hired extra people and wants to direct charge them to the contract. The contractor has other people performing the same functions for more than one contract where their labor is charged indirect. *Answer*. Since the work being performed is the same and the only difference is in the amount of effort required, this practice would not comply with CAS 402. The contractor must either (1) charge all of these costs indirect or (2) direct charge all of these costs. (*Editor's Note. The Bender text states if the extra effort is really a different effort but the contractor classifies it as planning and cost management then the extra effort may be treated as a direct cost. This is because the different effort is unique to the contract and is not performed for other contracts.*)

2. A contractor has hundreds of cranes located throughout the shipyard where their maintenance, taxes and depreciation costs are recorded in a general account and allocated to department overhead pools. The Dry Dock has the cost of eight cranes charged directly to its department overhead pool because their use is unique to Dry Dock operations. *Answer*. Since the Dry Dock cranes are used for special purposes and the Yard cranes for general, this practice does not result in "double counting" i.e. direct charging a contract costs normally charged indirect and then allocating to the contract a portion of the remaining indirect costs. However, if any of the Yard cranes are also used for special purposes (e.g. new ship construction) the practice would result in double counting. In this case, the special purpose cranes need to be eliminated from the general account and charged directly to the using department.

♦ Other Examples

1. The aircraft service center costs are charged to contracts based on pilot flight time. If the CEO takes a flight on corporate business not directly related to a contract, no charges are made i.e. the costs remain in the center cost pool. *Answer*. This is an inconsistency addressed by CAS 402. If the service center costs are charged directly to contracts then the cost pools benefiting from the service center should also be charged so a charge for the CEO's travel should be made to the G&A expense pool.

2. A contractor has two business units, one in Phoenix and one in Denver. At the Phoenix location all travel costs are charged directly to contracts while in Denver, travel costs are included in appropriate overhead and G&A pools. *Answer*. This is not a CAS compliance issue because CAS compliance focuses on the business unit level. Therefore, different business units are not required to have the same distinctions for direct and indirect costs.

3. A contractor has two plants in one of its business units. In Plant 1, electricity for the factory is metered to each machine and department where electricity identified with a machine is allocated to contracts on the basis of machine hours while electricity identified to a department is included in the department's overhead. In Plant 2, the company only meters the amount of electricity to the factory and this electricity is included in the plant-wide overhead. There are no overhead pools allocated to both plants. *Answer*. CAS 402 would cover this since there is only one business unit but since there is not an inconsistency between direct and indirect classifications (the inconsistency is the difference in accounting for indirect costs between the two plants) there is no CAS 402 noncompliance.

Classic Oldie…

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 is a member of our "Ask the Experts" panel where subscribers can send questions or chat with one of our panel of experts 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 federal and state employment laws.*) 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 contractor 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 indicated 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).

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2004

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and the Comptroller General say they are, we are continuing our 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. This article is based on the January 2005 issue of Briefing Papers written by Miki Shager, Counsel to the Department of Agriculture Board of Contract Appeals. We have referenced the cases in the event our readers want to study the cases.)

Protests of Award Decisions

♦ Task Orders Under MAS Contracts

Though the General Accountability Office does not usually have jurisdiction over bid protests of task or delivery orders under indefinite-delivery/indefinite-quantify contracts this limitation does not apply to a protest challenging the terms of the underlying solicitation or where the protester claims the order is beyond the scope of the original contract (*Specialty Marine, Inc., Comp. Gen. Dec. B-293871. Unless handled by a Court we will reference Comp. Gen. Decisions with only the numeric reference*). Once a contract is awarded the

GAO will not review modification to the contract because such matters are related to contract administration and are beyond its jurisdiction. However, an exception applies when a protester alleges the modification is beyond the scope of the original contract (*Anteon Corp. B-293523*). The government modified the contract to allow for changes not contemplated in the original contract where in doing so the contract was almost doubled and the nature of the changes were substantial. The Court ruled the government could not circumvent the competition requirements by modifying a contract not within the contract's original scope without re-soliciting the contract (*Cardinal Maintenance Service Inc. v. US, 63 Fed. Cl. 98*).

Though competition is not required before award of a task or delivery order under a Federal Supply Schedule contract, if such competition is held the GAO will entertain a protest to ensure the competition is fair, reasonable and consistent with the solicitation. The GAO affirmed that the exemption from full and open competition for FSS contracts applies only if all goods or services included in each task or delivery order are included and priced on the schedule contract and it sustained a protest where the government had issued a purchase order to a vendor whose quotation included a non-FSS item that was priced above the $2,500 micro-purchase threshold (*CourtSmart Digital Systems (B-292995.2*). The GAO reiterated its position that exemptions from competitions for orders placed under FSS contracts applies only to those services and goods listed and priced in the FSS schedules. It sustained a protest where the awardee's schedule contract description of education/experience and functional requirements for a particular job title did not match those for the RFQ position even though the background of the individuals met those specified in the RFQ (*American Systems Consulting, B-294644*). The GAO also sustained protests where a delivery order was improperly issued for items not on the FSS vendor's schedule (*Armed Services Merchandise Outlet, B-294281*) and where specialized online research services were outside the scope of the awardee's services contract (*Information Ventures, B-292743*).

♦ Rejection of Offers

It is the offeror's responsibility to prepare an adequate written proposal and to furnish all information required by the solicitation. An agency properly may eliminate from competition an offer with significant informational deficiencies (*HDL Research Lab, B293105*). A low priced, incumbent offeror who did not submit a mobilization plan showing how it would mobilize its workforce had its protest denied where the Court ruled it is a well established fact that all offerors, including incumbents, are expected to demonstrate their capabilities in their proposals (*International Resource Inc. vs US, 60 Fed. Cl. 1*).

The GAO has ruled that when using commercial items procedures, an agency is not required to evaluate and document whether the proposed items are in fact commercial items unless the solicitation requires it or there is an indication the proposed items are not commercial (*Firearms Training Systems B-292819*).

♦ Unbalanced Offers

A bid is considered materially unbalanced if it is based on prices significantly less than cost for some work and significantly overstated for other work and there is reasonable doubt the bid will result in the lowest overall cost. However, an agency's acceptance of a proposal with unbalanced pricing is not, in itself, improper provided it concluded the pricing does not pose an unacceptable level of risk and the prices the agency is likely to pay are not unreasonably high (*Islandwide Landscapting B-293018*). An offer that was 23% over the government's estimate was ruled not to be significant enough to be considered unbalanced (*Diversified Capital, B-293105*). A protest asserting an agency improperly rejected the protester's bid as unbalanced was denied where the bid included overstated prices for some line items and the agency determined that due to uncertainty in estimated quantities for those items the bid posed the risk the government would pay an unreasonable price for contract performance (*Burney & Burney Construction B-292458*).

Below-cost pricing is not prohibited and the government cannot withhold an award from a responsible offeror merely because its low offer is or may be below cost. However, make sure the low bid does not make the offeror non-responsible. The GAO ruled there was no prohibition against an agency accepting a below-cost offer on a fixed price contract (*First Enterprise, B-292967*) and the fact an offeror submitted an unreasonably low bid or even one below cost is not valid grounds for protest (*Government Contract Consultants B-294335*). The court also dismissed a qui tam suit alleging the contractor had fraudulently induced the CO to award it a contract by submitting a low bid but never intended to perform at the bid price because only claims intended to cause the government to pay money not otherwise due is

fraudulent and the mere submission of a low bid does not meet this test (*US ex rel. Bettis v. Odebrecht Contractors, 297 F. Supp. 2d 272*).

♦ Negotiated Contracts

The government gets to use a variety of *evaluation factors* in making its award decisions but the RFP must describe the factors and significant subfactors to be used as well as their relative importance (*Burns & Roe Services, B-291530*).

Agencies must apply evaluation criteria equally to all competitors. The agency evaluated key personnel in determining the corporate experience rating of the awardee but did not do so for the protester, claiming the solicitation did not require it. The GAO found it unfair to treat the corporate experience factor unequally (*Ashe Facilities B-292218*).

FAR 9.104 provides that to be determined *responsible,* a prospective contractor must, among other things, be able to comply with the required performance schedule, have adequate financial resources and have the necessary organization, experience, operational controls and technical skills or ability to obtain them. The burden is on a prospective contractor to demonstrate its responsibility and in the absence of such information clearly indicating the offeror is responsible, FAR 9.103 requires the CO to make a determination of non-responsibility. The GAO will not disturb such a non-responsibility determination unless the protester can show the agency had no reasonable basis for its determination – in other words, the CO has broad discretion in exercising business judgment (*Daisung Co. B-294142*).

♦ Past Performance Evaluations

Past performance is one evaluation factor that has become increasingly important in a great many award decisions in general and it must be considered in all negotiated procurements. Whereas FAR 15.306(b) and (d) provides for discussions in negotiated procurements and gives offerors the opportunity to clarify adverse past performance information (PPI) FAR 15.306(a) merely provides that offerors *may* be given an opportunity when awards are made without discussion.

An agency has broad discretion to determine whether a particular contract is relevant to the evaluation of past performance (PP). However, the GAO held that an agency erred in considering one of the awardee's prior contracts where the RFP stated only information on contracts "similar in size, scope and complexity" to the work to be awarded would be evaluated but the GAO found the contract at issue was "substantially less than the dollar value of the requirements under the RFP and relevant only to a limited portion of the solicited work" (*Si Nor Inc. B0292748*). A protest asserting the agency improperly placed undue weight on whether an offeror had previously produced the same item was denied. The agency showed, consistent with the solicitation's terms, the offeror's past performance producing the same items was "most relevant," and that it had reasonably assigned a higher rating to awardee's higher priced proposal because the firm previously produced the item (*Entz Aerodyne, B-293531*).

Where the solicitation required PPI on contracts producing items similar to the grenade fuze being procured and the awardee's previous experience was in producing part of a different fuze involving differences in design and complexity the GAO ruled the evaluation of the awardee's PP as "excellent" was unreasonable (*Kaman Dayron, B-292997*). In contrast, where the evaluation factor called for contracts of similar dollar size and complexity the GAO upheld a grounds maintenance contract to a company with limited experience in that specific area but with extensive experience in managing contracts of similar dollar value and greater complexity, noting that "mowing grass is not a difficult task" (*Family Entertainment Services B-291997*). The Court held the solicitation permitted the agency to evaluate the protester's PP on the basis of size, scope and complexity and it had not erred in downgrading the protester's performance rating where past contracts were all small relative to the present solicited work. The Court also held the CO had discretion to choose which references to contact for purposes of evaluating the protester's PP and did not abuse the discretion by choosing not to contract references related to services different from those required under the contract (*The Arora Group v US, No. 04-366C Fed. Cl.*).

It is the contractor's responsibility to provide sufficient evidence to establish its past performance history. The GAO upheld a challenged PP evaluation where only two of the nine past performance references provided were relevant and within the time period specified in the RFP and neither of those two listed the required information (*Carpetmaster, B-294767*). Though the Court found the Navy had improperly failed to incude the contractor's PPI in the Contractor's Appraisal System, it found the significance of that error was reduced because the

contractor bore a degree of responsibility to ensure its evaluations had been properly recorded. The Court found that where the contractor had not ensured the accuracy of its PP data, the government did not err by relying on the inaccurate data (*J.C.N. Construction v. US, 60 Fed. Cl. 400*).

Prior cases have established an agency may properly attribute the experience or PP of a parent or affiliated company to an offeror where the firm's proposal demonstrates the resources of the parent or affiliate will affect performance of the offeror. In JACO the GAO said an agency may consider the experience and PP history of individual joint venturer's proposal where the solicitation does not preclude doing so and both joint venture partners will be performing work under the contract (*JACO & MCC Joint Venture B-293354*).

♦ Discussions

FAR 15.306(d) requires that COs discuss with each offeror being considered for award significant weaknesses, deficiencies and other aspects of its proposal that could, in the CO's opinion, be altered or explained to enhance the proposal's potential for award. *Discussions* should not be confused with *clarifications*. Clarifications are limited exchanges with offerors to allow correction of minor or clerical errors or to clarify proposal elements; discussions are exchanges with offerors undertaken with the intent of allowing proposal revisions. The GAO ruled that the agency had not "crossed the line into discussions" during awardee's oral presentation and that the agency properly made the award without discussions. The GAO held that during oral presentations an agency may express views on the proposals but may not allow an offeror to revise its proposal in light of those comments without providing all offerors meaningful discussions and an opportunity to revise proposals. In this case, the awardee furnished additional staffing information in response to agency questions but the additional information was merely a clarification (*Sierra Military Health Services, B-292780*). No discussions had occurred when the winning offeror corrected an obvious mathematical error before award (*Galen Medical Assocs.v. US, 369 F.3d 1324*).

There is no requirement that all areas be addressed during discussions only significant weaknesses i.e. those that appreciably increase the risk of unsuccessful contract. While an agency must conduct meaningful discussions (i.e. discuss areas in a proposal requiring amplification or revision), an agency is not required to "spoonfeed" offerors or conduct successive rounds of discussions until they have corrected all proposal defects (*Base Technologies B-293061*). The GAO held that where an offeror's price is not so high as to be unreasonable, the agency is not required to advise the offeror its price is not competitive (*Mechanical Equipment B-292789*).

Claims

When contract effort exceeds the original scope of work the contractor is entitled to receive a price adjustment to the contract price. A contractor generally carries the burden of proving the amount by which a change increased its cost of performance. The following address circumstances when a claim may be justified and some issues related to quantifying the price adjustment.

♦ Constructive Changes

A constructive change occurs when a contractor must perform work beyond contract requirements without a formal "order" to do so under the "Changes" clause. Such a change can include an *informal* order or direction of the government or by the *fault* of the government. To recover under this theory the contractor must advise the government it considers the contract to have changed. The Board held that contractor's notice to an official other than the CO was insufficient where there was no proof that the project manager had CO authority and his technical expertise did not imbue him with CO authority (*MC 11 Generator & Electoric, ASBCA No. 53389*). However, the Board granted the contractor relief for a number of constructive changes that resulted from the government inspector's misinterpretation of the contract specifications, ruling the inspector had delegated authority to change the contract as part of the inspection process (*Dan Rice Construction, ASBCA No. 52160*).

♦ Defective Specifications

Design specs describe in precise detail the materials to be employed and manner in which the work will be performed while *performance* specs set forth a standard to be achieved and the contractor is left to its own devises in the manner and means of proceeding as long as the standard is met. When drawings are considered design specs the agency is liable for any defect in the design (*U.S. v. Spearin, 248 U.S. 132*). A series of cases involving the M.A. Mortenson Company evaluated the differences between design and performance specs. The contractor claimed the

agency increased the structural requirements for stone-panel footings beyond the contract requirements and the board found the specs required the contractor to design the footings and thus they were of the performance variety (*M.A. Mortenson, ASBCA No. 53229*). Where the contract called for the use of a UL-listed product where none existed, the contractor was entitled to an equitable adjustment for the cost of designing an acceptable one (*M.A. Mortenson, ASBCA No. 53394*). Even though the drawings were deficient, the contract imposed coordination and review duties so the Board ruled there was not an equitable adjustment because the contractor failed to prove it complied with the coordination and review requirements that would have discovered and resolved the drawings deficiencies (*M.A. Mortenson, ASBCA No. 53105*). It later discovered a discrepancy on its grass mowing and daily policing contract and the Court concluded the contractor was misled by the defect and relied on the defective specs in its pricing so it was entitled to an equitable adjustment (*E.L. Hamm v. England, 379 F3d 1334*).

♦ Eichleay

The so-called Eichleay method is a formula for recovering unabsorbed overhead. Use of the method requires the contractor to by on "standby" which has been defined in a couple of cases. The Court established four conditions that satisfy the requirement the contractor has been put on standby for purposes of using the Eichleay formula to recover unabsorbed overhead: (1) the CO issued an order suspending all of the work order for an uncertain duration with no time for remobilization (2) absent a direct suspension order, the contractor must show the delay was both substantial and of uncertain duration (3) during the delay, the contractor must have been ready to resume work at full speed without time to "remobilize" and (4) the contractor must show that much, if not all, of the work was suspended (*P.J. Dick v US, 324 F.3d 1364*). The Eichleay formula was not available where the contractor presented no evidence it was required to remain on standby and be ready to resume work when the suspension was lifted and in fact did not resume full work immediately when the suspension was lifted (*TPS ASBCA No 52421*). In its contract to relocate a butterfly valve on a lift gate at a dam, where the contractor had to receive notice from the government to work, the Court ruled the contractor met its burden of being on standby to receive home-office overhead for the period its employees were forced to wait (*Tulsa Mid-West Construction, ASBCA No. 53594*). Though the work was 90% complete, the government issued a stop-work order. The Board ruled the contractor was entitled to unabsorbed overhead expenses under the Eichleay formula. It ruled the percentage of contract completion does not determine the Eichleay remedy but rather the nature and magnitude of the government-imposed delay and the extent to which the delay placed the contractor on standby, precluding it from obtaining additional work (*Rex Systems ASBCA No. 54444*).

♦ Lost Profits

To demonstrate entitlement to lost profits, a contractor must prove causation, foreseeability and reasonable certainty as to amount. The Court rejected the government's assertion that lost profits are necessarily speculative (*Data Marketing V. US, 107 Fed. Appx. 187*). However, a contractor is not entitled to lost profits on option years where the government chose not to exercise the options because in that case lost profits would be shear speculation (*Hi-Shear Technology v US, 356 F.ed 1372*). When it is established the government negligently estimated the quantity of its needs and the contractor is entitled to an equitable adjustment on the delivered quantities, the court held the contractor is not entitled to anticipated profits on the estimated quantity unless it proves the government's requirements were diverted to another contractor (*Rumsfeld v Applied Cos., 325 F.3d 1328*).

Costs

For many years now the boards and courts have distinguished between unallowable costs of prosecuting claims and allowable costs of contract administration where the basic guidance is if costs are incurred to permit a negotiated resolution of problems arising during contract administration they are presumably allowable while if they are incurred to begin the process of litigating a claim they are unallowable. The contractor incurred at least part of its legal and consulting fees to facilitate negotiations of an equitable adjustment for changed work and thus at least some of the legal and consulting costs incurred were allowable contract administration costs (*B.V. Construction, ASBCA No. 47766*). A "Limitation of Cost" clause that establishes funding limits on a cost type contract that is incorporated in an ID/IQ contract applies to each delivery order rather than the contract as a whole (*Analysas Corp. ASBCA 54183*). When the existence of defective pricing is established, there is a rebuttable presumption that the natural and probable consequences of defective cost or pricing data is to cause an overstatement of price.

However, that presumption was rebutted where contractor presented evidence that no one involved in the contract negotiation reviewed the subject cost or pricing data (*United Technologies, ASBCA No. 51410*).

A termination of convenience basically converts a fixed price contract into 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. Even though the agency did not challenge a contractor's claimed termination charges, the board refused to allow the contractor to recover profit on costs incurred, since it was clear the contractor would have suffered a loss had performance been completed. Interestingly, though, the board did not apply the loss formula to reduce contractor's cost recovery (*Diversion Services, GSBCA No. 15997*). The Board ruled that a prime contractor is not entitled to obtain a profit on completed work included in a subcontractor's settlement proposal under a cost type contract but the prime is entitled to profit on completed subcontract work under a firm-fixed price contract (*Lockheed Martin, ASBCA No. 53032*).

NEW RULE ON COST IMPACT PROPOSALS

Compiling a cost impact analysis to ensure the government does not pay increased costs resulting from an accounting change or an allegation of non-compliance with a cost accounting standard is one of the most burdensome requirements of conducting business with the federal government. Whether a firm is fully or modified CAS covered, the CAS Board standards, rules and regulations define a range of circumstances under which price and cost adjustments to CAS covered contracts are necessary due to changes to the cost accounting system. Though the rules explicitly cover full and modified CAS covered contractors, much if not all of the information is often informally required for non-CAS covered contractors when an accounting change is made or anticipated and the government wants to make sure the change will not increase the costs it must pay. The content of cost impact proposals is left up to individual agencies but the following information is usually required: (1) description of all changes to a cost accounting practice (2) general dollar magnitude statement showing cost shifts by contract type, agency or department (3) identification of CAS-covered contracts and (4) oftentimes, a contract-by-contract cost impact proposal. Sometimes the information must be provided on an historical basis (e.g. allegations of CAS non-compliance) and/or on a prospective basis where estimates to complete must be included.

As we reported in the last issue of the GCA Report, a new government wide rule was issued March 9, 2005 (Fed. Reg. 11,742) effective April 8, addressing the cost impact process. The process is intended to provide "significant flexibility" to both the "cognizant federal agency official" (CFAO) – representing the government – and the contractor according to the Federal Acquisition Regulation Council. Specifically, this flexibility includes:

- The ability to determine any time in the process the materiality of the contractor's cost accounting practice change with respect to costs paid by the government. This is a critical change – we cannot count the number of times auditors and COs insisted on full scale cost impact analyses when it was clear from the beginning that the impact of a change was insignificant.
- If the cost impact to the government is material, the ability of the contractor to submit, in any form acceptable to the CFAO, either a general dollar magnitude (GDM) proposal reflecting the minimum data to resolve the cost impact or a detailed cost impact (DCI) proposal.
- The ability of the CFAO and the contractor to negotiate the cost impact by adjusting a single contract, multiple contracts or some other suitable method. The ability to adjust one contract saves considerable effort when compared to the need to obtain multiple acceptances from several COs and/or different government agencies and departments.

The final rule comes almost five years after the FAR Council first proposed a CAS administration rule in April 2000. That proposal was criticized for being overly prescriptive and burdensome by commentators who submitted written comments and attended two public meetings. In July 2003, the FAR Council issued a second proposed rule that differed significantly from the first.

The new final rule addresses public comments received from the second proposed rule as well as the FAR Council's observations regarding those comments. Some include:

- Because each cost impact must be evaluated based on its particular facts and circumstances, the

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rule does not provide guidelines on documentation for materiality determinations.

- There will be instances in which a determination of materiality can be made before the contractor submits a GDM and the rule gives the CFAO flexibility to determine the data required on a case-by-case basis.
- The rule includes a requirement for the CFAO to document a determination that the cost impact on the government is immaterial.
- The rule does not include a specific time requirement for CFAO action on cost impact proposals.
- Allowing but not requiring the submittal of a GDM gives contractors flexibility to submit proposals as complex and precise as they choose, up to and including a full DCI.
- For some contractors, the projection of representative samples is a feasible method for computing increases and decreases in cost accumulations for a GDM; for contractors that find it problematic to reach agreement with the government on what constitutes a representative sample, there are alternative methods for computing increases and decreases in cost accumulations.
- Using current estimates to complete is the only feasible method for computing the cost impact of changes in cost accounting practice.
- The rule eliminates the discussion of interest calculations as overly prescriptive.
- The rule does not preclude combining cost impacts for changes implemented in different years but it does prohibit combining the cost impacts of required/desirable changes with the cost impacts of unilateral changes/noncompliances. (The cost impact requirements for changes that are required because of changes to the CAS or that are considered "desirable" are different from the impact requirements steming from contractors choosing to make an accounting change or that result from CAS noncompliances.)
- The calculation of the cost impact of an accumulation noncompliance is necessary to ensure the government recovers the full extent of any increased costs as well as any statutorily required interest.
- The adjustment of final interest rates by the CFAO does not force CAS issues on non CAS-covered contracts because the contractor must agree to any such adjustment. (Remember, contractors are not CAS-covered, but rather contracts are.)

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