GCA Digest

(A publication of Government Contract Associates)

Second Quarter 2010 Vol 13, No. 2

RECOVERY OF COSTS WHEN WORK IS DELAYED BY THE GOVERNMENT

(*Editor's Note. We have been involved in several consulting engagements lately where we have helped clients quantify costs related to work stoppages and suspension due to a variety of reasons as well as when those delays result in an eventual termination. We have been boning up on the rules related to delays and decided to offer some of our insights to our readers. The sources of this article are many – an old article by Rand Allen and Phil Harrington in the long defunct Government Contract Audit Report, FAR and DCAA audit guidance as well as our own experience.)*

It is quite common for a contractor's performance to be delayed or disrupted by any number of unforeseen events. To address these situations, the government has created three clauses that allow it to suspend or stop contract performance – FAR 52.233-3, Protest After Award; FAR 52.242-14, Suspension of Work and; FAR 52242-15, Stop Work Order. While these clauses give the government the right to interfere with contract performance they also create a corresponding responsibility for the government to compensate the contractor for the interference. However, this entitlement is not automatic but rather the burden of proof falls on the contractor to demonstrate it suffered financial harm as a result of the government ordered delay. In addition, the proof required and the amount due can vary depending on the clause the government invoked to delay the work.

The FAR Clauses

♦ Suspension of Work (FAR 52.242-14)

Of the three clauses, this clause is the least generous and places the most burdens on the contractor. This clause is often used for construction and architect-engineering services but we have seen it in many others. The clause imposes a number of hurdles that must be cleared to recover extra costs. First, the contractor must demonstrate not only the government delayed the work but the delay was for an unreasonable period of time. What constitutes unreasonable can vary widely where, for example, 1-10 hours have been ruled as unreasonable while in other circumstances 12 days have been held to be reasonable.

Second, the delay must not be attributable to contractor fault or negligence. So, for example, if the contractor could not perform the work, did not furnish material the government required or refused to cooperate cases have ruled the contractor would not be entitled to compensation under this clause.

Third, the clause prohibits recovered of government-ordered delays "for any costs incurred more than 20 days before the contractor shall have notified the CO in writing of the act or failure to act." This does not require the contractor to file a claim without this 20 day period but rather requires it to put the CO on notice of a triggering act or failure to act within the 20 day period. The final step is for the contractor to submit a written claim to the CO. Though the clause requires the claim to be filed "as soon as practical" following the end of the delay, it does provide that a claim is considered timely if it is submitted by the date of the final payment under the contract. The Suspension of Work does contain a provision that prevents recovery of an important element – profit, which cannot be part of a contractor's claim.

♦ Protest After Award (FAR 52.233-3)

It is becoming more and more common to find after receiving a contract that a losing competitor is protesting the award to the GAO. If the protest is filed on time, the government is required to suspend contract performance. Upon notice of the protest, the government will usually order the contractor to stop all work on the contract and take reasonable steps to minimize costs allocable to the contract. After the GAO issues a decision on the protest, it may either cancel the stop work order, let it expire on its own which would permit the contractor to resume work or terminate the work covered by the order. In any event, the contractor is entitled to recover not only the costs incurred during the stop work period but profit on those costs also. Unlike the Suspension clause discussed above, there is also no requirement

for the contractor to show the government-caused delay extended for an unreasonable delay of time.

In practice we have encountered several methods the government has tried to use to escape its obligations under this clause:

1. Stop work means stop incurring costs. In spite of the stop work notice, the contractor is not required to stop all costs that may be allocable to a contract. Rather, its obligation is to take prudent steps to *minimize* the incurrence of those costs – "Upon receipt of the order, the contractor shall immediately comply with its terms and take all reasonable steps to minimize the incurrence of costs allocable to the work covered." Thus in some circumstances it may be less costly to the government for a contractor to continue to incur costs at some reduced level. This confusion of stop work being the same as stop all costs is quite common. We are now challenging questioned costs by the CO and DCAA who are disallowing all costs incurred by our client after a stop work notice even though they were able to persuasively show the costs were necessary and in fact saved the government money.

2. No NTP was issued. In some contracts the agency is supposed to issue the contractor a Notice to Proceed (NTP) before the contractor can begin performance. We have seen agencies try to escape payment by saying a NTP was not issued but cases have held that withholding a NTP subsequent to a protest will be treated as if it were a stop work order discussed next.

3. The Protest After Award clause was not in the contract. This clause is covered under the so-called "Christian Doctrine" that provides if the solicitation and resulting contract do not expressly contain certain clauses they are nonetheless considered to be part of that contract by operation of law.

♦ Stop Work Order (FAR 52.242-15)

This clause allows the government to stop all or any part of work for 90 days or longer if the parties agree. The provisions of the clause virtually duplicate those under the Protest After Award clause where the Stop Work clause (1) does not require the contractor to show the period of delay was unreasonable (2) entitled to profit on its incurred costs caused by the delay (3) not required to stop all costs but only to minimize them and (4) entitled to an equitable adjustment to the contract. Like the Protest after Award clause, the CO, after 90 days, must either cancel the stop work order or terminate the contract. If the stop work order is cancelled (or the period of the order expires) the contractor "shall resume work" and the CO "shall make an equitable adjustment" in either or both the delivery schedule or contract price.

Recovering Costs and Profit

Though not common in the commercial work, the government has the right to suspend or stop performance but if this happens it has the obligation to compensate the contractor for the additional costs it incurred for the delay. However, the burden is on the contractor to show what it is entitled to. It is essential that once work is delayed to immediately start identifying all of the costs related to the delay. A separate charge number is advisable and all employees should be told to charge their delay-related costs to that charge number no matter how long the delay lasts.

In deciding which specific costs for the delay are recoverable, most courts have ruled that the rules for equitable adjustments should government change orders. As such the contractor should "remain whole" where the basic pricing formula is the difference between what would have reasonably been the cost as originally required and what it reasonably cost to perform the work as changed. The following costs, which are supported by court and board decisions, are normally recoverable (keep in mind that if the contract is subsequently terminated, additional costs under termination settlement rules are also recoverable):

Standby labor and related costs. The costs of personnel who become idle as a result of the stopped or suspended work should be separately identified and all burdened costs of that labor (fringe benefits, overhead, G&A) should be recovered.

Retention of personnel. The cost of retaining key personnel that may become unavailable due to the delay.

Severance payments. Such payments incurred because of the delay.

Recruiting costs to replace staff. Staff recruited for the contract may take other employment after the work is stopped so the added expense of recruiting replacements are allowable.

Idle and underutilized equipment and facilities. The cost of equipment and facilities that would have been used on the contract that become idle or underutilized are recoverable. Normally, the best gauge of this these costs are either costs for the facilities (e.g. rent) and depreciation for the equipment. Be aware that

the assets need not be totally idle –some may be used for other work, for example – so the idle portion may be charged to the delay.

Demobilization and remobilization. These costs are recovered if they are caused by the stopped work even though they may not have been had there been no delay.

Material and labor escalation costs. The cost of performance should be increased to account for inflation due to the slippage of work.

Loss of efficiency. If the contract envisioned lower prices due to efficiency or learning curve effects the impact of loss of efficiency in contract performance is recoverable. These computations that may have been used during preparation of the original proposal should be maintained.

Unabsorbed overhead. Because disruption of work prevents direct costs from being incurred, the amount of indirect costs that would have been applied as an indirect cost rate are recoverable because they are not "absorbed." The so-called Eichleay formula is normally the only method available to compute this unabsorbed overhead.

Increased subcontractor costs. Any subcontractor costs that are affected by the delay will have the same rights as the prime contractor so these subcontractor costs should be included in the adjustment claim.

Profit. Profit is allowed if the stop work was ordered under either FAR 52.233-3 or 52.242.15 but not 52.242.14.

Proposal preparation costs. The costs of preparing the equitable adjustment request are recoverable as direct costs of the claim, even if they are normally indirect costs (just be sure to deduct them from the relevant pool of costs when calculating the indirect cost rates applicable to the claim).

Many cases have ruled that quantification of these costs "is not an exact science" so it is normally not essential to have the same level of precision or documentation required under say an incurred cost or invoice audit. Rather the standard is evidence that permits a "fair and reasonable approximation" of the costs. A reasonable segregation of costs along with a reasonable approximation of costs related to the delay should be enough to ensure the contractor is made whole. Auditors may need to be reminded of this guideline at the entrance conference of the audit of the proposal to avoid too high a level of documentation requirements.

SOME CONSIDERATIONS WHEN BUYING A FEDERAL CONTRACTOR

(Editor's Note. Increasingly, we are seeing contractors buying and selling whole or parts of businesses to be able to more effectively compete in the government marketplace. Our consulting practice has become more involved in the due diligence process of these transactions where we provide insights from our government cost and contracts expertise. We have written about the issue in the past and put together some basic considerations from both those articles and new insights from our consulting practice)

We have been seeing many instances where acquiring another federal contractor has been seem as creating many potential advantages. Whether by eliminating duplication of effort or combining two business bases to increase the denominator of the indirect rate calculation, combining two can lead to reduction in overhead and G&A rates making the new business more cost competitive. A purchaser can gain the experience of the company it buys thereby creating the opportunity to create new areas of work. One company can compliment the strengths of another – for example, we have seen one company with a strong specialty or positive relationship with an important buying office while the other company brings much needed financial backing needed to take advantage of great new opportunities. We have seen the much discussed "synergy" become a reality under the right circumstances. Done correctly the acquisition process can be a smooth transition to a combined stronger entity. Done incorrectly, the acquisition process can be frustrating, creating distrust and misunderstandings often landing in court where only the lawyers benefit.

Contracting Considerations

A critical consideration in acquiring a federal contractor is the transfer of its contracts to the new owner. Thought the Anti-Assignment Act generally prohibits the transfer or sale of government contracts the FAR establishes novation procedures where the government will consent to the transfer. When federal contracts are transferred as part of the sale of all or substantially all of the company's assets to another entity the government may consent if the new entity has the capability to perform, has required security clearances and other applicable qualifications and has the ability to assume all obligations under the contract.

Where the government consents to a transfer, a novation agreement is signed by the buyer and seller and the government formally recognizes the buyer as the successor-in-interest to the contracts.

The novation process can be burdensome. It can take months to complete depending on the number of contracts and capabilities of the government agency. Usually the acquisition must be made before the novation request is made so the purchase agreement needs to make certain that the successful novation of the contracts is a condition to the closing where, if unsuccessful, the buyer can rescind the transaction or, at a minimum, reduce the purchase price.

Under a stock acquisition, a novation of contracts is not required. This is because a stock acquisition means there is a change in ownership of the company rather than a transfer of the contract to a new entity. Though this is often more attractive, it is common following a stock acquisition for the seller to become a wholly owned subsidiary of the buyer where when the two companies are merged, the novation requirement will be triggered when the new contracts are transferred to the newly merged entity. In such cases, the novation process is not avoided.

Pending proposals are typically transferred to a buyer without difficulty provided they are transferred as part of the business sale and the transfer is to a legal entity which is the complete successor-in-interest. The parties need to promptly notify the contracting agency of the transaction so the agency can confirm the buyer is a true successor-in-interest. (*Editor's Note. Timing of transactions needs to be carefully considered. One of us was a CFO of a company on the verge of winning a $100 million contract partly because of our association with our large parent company. A day before announcement of the award we had to notify the government of our impending sale to a smaller company which resulted in our loosing the contract, negating most of the benefit of the sale.)*

An acquisition raises additional issues for small businesses and 8(a) companies where the buyer needs to determine whether the combined entity, together with other affiliates that may exist, will still fall into the small business size standards of the relevant NAICS codes. (*See our article on small business affiliation rules in the 4Q09 issue of the DIGEST*). In the case of 8(a) firms, the SBA generally prohibits the transfer of 8(a) contracts to another firm no matter if they are structured as an asset or stock deal. Some waivers are permitted but they are quite limited so it is wise to pursue a waiver prior to any closing of the transaction unless there is a formula to reduce the price in case the contracts are not transferred. Also, if the buyer is an 8(a) firm, only the buyer can obtain 8(a) contracts, not the new subsidiary. Consequently, if an 8(a) firm wants to use the newly acquired company in the performance of 8(a) contracts it will typically merge the subsidiary into the parent.

Structuring the Deal

Choose the form. The first step to offering a deal is to decide on the preferred form of acquisition – merger, stock exchange or consolidation which comes down to a stock versus asset transaction. Generally, buyers tend to choose the asset route because of favorable tax treatment (too far afield here to discuss). Another factor to consider is assumption of liabilities which also favors an asset purchase. From an administrative point of view a stock transaction is usually more simple because (1) it avoids complexities involved in transferring title of real and personal assets to the new entity and (2) most contracts of the seller (e.g. teaming arrangements, subcontracts) are not easily transferred quickly without consent of all parties.

Reduce buyer risk. When a buyer acquires the stock of a company it inherits all the liabilities of the company whether known or not. Therefore the due diligence process must be thorough. In addition to extensive due diligence other ways of reducing risk for the buyer is (1) include specific representations in the purchase agreement regarding the condition of the seller and (2) require the seller to indemnify the buyer if any representation or undisclosed liability arises after the close. It is quite common to hold back or escrow a portion of the price for a period of time (e.g. one year) to apply those funds to any surprises.

Letter of intent. A letter of intent – expression of desire to sell – should have a clear statement the terms are non-binding. The letter of intent is typically signed early, well before much due diligence has occurred, so the buyer wants to make sure they can restructure or even walk away from the deal. Make sure a lawyer carefully reviews the letter.

Compliance Related Considerations

When evaluating the company, usually during the due diligence phase, certain aspects of the sellers' contract work needs to be examined to ensure there are no surprises. Areas that we commonly examine include:

1. *Valuation of Backlog*. The variations of government contracts make assertions about contract backlog

problematic. For example, use of IDIQ, Multiple Award Schedule and Blanket Purchase Agreement contracts does not obligate the government to purchase significant items or services. Though these contracts may be awarded with great fanfare and large dollar amounts announced, they often only provide the contractor with the right to compete for future orders and those orders may never be funded. What really counts when assessing a seller's backlog is the receipt of funded orders. Hence the buyer needs to carefully examine orders actually received under IDIQ, MAS and BPA vehicles when conducting due diligence of seller's backlog with particular focus on the amount of funding, terms and scope of the orders.

2. *Claims & Terminations.* The buyer needs to assess all existing claims, potential claims and termination settlements and estimate the likelihood of recovery. In our due diligence, we have found many circumstances of exaggerated assertions of potential recovery. We have also encountered the opposite circumstances where though the seller did not identify any potential claim and termination benefits, our close examination of the likelihood of certain recoveries provided a significant source of unexpected value to our buyer client that was later realized.

3. *Cost Allowability/Indirect Rate Submissions.* Other than firm fixed price contracts (though defective pricing audits can adjust prices paid), there can be significant retroactive adjustments to interim billing and forward pricing rates based on audits of the contractor's actual incurred costs experience for a given year. The amounts of these readjustments are not often clear at the time of a buyer's due diligence efforts resulting in potential time bombs in the future. Incurred cost proposals for relevant years may not have been prepared. If prepared, they may not have been audited. If audited, the rates for a given year may not have been settled, where the contractor, government auditors and contracting representatives may be in the middle of resolving numerous questioned cost issues. If settled, the seller may have (inadvertently or not) not disclosed the results and the impact on relevant contracts and subcontracts. The due diligence efforts need to identify the potential liability of these potential time bombs. An estimate of liability needs to be taken. For example, at the very least, the buyer may want to ascertain the seller's historical experiences (e.g. ratio of billed to settled costs), adequacy of financial reserves, etc.

In addition to the quantitative issues discussed above, the protection of the seller's intellectual property needs to be evaluated. A contractor doing business with the government needs to exercise considerable care to assure it does not grant an "unlimited rights" license to the government for its technology or other assets. Such a license could entitle the government to give the design - either in the form of technical data or computer software code - to other companies and to authorize those companies to copy and sell the product illustrated in the data or code to any customer, anywhere. On the other hand, a contractor that developed its intellectual property at private expense or, to some degree, not at government or public expense can protect it, the company's policies related to protecting its intellectual property and the status of its intellectual property, especially if the seller's proprietary technology accounts for a significant share of its value, needs to be examined during a due diligence.

WHAT LEVEL OF THE CONTRACT DO CAS AND FAR APPLY TO

(*Editor's Note. In the government contracting world, we are always faced with the question of whether this or that contract is covered by such rules as Cost Accounting Standards, Federal Acquisition Regulation, Truth in Negotiations Act, etc. The question relates not just to the dollar threshold that triggers coverage but under today's circumstances particularly, what parts of a contract may apply. The proliferation of Indefinite Delivery, Indefinite Quantify (IDIQ), basic orders of agreement (BOAs) and letter contracts as well as traditional elements such as contract mods and options constantly raises the question about whether, for example, the task order or contract itself is covered. We came across an interesting article in the Nov 2009 issue of Costs, Pricing & Accounting Report by Karen Manos and Darrell Oyer that addresses many of these points though its main focus is on how CAS applies to these various contract elements so we thought it would be instructive to recount some of their main points(don't hold the authors responsible for more than their discussion of CAS*).

Common questions related to the cost accounting standards are when do they apply, which contracts are covered either fully or modified and when is a disclosure statement required. The threshold for these are when a CAS-covered "award" or "net award" are received by the contractor or subcontractor. For example the threshold for full CAS-coverage applies when a single CAS covered award of at least $50 million is made or at least $50 million in net CAS-covered awards in the previous fiscal year. Similarly,

a disclosure statement is required if a business unit received a CAS-covered award of at least $50 million or if a company, together with its segments, received net awards of at least $50 million in its most recent accounting period.

Definition

Other than a definition, the CAS Board provided little guidance on what "net awards" mean. The term "award", which is not defined, is used interchangeably with "CAS-covered contract" which is defined as "any negotiated contract or subcontract in which a CAS clause is required to be included." "Net awards" are "the total value of negotiated CAS-covered prime contract and subcontract awards, including the potential value of contract options, received during the reporting period minus cancellations, terminations and other related credit transactions." This definition is similar to the FAR. In addition to mentioning the anticipated dollar value including options the FAR states "if the action establishes a maximum quantity of supplies or services to be acquired or establishes a ceiling price or final price to be based on future events, the final anticipated dollar value must be the highest priced alternative to the government, including the dollar value of options." Though similar there are two noticeable differences between the FAR and CAS: (1) the FAR does not take into account cancellations, termination or other credit transactions and (2) the FAR requires use of the maximum quantity and highest final priced alternative to the government. The authors state the FAR definition applies to interpretations of the FAR.

Most of the CAS guidance comes in the form of Working Group publications which was a Board of "experts" who from 1976 through 1981 published 25 "Working Group Items" (WGI) The items are intended as internal guidance for the DOD and are not necessarily binding on contractors though they are considered useful starting points for analyzing CAS thresholds.

Contract Modifications

A determination of whether a contract or subcontract (*we will allude only to contracts where the meaning will apply to subcontracts as well*) is subject to CAS is made at the time of award and is not affected by modifications subsequently made, regardless of dollar value. DCAA's position is that their interpretation of WGI No. 76-2 is a modification that adds new funds is be treated for CAS coverage as if it were a new contract.

Options

Options are defined in the FAR as a unilateral right for a specified time for the government to elect to purchase additional items called for in the contract or it may extend the terms of the contract. With respect to the option amounts that should be considered in net awards the authors put forth a persuasive argument that it should apply for the most *likely* or *probable* amounts. However, they warn that most auditors usually take the position that the *maximum* amount of unilateral, priced options apply.

Basic Agreements and Basic Ordering Agreements

The FAR states a basic agreement is not itself a contract but is a written instrument of understanding containing clauses applicable to future contracts and contemplates future contracts will incorporate the applicable clauses agreed to in the basic agreement. The FAR describes a BOA as a written instrument of understanding that contains terms and clauses applying to future contracts (orders), description of supplies or services, method of pricing, issuing and delivering future orders. It states its use is to expedite contracting for uncertain requirements and quantifies that are not known but a substantial number are expected to be required. WG 76-2 correctly observes that basic agreements and BOAs are not contracts and concludes that orders issued under either type of agreement must be considered individually in determining applicability of CAS where only orders that exceed the CAS threshold are CAS covered. BOA and basic agreements need not be included when calculating CAS thresholds where only individual CAS-covered orders are to be included.

Letter Contracts

A letter contract is defined by the FAR as a written preliminary contract instrument that authorizes work to begin. WG 77-16 states that CAS applicability is determined based on the value at time of award where the subsequent definitization would not trigger CAS coverage since definitization is a contract modification, not a new contract.

IDIQ Contracts

IDIQ contracts are the most difficult. It is used to acquire goods and services when neither the exact times or exact quantities are know at the time of contract award. They are particularly popular for technical services contracts where multiple awards are

made through the contract award process and when specific work or task orders are needed the agency solicits awardees to price the task order using rates established in the contract award. The initial competition obtained offered rates and the task order competition obtained pricing of labor hours.

Technically an IDIQ contract is only a contract to the extent the work is completely priced and can be unilaterally ordered by the government. To the extent an IDIQ contemplates newly priced offers to perform additional work such work is not part of the originally awarded contract but is more like a BOA.

On the one hand, unlike basic agreements and BOAs, IDIQ contracts are plainly contracts within the meaning of FAR Part 16. On the other hand, it is usually impossible to value an IDIQ contract at the time of award, especially in the case of multiple awards. IDIQ must specify the total minimum and maximum quantity of supplies or services to be acquired. Though the government is obligated to purchase the minimum amount the maximum need not even be a realistic estimate. This is in contrast to options or requirements contracts where the government must have a reasonable basis for estimating the contract work.

Determining the value of an IDIQ is very problematic. Only a nominal minimum amount is guaranteed while large maximum dollar amounts have little chance of being given to one contractor. Imposing CAS requirements on multiple awarded IDIQ contracts would be a disincentive to obtain competitive quotes. For example, if a contractor with no CAS covered contracts were to accept an IDIQ contract with a $10,000 minimum and a $50 million maximum and the maximum amount was used to determine CAS coverage then that IDIQ contract – and all negotiated contracts over $650,000 - would be subject to full CAS coverage even though it may never receive orders totaling more than $10,000.

As of this time there have been no cases directly addressing the issue though the authors provide an analogous one. For now, the authors state that operationally, IDIQ contracts are most like BOAs which recognizes awards only as task or delivery orders are awarded. Awarded IDIQs should be carefully analyzed to determine the reasonably anticipated amount the government will order at pre-established prices. That figure should be used for CAS threshold purposes. Possible additional task orders requiring new pricing orders should be then treated as separate contracts if they materialize.

JUSTIFICATION OF ONE OVERHEAD RATE AT MULTIPLE LOCATIONS

(Editor's Note. The following article continues our practice of presenting real life situations from our consulting practice. It is a highly edited opinion memo addressing a possible challenge to a government's insistence that a company alter its indirect rate structure by creating two overhead rates after it added another facility (Many of the original memo's references to FAR, CAS, Cases and even DCAA guidelines are highly abbreviated here.). Though the circumstances are not likely to be duplicated by others, the regulation citations and arguments put forth by the government and ourselves should be instructive We were aided in this memo by Len Birnbaum of Birnbaum and Associates, a renowned consultant and attorney in contract costing issues who happens to be a member of our "Ask the Experts" board.)

Background

Contractor has two facilities. In Facility 1, employees predominately engage in research and development, program management, contract administration and general and administrative activities. Prior to 2008, this is where the contractor conducted all of its operations since the company's inception twenty years earlier. Facility 2, started in 2008, is dedicated to manufacturing operations. The company has always used one overhead rate. Since Facility 2 is new, it incurs a significant portion of the company's depreciation expenses. It also incurs abut 86% of the firms direct labor which is the base in which overhead costs are allocated.

Audit Position

A large cost type research and development proposal with the Department of Energy triggered an audit by DCAA DCAA's position is that the current method of allocating overhead expenses (particularly depreciation expenses) cause developmental contracts to absorb a disproportionate amount of indirect costs since the direct labor is incurred primarily in Facility 1 whereas the bulk of depreciation expense is incurred in Facility 2. The current system results in an "inequitable" distribution of costs where there is no "causal/beneficial relationships between the indirect expense and the direct labor activity." Consequently, the contractor should be required to segregate its overhead expenses into two separate "homogeneous expense pools" at each facility starting in fiscal year 2010.

DCAA cites FAR 31.203(b) and 31.203(d) in support of its position. The relevant sections in FAR 31.203(b) states "Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives…The base should be selected so as to permit allocation of the groupings on the basis of the benefits accruing to the several cost objectives." FAR 31.203(d) states that the cost accounting standards should govern if a contractor is CAS covered and otherwise, generally accepted accounting principles (GAAP) should dictate accounting treatment. The method of allocating indirect costs may require examination when (1) "substantial differences occur between the cost patterns of work under the contract and the contractor's other work (2) significant changes occur in the nature of the business, extent of subcontracting, fixed-asset improvement programs, inventories, volume of sales and production, manufacturing process, the contractor's products or other relevant circumstances or (3) indirect cost groupings developed for a contractor's primary location are applied to offsite locations. Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives."

Our Response

Assessment of the Facts. The contractor conducted its manufacturing operation at both facilities during FY 2008 and in the second quarter of 2009, it moved most of its manufacturing operations to Facility 2. While Facility 1 is designed for R&D effort going forward, Facility 2 includes both manufacturing and R&D effort. The contractor's DOE contract requires a manufacturing facility to qualify for award. This contract identify tasks that specify process, product and performance improvements of manufacturing operations and products. These tasks cannot be accomplished in Facility 1 since it does not have the requisite manufacturing capability. Therefore, there is a direct relationship between the indirect expense and labor activity since the developmental DOE contract is conducted at Facility 2. Consequently, these expenses should be included in one cumulative overhead rate calculation as proposed.

Response to DCAA's FAR Citations. DCAA's recommendations infer that FAR 31.203(b) and FAR 31.203(d) supports its position that in order for an expense pool to be homogeneous separate pools *must* be created. This is not correct. First, the cited regulations do not use the term "homogeneous expense pools" nor do they state separate manufacturing pools must be established for each location. FAR 31.203(b) provides, in part, "the base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives." Though FAR 31.203(d) provides that multiple overhead rates *may* be adopted, there is no stipulation they must be created. Further, GAAP does not address the number of overhead pools that need to be created.

Though the contractor is not CAS covered CAS 418 nonetheless does provide useful guidance with respect to defining homogeneous indirect cost pools. An authoritative text (Accounting for Government Contracts, Cost Accounting Standards by Lane Anderson) states that in assessing the homogeneity of an indirect expense pool, the following four things must be considered:

1. The cost in the pools should represent activities having commonality of purpose.
2. The cost pools should be a logical group of costs.
3. The allocation base should have a direct causal relationship to the costs in the pool and to the cost objectives.
4. Diversity of products (final cost objectives) should be minimal for each cost pool.

The contractor's use of a single overhead rate is in conformance with these four requirements. (We omit the analysis of the assertions here.)

The Cost Accounting Standards Board, Summary of Objectives, Policies and Concepts (May 1992) is instructive here. The Board states that homogeneity is a matter of degree. Homogeneity exists if the costs or functions allocated by a single base have the same or similar relationship to the cost objectives for which the functions are formed.

Finally there is also a seminal case that is relevant here. The Armed Services Board of Contract Appeals in *Litton Systems Inc. Guidance and Controls Systems Division (ASBCA No. 37131)* resolved homogeneous pool issues of a major contractor that used a composite overhead pool for two divisions in different geographic areas. The Board stated "the standard does not mention the location of cost incurrence as a relevant factor, nor is it relevant from a purely conceptual view…Nothing in CAS 418 or any other Standard indicates that location of facilities or cost levels of operation has any effect on the characteristics

of homogeneity of indirect cost pools as described in CAS 418.50(b)(1)."

Our conclusion is that use of a single overhead rate conforms to regulations, authoritative reference material and case law.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2008

(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 and selected cost issues. This article is based on the January 2009 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

♦ Interested Party

To have standing to protest a procurement, a protester must be an interested party – an actual or prospective offeror whose direct economic interest would be affected by the award or failure to obtain the award. A protester is an interested party where there is a reasonable possibility its proposal would be in line for award if the protest is sustained (*Philips Healthcare Informatics, Comp. Gen D. B-401249 – we will refer to GAO decisions by the case number*). A protester is not an interested party if the record shows it would not have been in line for award (*ALJUCAR LLC, B-401249*); if an intervening offeror would be in line (*CLI Solutions, B-401176*) or is not an approved source for an item (*Standard Bent Glass, B-401212*). A protester is an interested party when though it is an unqualified supplier (*L-3 Communications EOTech vs US, 85 Fel. Cl. 667*) or even a non-bidder (*Global Computer v US, 88 Fed. Cl. 35*). A subcontractor is not an interested party because it is not an actual or prospective bidder (*Kling Cor Vs US, 87 Fe. Cl 473*) nor is an "other than small" business when challenging a small business set-aside (*Taylor Consultants v US, 90 Fed. Cl. 531*).

♦ Unbalanced Bids

A bid is unbalanced if it is based on prices significantly less than cost for some work and significantly overstated for other work and there is some reason to doubt the bid will result in the lowest overall cost. An acceptance of a proposal with unbalanced pricing is not, in itself, improper provided the agency has concluded that the pricing does not impose an unacceptable risk and the prices the agency is likely to pay is not unreasonably high (*Cherokee Painting, B-400581*). Below-cost pricing is not prohibited and the government cannot withhold an award merely because its low offer is or may be below costs. An offer can have numerous legitimate reasons for proposing a low price, including a below-cost offer (*JSW Maintenance, B-400581*); an agency is free to accept a below cost offer on a fixed price contract (*DMS All Star JV, B0319932*) and; a below cost offer does not itself create risks (*General Dynamics, B-401658*). However, in other cases the agency erred in failing to conduct a sufficient price realism analysis when the total price was lower than the average and the government knew it was significantly understated (*Afghan American Army Svc V US, 90 Fed. Cl 341*); the protester's price was risky because it would lose money on every unit ordered (*Bering Straights Technical Svcs, B-401560*) or; the unusual low price indicated a critical failure to understand the degree of effort required (*Mangi Environmental Group, B-401783*).

♦ Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals. However, the RFP must describe the factors and significant sub-factors to be used to evaluate proposals and their relative importance and agencies must evaluate the proposals according to the criteria established in the solicitation (*DME Corp, B-401924*). Agencies must apply evaluation criteria in the solicitation equally (*Marinette Marine Corp, B-400697*) where unequal evaluations are considered a violation of the solicitation (*Red River Hldgs vs US 87 Fed. Cl 768*) or where the agency credited awardee but not the protester with experience of subcontractors even though the agency viewed each firms' subcontractors as having relevant experience (*Ahtna Support and Trng, B-400947*). However, there was no unequal treatment when differences in agency discussions are a result of agency's recognition of different underlying facts (*Academy Facilities Management v US 87 Fed Cl. 441*).

Agencies must consider *cost or price* in evaluating competing proposals (*USGC Inc, B-400184*). Relative price must be considered when determining competitive range (*Medical Staffing JV, B-400705*); even if price is less important than non-price factors, an agency must consider price meaningfully (*ACCESS Stms, B-400623*); in a "best value" competition a proposal's superiority in the non-price

factors must be shown to be worth the higher price (*Coast Envir., B-401889*) and; protester's discounts were erroneously not considered in the technical evaluation (*Humana Military Health, B-401652*). The type of contract to be let is within the discretion of the CO and it was appropriate not to award a contract to a contractor who did not have in place an accounting system appropriate for cost type contracts (*Wartsila Defense, B-401224*).

There were many cases addressing firms' *organizational conflict of interest (OCI)*. While creation of a "firewall" might create the appearance of mitigation of OCI it did not avoid an impaired objectivity OCI as personnel from both contracts still worked in the same organization with incentive to benefit it overall (*Nortel Gov Sltns, B-299522*). However, there was no OCI where it found no corporate relationship existed between the firms such that one firm was evaluating itself or an affiliate was making judgments that would directly influence its well being (*L-3 Svcs, B-400134*) or there was no financial relationship between the awardee and the contractor before contract award and that any potential benefit to the contractor was too speculative and remote to establish an OCI (*Marinette Marine*). There were "biased ground rules" OCI where the relevant concern is not merely whether drafted specifications are adopted into the solicitation but whether a firm is in a position to affect a competition, intentionally or not (*L-3*), or whether the involved contractor titled the competition in favor of itself (*Rhinocorps v US, 87 Fed. Cl. 261*).

Many cases in the past ruled that "unequal access to information" can constitute an OCI but that incumbent status by itself is insufficient to create an OCI. Where an incumbent may have performed activities identified in the solicitation where it could be expected to have a more informed understanding than a first time contractor, any advantage was the product of experience rather than having access to nonpublic information garnered from its special relationship with the government (*PAI Corp vs US, No. 09-411C WL3049213*). Mere employment of a former government employee familiar with the type of work required but not privy to the proposals or inside agency information does not constitute an unfair competitive advantage (*Academy Facilities*). However, unequal access OCI did exist when the agency relied on a mitigation plan that was undisclosed, unevaluated and unmonitored by the agency (*L-3*); an offeror's program manager knowingly and improperly obtained sensitive and proprietary information and the offeror refused to segregate the program manager from the competition (*Kellogg Brown & Root. B-400787*) and; use of a former government official in proposal preparation was considered indistinguishable from a firm having unequal access to information (*Health Net Fed Svcs., B-401652*).

♦ Past Performance

FAR 15.304 requires that past performance (PP) be one evaluation factor that must be considered in all negotiated procurements and the boards and courts are defining how this new factor will be applied. Where both offerors relied on experience of their subcontractors the protester successfully claimed the agency combined the relevant experience of the awardee and its subcontractor when determining its PP rating while focusing separately on the protester's lack of experience without similarly combining its and the subcontractor (*Ahtna Support*). In evaluating an offeror and their parent and related affiliated companies, the agency identified the contracts "generically" as being performed by Aetna without evaluating the relevance of PP for the parent and affiliates who would be involved in contract performance (*Health Net*). Proper evaluation of past performance occurred where the agency reasonably considered the relevant experience of the awardee's key personnel in determining the PP was highly relevant (*Divakar Tech., B-402026*); where both offerors have relevant PP, the agency is not required to further differentiate on a more refined level (*DETA Support Svcs, B-401754*); contracts determined to be relevant in the PP review involved many of the same activities required under the solicited contract (*Advanced Envir.*) and; it was proper to consider relevant PP experience of awardee as a subcontractor where the solicitation did not prohibit it (*George C. Sharp, B-401077*). Though the awardee's largest prior contract was for $35 million while the contract at issue was for $170 Million the agency ruled the protester did not prove the conclusions of relevant experience to be unreasonable (*Gov Acquisitions Inc, B-401648*). However, the GAO sustained another protest where the agency relied in material part for its PP rating on a contract's low value without showing how it was similar in size or scope to the awarded contract (*Honeywell Tech. Sltns, B-400771*) and where the contractor's experience consisting of relatively low dollar value compared to the estimated value of the projects at issue was improperly considered to have the requisite experience (*Caddell Const., B401596*).

♦ Discussions

FAR 15.306 requires the CO discuss with each offeror being considered for award significant weaknesses,

deficiencies or other aspects of its proposal that could be altered or explained to enhance the proposal's potential for award. Discussions should not be confused with *clarifications* which are limited exchanges with offerors to allow correction of minor or clerical errors or to clarify proposal elements (*VMD Systems Integrators, B-401688*). Communications to permit offeror to correct obvious error in pricing is a clarification, not discussion (*EMS Ice, B-401176*); communications were clarifications where they did not result in the submission of revised prices (*CLI Slnts, B-401176*) and; an agency may allow an offeror to correct missing reps and certs through clarification and does not constitute discussions (*Kuhuna-Spectrum JV, B-400803*). But exchanges where offeror was allowed to make a revision were not mere clarifications (*Analysis Group, B-401726*) and acceptance of protestor's late submitted "clarification" letter constituted "discussions" since it materially altered the original quote

Discussions were found to be misleading where the agency advised the protestor its prices were low compared to the government's estimate but did not so advise other offerors even though their prices were lower. Also, following these discussions the government changed the estimate against which the proposals were measured and the court found this change to have rendered the earlier discussions misleading, requiring a reopening of discussions (*AshBritt v US, 87 Fe. Cl 344*). Discussions were found not to be meaningful where the agency failed to discuss the offeror's management plan then referenced this item as the sole technical discriminator in the award decision (*Ashbury Intl Group, B-401123*). However, an agency need not discuss all aspects of a proposal that does not receive the highest possible rating (*Struc Assoc/, etc. 89 Fe. Dc. 735*).

Costs

Equitable Adjustments. An equitable adjustment is the difference between the reasonable cost of the work required under the contract and the actual reasonable cost to the contractor of performing the changed work, plus a reasonable amount for overhead and profit. A contractor carries the burden of proving the amount by which a change increased its costs of performing on the contract (*Hedlund Const. v US, CBCA No. 105*) while the government bears the burden of a downward adjustment in contract price (*Osbourne Const., ASBCA No 55030*). A contractor failed in its burden of proof where the Board found the design changes were contemplated by the contract's structure and the contractor did no more than was required under the terms of its contract (*DMJM H&N, ASBCA No 56557*). Though bilateral contract mods usually cover cost of time of performing the changed work, changed orders may also add to the contractor's time and effort if performing unchanged work (*Bell BCI Co v US fed. Cl 617*).

Termination Settlement Costs. A termination for convenience is often characterized as converting a fixed price contract to a cost reimbursement contract that entitles 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. Once the termination for default is converted to one for convenience, the contractor becomes entitled to costs related to un-priced changes, constructive changes, suspension of work, differing site conditions, defective specs and even some work that might not have been complied with in all respects (*Red River*). Contractor was entitled to unrecovered portions of truck costs, including insurance, the contractor was unable to recoup over the full term of the contract as expected (*Elton T. Calvin, Jr., PSBCA No 6220*). The termination for convenience clause applicable to commercial items make FAR Part 49 concepts inapplicable but the court awarded contractor the contract price less costs of nonconforming items and price paid to re-procurement contractor for work not performed (*United Partition Sys., v US, Fed. Cl. 74*).

Legal and Accounting Costs. An appeals court reversed a board decision that allowed defense and settlement costs associated with Title VII sexual harassment suit. It established if the alleged conduct would be a breach of contract then the costs associated with an adverse judgment would be unallowable – here sex discrimination was in violation of Title VII which would be a breach of the Equal Opportunity clause of FAR that is referenced in the contract. If the costs of the underlying judgment would be unallowable then settlement costs are also unallowable unless the contractor can establish the private plaintiff had very little likelihood of success (*Geren v Tecom, 566 F.3d 1037*).

Executive Compensation. The Board held that the contract must be interpreted in accord with the FAR cost principles in effect at the date of contract rather than those in effect at the time the costs were incurred (*ATK Lauch Sys, ASBCA No. 55395*).

Contract Administration. For a long time boards and courts have distinguished between unallowable costs

GCA DIGEST
P.O. Box 1235
Alamo, CA 94507

FIRST CLASS
U.S. Postage
PAID
CONCORD, CA
PERMIT NO 249

of prosecuting claims and allowable costs of contract administration where in a seminal case (*Bill Strong*) the basic guidance is that if the costs are incurred to permit a negotiated resolution of the problems that arose during contract performance they are presumably allowable costs of contract administration while if they are incurred to begin the process of litigation they are unallowable. The board found incurred costs for a claim preparation and consulting fees incurred before submission of the claim was for the purpose of furthering the negotiation process and hence allowable but quantified the amount due not at the contractor's claimed rate but the employee's hourly rate (*SUFI Network Services, ASBCA No 55306*).

Allocability. Costs of developing a software program were not allocable under FAR 31.201-4 because the software did not benefit the government contract and was not necessary to the overall operation of the contractor's business (*Teknowledge Corp. v US, 85 Fed. Cl. 235 – see the last DIGEST issue for expanded discussion of this case*). Though there were understandable reasons for loosing records in Iraq, the Board rejected the government's assertion that absence of document justified not paying the contractor - though the contractor bears the burden of proving allocability of costs, the Board allowed testimony of three employees saying the contract clauses do not impose the stringent requirements of either "nice neat little files" or contemporaneous records *(Bearing Point, ASBCA No 55354)*.

Limitation of Funds. Both the Limitation of Cost (FAR 52.232-20) and Limitation of Funds (FAR 52.232-22) clauses are prescribed for cost reimbursable contracts where the LOC is used when the contract is fully funded and the LOF is used when incrementally funded. Both clauses require the contractor to give timely notice of impending cost overruns and relieve the government of liability over costs in excess of the ceiling amounts. The dispute arose under two IDIQ cost type contracts where the contractor experienced cost overruns due to increased medical and workers comp insurance and use of higher cost contract labor due to the government's sporadic and unpredictable ordering. The Board found its oral notification of $1 million contract cost overrun insufficient saying (1) it had to identify overrun amounts on each task and delivery order and (2) its absence of a cost information system did not excuse it, even thought absence of cost documentation from its NYC office due to the 9/11 attacks was excused (*George C. Sharp*).

INDEX

RECOVERY OF COSTS WHEN WORK IS DELAYED BY THE GOVERNMENT 1

SOME CONSIDERATIONS WHEN BUYING A FEDERAL CONTRACTOR 3

WHAT LEVEL OF THE CONTRACT DO CAS AND FAR APPLY TO 5

JUSTIFICATION OF ONE OVERHEAD RATE AT MULTIPLE LOCATIONS 7

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2008 9

GCA DIGEST · P.O. Box 1235 · Alamo, CA 94507 · (tel) 925-362-0712 · (fax) 925-362-0806 · Email: gcaconsult@earthlink.net
Website: www.govcontractassoc.com
This publication provides general information and is not a substitute for accounting, legal, or other professional advice.
Duplication of this publication, without written permission, is prohibited.
Subscription: $175 for one year, $325 for two years.