# GCA DIGEST

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**Knowing Your Cost Principles and Cost Accounting Standards**

# COST ACCOUNTING STANDARD 414, COST OF MONEY AS AN ELEMENT OF FACILITIES CAPITAL

(*Editor's Note. How would you like to recover a non-cost cost – CAS 414 allows you to do so. Though primarily capital intensive manufacturing firms used to seek cost of money recovery more and more other firms are seeing the value of proposing the costs. Whether it be realization that if they don't propose it on a contract they loose it forever, many intangible assets qualify, increased capital purchases and recovery of at least some of their financing costs make it worthwhile to claim the costs. Basically a contractor invests in facilities that are employed in performance of its contracts and has hopes to have a return on that investment. The cost of money is, in effect, a guaranteed return on it. The government specifies an interest rate to use and that rate is applied to the average net book value of assets associated with cost pools that contain either depreciation or amortization costs. We have used the standard, a variety of texts and our experience as sources for this article.*).

## Background

CAS 414 provides a unique accounting idea in as much as it recognizes an imputed interest as a cost. The CAS Board came up with this concept called the "cost of money as an element of the cost of facilities capital" (we will use the term cost of money) as an incentive for contractors to modernize and upgrade their capital facilities. Depreciation expenses were not considered adequate motivation for such investments so the government came up with an additional incentive. Rather than use interest costs as a basis for rewarding investments, where such costs are incurred only when debt is used to buy the assets, the government wanted to provide the motivation to invest where there would be no preference given for the means of acquiring the assets. The cost of money applied to the net value of the assets, regardless of the method of acquiring them, seemed the perfect solution. Since there is no real associated cost with the revenue generated, it translates into pure profit.

## Purpose

CAS 414 provides guidance for (1) measuring the cost of facilities capital (2) determining imputed interest rates and (3) determining the base for identifying facilities capital. Whether or not a contract is CAS covered, CAS 414 applies when a contractor chooses to recover cost of money. So, FAR 31.205-10, Cost of money allows it to be a recoverable cost on government contracts provided it is computed in accordance with CAS 414. CAS 414 does not apply to contractors whose compensation for the use of facilities is based on use rates or allowances. If contractors recover costs for some facilities by use rates and others by depreciation then the standard would apply to those assets being depreciated.

## Definitions

The "cost of capital committed to facilities" is defined as "an imputed cost determined by applying a cost of money rate to facilities capital." Facilities capital is defined as the "net book value of tangible capital assets and those intangible capital assets that are subject to amortization." Though there is no rigorous definition, a "facility" means real property such as capital equipment. An "intangible capital assets" is defined as "an asset having no physical substance, has more than minimal value and is expected to benefit the enterprise longer than the current accounting period." Accounting textbooks provide several examples of intangible assets such as goodwill, patents, trademarks, other licenses, certain nonexclusive franchises, address lists, copyrights, exclusive franchises, motor-carrier operating rights, FCC licenses and computer software. In spite of its inclusion as an example of intangible assets, goodwill is not to be included in the investment base of the cost of money calculation because it is not considered a cost of doing business but rather an accounting creation under the purchased method of accounting for an acquisition where the price paid exceeds the sum of individual assets less liabilities and the costs of writing off this goodwill is unallowable.

## Elements of Cost of Facilities Capital

The amount of facilities capital measured and allocated becomes the investment base to which the contractor applies a cost of money rate. These two elements are the essential ingredients for determining cost of money.

### ♦ Investment Base

The investment base is represented by the fixed assets that give rise to the depreciation costs in the indirect cost pools as well as costs of land. The value used in the investment base is the net amount of assets (undepreciated value), not the gross amount. Appendix A of the standard states the net book value should be an average balance during the cost accounting period so taking the beginning and ending balance is the normal accepted method of determining the average balance. If there are major variations through the year an alternative may be used e.g. average month-end balances.

The standard recognizes three categories of facilities: (1) *Recorded facilities* - facilities items owned by the contractor, carried on the books of the business unit and used in its regular business activity (2) *Leased property facilities* where only capital leases are included, not value of operating leases and (3) *Corporate facilities* that are allocated to the business segment according to CAS 403.

What facilities are to be excluded? The essential criteria for including an asset in the investment base is that it be used in the contractor's regular business activity. DCAA has put forth examples of assets not be used such as land held for speculation, idle facilities or capacity or assets under construction and/not yet in service. Other examples are deferred charges for restructuring costs or facilities that do not generate depreciation such as fully depreciated assets and assets purchased after the depreciation clock starts (purchased at second half of year for those contractors recognizing depreciation only for new purchases in first six months).

### ♦ Cost of Money Rate

This rate is that based on interest rates established every six months – Jan through June and July through Dec. - by the Treasury. The standard stated the cost of money rate for any accounting period must be the arithmetic mean of the interest rate in effect for that accounting period. If the contract accounting period is the same as the calendar year, it would be the average of the two six month rates. If the period is different, a weighted average – each rate weighted by the months of the period in effect – is recommended by the Defense Department. If there is a transition period for establishing an accounting period where more or less than 12 months exist, an average for the months included in the transition period should be used.

## Allocation Procedures

CAS 414 was designed to be a recovery in connection with individual proposals, forward pricing rate agreements and incurred cost proposal settlements. It is an imputed cost to be associated with all or certain indirect cost rates and so is associated with other costs included in those indirect rate pools and bases. The basic allocation requirement is to:

(1) *Assign facilities values to indirect cost pools*. The standard takes the position that facilities values should be identified with specific indirect cost pools such as overhead and G&A to the extent such identification is possible. Any asset value not directly identifiable with an indirect cost pool are allocated to the pools on a basis that approximates the pools' absorption of depreciation or amortization costs. The standard also provides a method of allocating asset values to service centers.

(2) *Compute cost of money factors for each indirect cost pool.* The standard requires contractors to compute a cost of money factor for each indirect cost pool for each accounting period using the following steps: (a) identify the average net book value of assets identified with each indirect cost pool having a significant amount of assets (b) for each pool multiply these average net assets by the applicable cost of money rate and (c) divide the resulting pool of cost of money by the allocation base (e.g. direct labor for overhead, total cost input for G&A).

(3) *Assign cost of money to final cost objectives (e.g. contracts).* Contractors are to determine the amount of cost of money allocable to its contracts by multiplying the factors (e.g. cost per direct labor dollar) by amount of allocation base units for each contract (e.g. amount of direct labor dollars in that contract).

Simpler alternative procedures are allowed especially when the cost of money is a minor amount compared to total estimated costs (which is usually the case) or the contractor ahs a variety of service centers and other indirect costs that do not have a significant amount of facility investments. The most common procedure we have used is to accumulate all assets

into one expense pool (e.g. G&A is the most defensible) and then accumulate the cost of money factor using the G&A allocation base units.

Contractors are warned in FAR 31.205-10 they must propose cost of money at the beginning or they will not able to recover it later through, for example, incurred cost submittals. However, a case (*AT&T vs. GSA, GSBCA No. 6190*) did provide an exception when it found that a contractor's failure to include cost of money on its fixed price contract that was where no cost or pricing data was used because it was awarded on a competitive basis did not preclude recovery on a subsequent cost-based changes to the contract.

### Requirements of Form CASB-CMF

The cost of money factor for each indirect cost pool is determined in accordance with FAR CASB-CMF (not reproduced here) and its instructions as part of the standard. Be aware it is not a simply form to understand so though it incorporates the steps identified above it requires several readings to follow.

## WAYS TO LESSEN THE IMPACT OF A NEGATIVE DCAA FINDING

*(Editor's Note. We used to help teach a two day seminar each year entitled "Government Contract Audits and Resolving Audit Disputes." One of the interesting topics covered, where instructors and students put forth examples from their experiences, was how to mitigate the impact of a negative audit position short of litigation. Though we have occasionally addressed this topic periodically in the past, recent significant changes in how DCAA and ACOs handle challenges to auditor opinions have made this issue more relevant than ever.*

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

### Ways Negative Findings Surface

Many auditors tend to play it close to the vest and not show their hand. You will need to use every means to become aware of negative findings that are often quite visible throughout the audit process – during question and answer sessions, requests for data, informal discussions, more formalized communications of preliminary findings, distribution of draft reports, exit conferences, discussions with contracting officials and issuance of a Form 1.

Recent DCAA guidelines in the form of "Rules of Engagement" has significantly expanded the opportunity of contractors to learn preliminary audit positions (see the Nov-Dec 2010 issue of the GCA REPORT for more information). Now there is more explicit responsibility of auditors to divulge information to contractors than ever before about their findings. Initiated as guidelines to have auditors comply more with auditing standards, the new guidelines (1) allude to general requirements to have effective communications with both parties during an audit to understand a proposal and all pertinent facts and seek out contractor's views of audit conclusions (2) renewed emphasis on both entrance and exit conferences (they were often a disliked formality that auditors tended to avoid or provide only cursory communications) where preliminary audit findings are discussed to ensure a complete understanding of relevant facts are made and (3) except for forward pricing proposals auditors are told they must now provide, at a minimum, draft audit reports including opinions and exhibits and notes or statements of conditions and recommendations. Nonetheless, many auditors tend to shy away from any form of confrontation so you will need to use clever means to find out audit positions.

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

*Findings During the Exit Conference.* If problem areas have not surfaced beforehand, the Audit Exit Conference is the last best time to identify audit positions. The level of detail divulged depends on the type of audit. For audits of *incurred costs*, the results should be discussed in detail. Often draft reports have been prepared before the Exit Conference so attempts to receive copies of them should be made. Also, if needed to understand their position, the contractor is entitled to receive copies of the audit workpapers

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

## Deciding What Course of Action to Take

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

## Window of Opportunity Within DCAA

If your position has merit and the issue is one DCAA is likely to be flexible about then you have an option before formally responding to the audit position or negotiating with the CO. There is an informal "window of opportunity" to challenge the auditor's position between the time an audit issue surfaces and negotiations with the CO commence. *(The incentive to reach a settlement with DCAA is particular strong when the negotiators often say "don't convince me, convince the auditors".*) There is no formal appeals process within DCAA but the opportunities for informal agreements though less significant these days still exits. It is an often repeated truism that, especially at the branch level, supervisors will simply rubberstamp the auditor's position. In the past we tended to believe such an assertion was overstated where we were constantly surprised at how often the original audit position is either reversed or some other mutually-agreed to position is found following discussions with a supervisor or branch manager. Unfortunately, those frequent opportunities to change an initial audit position have become less frequent in recent times since highly publicized criticisms of DCAA has resulted in reluctance of supervisors to challenge their subordinate auditor's positions, even if they believe it to be wrong. However, we are beginning to see this pendulum change recently where we have become much more successful in reaching a resolution of initial audit positions in meeting with auditors and their supervisors, sometimes including the branch manager.

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

Within the branch office there are usually two distinct avenues of informal appeal. The first is the audit

supervisor. Though the supervisor often develops the audit position with the auditor it is far from always so. The supervisor may have had other administrative duties, training, sickness or is "hands-off" and if properly approached with a request for an open mind, will give a fair hearing to your position. Even if involved in the original position, they may have relied more on the auditor's judgment and the presentation of a strong counter argument may be sufficient to change their mind. There may be other motives to change the finding such as hesitancy to fight a weak position, other priorities, etc.

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

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

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

## Next Step – The CO

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

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

Just as recent publicity has made audit supervisors gun shy about challenging their auditors position, similar reluctance has affected ACO's willingness to change an audit opinion. Recent audit guidelines have been established to encourage auditors, on their own without supervisory review, to go to investigative services when they believe ACO are improperly challenging their position. Such actions, along with ACO's tendency to rubberstamp DCAA position because of lack of accounting expertise or shortage of support staff, has significantly lessened the

opportunities to have ACOs overturn audit positions. But in spite of these obstacles, we are beginning to see a reaction to such fears and more instances of accommodation to reach mutually acceptable resolution of audit issues.

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

If a good argument is put forth by the contractor, the CO will often obtain advice in-house from their price analysts and legal counsel. If the dollar value is significant, the issue may even be elevated to the special Overhead Center in the Defense Contract Management Agency tasked with resolving high priority cost issues. If the contractor's position has merit, the ACO commonly seeks a position to satisfy both DCAA and the contractor rather than go through the disputes process and avoid issuance of a Form 1.

# REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2010

*(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. We find a study of award protests is not only interesting to prospective protesters but also illuminates the rights and wrongs of award selections. This article is based on the January 2011 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. Examples of being an interested party include being an awardee who challenges an agency's decision to resolicit proposals (*Sheridan Corp v US, 95 Fed Cl 141*), incumbent contractor challenging agency's failure to follow its guidelines (*Angelica Textile Svcs v US, 95 Fed. Cl. 208*), non-bidder who alleges it was improper to limit bidding to 8(a) contractors only (*Assessment & Training Sltns. v US, 92 Fed. Cl. 722*) or eliminated from competition where it might have submitted a more favorable proposal upon resolicitation (*Esterhill Boart Service Corp v US, 91 Fed. Cl. 483*). However, contractors are not interested parties if they are ineligible for award (*LLC v US, 93 Fed. Cl 254*), if they submitted an unacceptable proposal (*Homesource Real Estate v US 94, Fed. Cl. 466*) or was a nonbidder (*Shamrock Foods v US, 92 fed. Cl. 339*).

The Courts also continue to apply the "prejudice" principle – but for the alleged error there was a *substantial chance* it would be awarded the contract - to determine whether a protester is an interested party. "Reasonable likelihood" of winning is sufficient for establishing prejudice (*EREH V US, 95 Fed. Cl. 108*). The standard is not so demanding as to require actual causation – the protester need not show it would have won the contract but for errors (*PlanetSpace v US, 92 Fed. Cl. 520*). However, the protester must show more than a mere possibility of winning (*Bilfinger Berger v US, 2010 WL 4721297*). In preaward protests the protester must demonstrative a "nontrivial" competitive injury (*Week Marine v US 575 F.ed 1352*) and in post awards protests prejudice is proven by establishing the protester had a substantial chance of winning but for alleged procurement errors (*Benefits Consultants v US, 93. Fed. Cl 254*). Prejudice was found when there are only two offerors where if one is found ineligible the other would win and if both were ineligible the award would be recompeted where the protester could compete again (*Allied Technology v US, 94 Fed. Cl. 16*)

### ♦ 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 (*JND Thomas Co., Comp. Gen. Dec B-403831, we will refer to GAO decisions by the case number)* Below-cost pricing is not prohibited (*Bering Straits, B-403799*) and the government cannot withhold an award merely because its fixed price low offer is or may be below costs (*Hillstrom's Aircraft Sevcs, B-403970*). An offer can have numerous legitimate reasons for proposing a low price, including it is an important part of corporate strategy (*Flight Safety Svcs., B-403831*) or its staffing approach is different than other offerors (*Aegis Defense Svcs., B-403226*). However, protests were sustained when an adequate price realism analysis should have found awardee's proposal was unrealistic because its staffing plan was inadequate to meet contract requirements (*General Dynamics One Source, B-400340*) or failure to identify realistic labor rates jeopardized contract performance (*Computer Technology, B-403798*).

### ♦ Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals (*Crewzers Fire Crew Transport, B-402530*). 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 (*NEQ vs US, 88 Fed. Cl. 38*). Agencies must evaluate proposals according to criteria established in the RFQ (*Carothers Const., B-403382*), it must not announce in a solicitation it will be using one evaluation scheme and then use another (*Effective Shareholder, B-401796)* and if it's changed, it must amend the solicitation and notify the offerors of the change (*Electronic Data v US, 93 Fed. Cl. 416*). However, agencies may apply evaluation considerations not expressly outlined in the RFP where they are reasonably encompassed in the stated criteria (*K&S Assocs, B-402604*). An agency's assessment of weakness for failure to include a desired certification was ruled using an unstated evaluation criterion (*Powersh, B-402534*), agency's acceptance and consideration of more resumes for a position did not constitute reliance on unstated evaluation criteria (*Weston Sltns v US, 95, Fed. Cl. 311*) and agency's evaluation of "development and enhancement" was not an unstated evaluation criterion but was deemed fully consistent with stated evaluation criteria (*InnovaTech, B-402415*).

Agencies must apply evaluation criteria in the solicitation equally (*Eloret Corp, B-402696*). Protests were sustained and deemed unequal when the same features considered favorably for one awardee did not get the same favorable consideration for the other offeror (*Wackenhut, B402550*), an agency unreasonably rejected protester's quote while accepting awardees virtually similar quote (*Douglass County Fire, B-403228*) or agency's failure to clarify a wetland issue was ruled to have put the protester at a competitive disadvantage because the solicitation must provide for the submission of proposals based on a "common understanding" (*AMEC, B-401961*).

Agencies must consider *cost or price* in evaluating competing proposals (*Dayton T. Brown, B-402256*). Even when a price is less important than non-price factors agencies must consider cost or price in making selection decisions (*Systems Engrg, B-402754*).

To be deemed responsible, a prospective contractor must be able to comply with required performance schedule, have adequate financial resources and have necessary organization, experience, operational controls and technical skills where the burden is on the contractor to affirm its responsibility and in its absence the CO is to determine it is nonresponsible (FAR 9.104). Normally, the courts cannot disturb a responsibility determination unless the protester can show the agency had no reasonable basis for its determination (*McKissick+Delcan JV, B-401973*). The experience of a technically qualified subcontractor may generally be used to satisfy definitive responsibility criteria for a prospective prime contractor (*J2A JV, B-401663*).

### ♦ 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. In a case that disputed which products were relevant to determining PP, the GAO ruled the proper analysis should be based on comparable complexity to the contract being awarded as opposed to what specific products are considered (*FN Mfg, B-402059*). Where both offerors have relevant PP, the agency is not required to further differentiate between PP ratings on a more refined basis unless the RFP requires it (*SETA Support Svcs, B-401754*). Relevance of PP should mean incorporating many of the same activities required under the solicited contractors (*Advanced Environmental Slts, B-401654*). Agency properly considered experience producing the exact

same boots more relevant than producing merely similar boots (*McRae Industries, B-403335*). Protestor's prior contracts involved tasks that were subsets of the overall work involved in the solicited work and hence they were inherently less complex than the solicited work and not relevant (*Commissioning Sltns, B403542*). While the agency is not required to consider each and every piece of PP information, it must consider information that is reasonably available and relevant (*Highmark Medicare Svcs, B-401062*).

The GAO has ruled that while there is no requirement for an agency to consider all PP references some information is just "too close at hand" to ignore (*Shaw-Parsons JV, B0401679*). Adverse PP information contained in external material, including news articles provided to the agency during protest of the procurement were considered "too close at hand" to be ignored (*Contract Int'l, B-401526*).

A protest was sustained where the agency credited the awardee with the experience and PP of a specialty subcontractor but did not similarly credit the protester who proposed the same subcontractor (*Brican, B-402602*). It was appropriate not to credit the experience of affiliated companies where the protester did not establish the companies would be meaningfully involved in performance (*Bilfinger Berger*). A protest was sustained where the PP of the subcontractor performing small portions of the contract was given an inappropriately high weighting in evaluation (*CIGNA Gov't Svcs, B-401062*).

## Costs

*Claims.* The most common reason a request for an equitable adjustment in contract price is made is because of a delay. The contractor must prove that the delays were due to government-responsible causes where such delays may be due to superior knowledge the government had, defective specs or breach of government's duty to cooperate (*American Ordance, ASBCA No. 54718*). When the delay results in the contractor being put on "standby" the Eichleay formula is the exclusive method of calculating unabsorbed overhead (*Selpa Construction, PSBCA No. 5039*).

*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 (*Edge Const. v US, 95 Fed. Cl. 407*) while the government bears the burden of a downward adjustment in contract price (*Job Options, ASBCA No 56698*). Whereas the contractor claimed entitlement to compensation for the cumulative effect of the unchanged work of the numerous change orders issued on the project the Board nonetheless ruled the contractor was not entitled to recovery because it had released the government of responsibility under the modifications its had signed (*Selpa*).

*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. Contractor provided a commercial item under which the termination clause for such items stated a terminated contractor would be paid the percentage of the contract price based on the percentage of work performed as of the termination plus any costs resulting from the termination but since most of the work was done, the board accepted the cost-based methodology (*ALKAI Consultants, ASBCA No. 56792*).

*Legal and Accounting Costs.* In an interpretation of the Energy Department's acquisition regulations provision that makes costs incurred in defense of any civil or criminal fraud proceeding unallowable, the appeals board ruled a contractor could recover legal fees incurred in the successful defense of qui tam claims under the False Claims Act where it prevailed but could not recover the fees where it was found liable (*Boeing v Depart of Energy, CBCA No. 337*). Under the Equal Access to Justice Act that allows payment of litigation related legal fees to a small business if it is a "prevailing party" who is one that succeeds on significant issues or achieves a significant portion of recovery it sought during litigation (*Dallas Irrigation v US, 91 Fed. Cl. (689*). In spite of prevailing on all major issues its EAJA fee should not be reduced on grounds of partial success (*United Partition v US, 95, Fed. Cl 42*).

*IR&D Costs.* Independent research and development costs were ruled allowable as indirect costs when though they were related to the contract they were

not specifically required by that contract. Also the case ruled that research and development costs that do not qualify as IR&D may nevertheless be treated indirect if it is consistent with the contractor's disclosed practices (*ATK Thiokol v US, 598 F.3d 1329*).

*Joint Venture Costs*. The Court overruled the government rejection of a proposal for a joint venture contract that applied each participant's own overhead rates to their individual proposed direct labor ruling it was not necessary for the joint venture to have its own overhead rate structure (*McKissack + Delcan*).

## Classic Oldie...

# CHANGING FROM A TOTAL COST TO VALUE-ADDED G&A BASE

*(Editor's Note. We have received numerous inquiries and have had several consulting engagements recently where contractors wanted to change their G&A total cost input base to a value added one. Continuing our practice of illustrating a cost allowability or allocation issue using a real life situation, we will address the change from the perspective of challenging the Defense Contract Audit Agency's rejection of a proposed change that was prepared by a colleague of ours Len Birnbaum of Leonard Birnbaum & Company, LLP in defense of his client. Len is a member of our "Ask the Experts" panel where subscribers can email cost, pricing and contracts questions and have a member of our panel respond at no charge.)*

## Background

Len conducted a thorough review of his client's accounting practices and provided a position paper recommending Contractor (we will use "Contractor" in place of the actual firm) revise its G&A rate calculation using the value-added method rather than the total cost input (TCI) method. Contractor incorporated the new method in its forward pricing rates and continued to do so for the next four years.

In its draft audit report of Contractor's forward pricing proposal four years after the change, DCAA rejected Contractor's change from a TCI to a value added base (total costs excluding material and subcontract expenses) to allocate general and administrative costs. DCAA's position was the "abrupt" change would "adversely impact the allocation of G&A expense to existing cost reimbursable contracts." Acknowledging that FAR 31.203 (Contractor was not covered by the cost accounting standards) does not specifically require a total cost allocation base be used to allocate G&A expenses, DCAA cites FAR 31.203(c) in defense of its position stating "once an allocation base has been accepted it shall not be fragmented by removing individual elements." Contractor asked Len to prepare a response to DCAA that would be incorporated in the "Contractor's Reaction" section of the report.

## Response

### ♦ Distortion of Allocating G&A Expense

In its response, Len summarized his early position paper, asserting the value-added cost base is appropriate when inclusion of material and subcontractor costs would significantly distort the allocation of the G&A expense pool in relation to benefits received. The breakdown of direct labor and direct materials/subcontractors was:

| | R&D Contracts | % | Manufacturing | % | Total | % |
|---|---|---|---|---|---|---|
| Material | $300,000 | 25 | $17,000,000 | 74 | 17,300,000 | 72 |
| Direct Labor | 900,000 | 75 | 6,000,000 | 26 | 6,900,000 | 28 |
| | 1,200,000 | 100 | 23,000,000 | 100 | 24,200,000 | 100 |

Based on the above, the use of the total cost input method for allocating G&A expense would result in a gross distortion of such expense. First, 72% of the G&A type expense, based on the combined value of direct material/subcontractors and direct labor would be allocated to material and subcontractor costs which would not produce realistic results. The unrealistic results stem from the nature of G&A expenses which is closely associated with managing personnel and manufacturing operations as well as research and development rather than materials and subcontractors. Second, if each dollar of material is considered equivalent to each dollar of labor this would also result in a gross distortion in the allocation of G&A type expenses between the R&D contracts and manufacturing operations.

### ♦ Fragmenting the Base

As to DCAA's assertion the change will "fragment the base" a change in the method of allocation is not the same as "fragmentation." As FAR 31.208(c) suggests, fragmentation refers to the elimination of a portion of the cost input base (e.g. unallowable costs that are normally part of the base should remain in the base). If DCAA's logic is accepted, then a contractor, not withstanding major changes in its operations, would never be allowed to make a change in the method of allocating indirect costs. In other words, once a contractor adopts an accounting method it would be

required to use that method in perpetuity – an obviously incorrect result. FAR 31.203(d) provides that the method of allocating indirect costs may require reexamination (i.e. change) when (1) substantial differences occur between the cost patterns of work under the contract and the contractor's other work and (2) significant changes occur in the nature of the business, the extent of subcontracting, fixed asset improvement programs, inventories, the volume of sales and production manufacturing processes, the contractor's products and other circumstances.

In Contractor's case, in the past 10 years it has changed from a pure engineering firm into both an R&D and manufacturing company and its sales volume has increased from $3 million to $70 million. It is true that Contractor's G&A expenses should be allocated on a base representing its total activity but considering its operations, total activity is best reflected by direct labor and manufacturing overhead. The inclusion of raw materials and subcontract costs in the base produces a gross distortion in activity because as we have seen above, each dollar of material under the TCI method is considered equivalent to each dollar of labor and overhead.

### ♦ CAS 410 and the *Ford* Case

Though Contractor is not CAS covered, the guidance included in CAS 410, Allocating G&A expenses, and associated cases are helpful for illuminating the meaning of total activity. The justification of the use of a value added method in lieu of a TCI method is best illustrated in a classic case, *Ford Aerospace and Communications (Aerospace and Communications Corporation Inc. Aeronautic Division, ASBCA 23883*). In that case, it was noted the CAS Board in its prefactory comments to CAS 410 stated that "total activity" refers to the production of goods and services during the cost accounting period. It includes material, subcontracts, labor and overhead. In the *Ford* case, the government maintained that by omitting materials and subcontracts (i.e. using the value-added base) this would result in an inaccurate measure of total activity. The Board rejected this position. Though it noted material and subcontract costs can be "includible in total activity" it is fallacious to conclude "each dollar expended for materials and subcontracts necessarily bears the same relationship to incurrence of G&A expenses as each dollar of labor and overhead." To the contrary, the total cost of each element comprising total activity "may or may not best represent total activity depending on the circumstances of each business unit. The crucial question is not what activity elements may comprise total activity, but what best represents total activity."

CAS 410 does not establish a preference for the TCI method. Rather, CAS 410 expressly authorizes three cost input allocation methods (i.e. TCI, value added or a single element representing total activity) and leaves the selection to be based on individual circumstances of the company. In deciding that Ford was entitled to use the value-added method, the Board cited two primary reasons:

1. The material and subcontract content of Ford's contract is disproportionate and G&A expenses pertain more to Ford's in-house activity than to Ford's material and subcontract activity.
2. The G&A expenses provided substantially more benefits to Ford's labor-intensive development contracts than the material intensive production contracts.

This is equally true with respect to Contractor's operations.

## Case Study…

# DO ALLOWABILITY RULES COVERING TRAVEL COSTS APPLY TO BOTH DIRECT AND INDIRECT COSTS

(*Editor's Note. In our work as consultants we normally consider allowability rules primarily in the FAR Cost Principles to apply to relevant costs, whether they are direct or indirect. However, two clients have recently told us they believed the various regulations covering travel costs apply only when they are direct costs of a project and not when they were indirect and asked us to comment. We realized we were lulled by the assumption that whether a cost is direct or indirect should not affect its allowability so we looked forward to being forced to justify that assumption. We were first surprised that the issue is not clearly resolved by any one regulation and so we needed to consider an array of sources to put a credible argument together. This highly edited response to the inquiry should apply to not only travel costs but most other costs.*)

## Overall Summary

In our opinion, the regulations and accounting rules applicable to travel costs apply to both direct and indirect costs. Though the relevant regulations and laws, DCAA guidance and expert opinions express different levels of explicit references to indirect costs,

taken together they clearly indicate that both direct and indirect expense accounts and transactions must be scrubbed for unallowable costs. The bases for our conclusion is (1) review of the FAR (2) review of CAS (3) review of selected texts (e.g. Mathew Bender) (4) review of DCAA guidance and (5) our experiences as a consultants, employees for government contractors and DCAA auditors.

## Federal Acquisition Regulation

Several sections of the FAR that provide general guidelines on allowability of costs illuminate the issue raised here. For example:

*FAR 31.201-2, Determining allowability*. This section provides the parameters of what an allowable cost is. It provides five conditions for allowability of a given cost: reasonableness, allocability, Cost Accounting Standards, terms of the contract and any limitations set forth in the section. The element that most affects us here is the requirement that a cost be allocable to the contract which covers direct and indirect costs (we will use the term "contract" interchangeably with final cost objective, understanding that the later may include contracts, subcontracts, grants, task or delivery orders, CLINS, etc.)

The next section, 31.201-4, addresses what costs are allocable or assignable to a contract: "(a) is incurred specifically for the contract (b) benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received or (c) is necessary to the overall operation of the business, where a direct relationship to any particular cost objective cannot be shown." This quote clearly identifies direct and indirect costs as those costs that are allocable to a contract where in the case of most contractors (a) refers to "direct costs" while (b) and (c) refer to indirect costs where most commonly the (b) section identifies overhead and cost centers while the (c) section identifies general and administrative costs.

The following section provides even more explicit references to what types of costs are covered by the FAR cost principles.

*31.201-1, Composition of total costs.*

(a) "The total cost…of a contract is the sum of the direct and indirect costs allocable to the contract, incurred or to be incurred to the contract." The concept of total cost is particularly relevant in the government sphere because total costs are normally the basis for determining the contract "price."

Other sections of FAR Part 31.201 also address indirect costs:

*31.201-6 Accounting for unallowable costs.*

Section (a) refers to directly associated costs as unallowable where most associated costs are usually indirect costs.

Section (c) refers to the need to be compliant with CAS 405 and refers in several sections to use of statistical sampling to identify allowable costs in a particular account and penalties on unallowable costs. In that section, "any indirect cost in the selected sample is subject to the penalty provisions at FAR 42.709." Penalties apply only to certain costs that are deemed unallowable so here allusion to penalties refer to unallowable indirect costs.

*FAR 31.205-46, Travel costs.*

This cost principle provides details on what travel related costs are allowable or unallowable. The cost principle goes on to identify Federal Travel Regulation per diem limits. The cost principle does not distinguish between direct and indirect personnel nor, for that matter, individuals who work on government as opposed to non-government work. The only relevant reference is (a)(1) "Costs incurred by contractor personnel on official company business are allowable subject to the limitations contained in this subsection."

In Mathew Bender's "Accounting for Government Contracts – Federal Acquisition Regulation" commentary on the travel cost principle it states "travel costs for the overall administration of the business are allowable indirect costs. Travel costs directly attributable to contract performance may be charged directly to contracts." This quote indicates allowability considerations of the cost principle apply to all travel costs, both direct and indirect. In this case, the Federal Travel Regulation limits on what constitutes reasonable or allowable costs apply to all travel costs, whether they be direct or indirect.

## CAS 405, Accounting for unallowable costs

Though CAS 405 applies only to fully or modified CAS covered contracts, it is nonetheless instructive. It does not specifically address the issue of indirect travel costs. However, two statements in the standard are illustrative.

In 405-40 (a) "Costs expressly unallowable…shall be identified and excluded from any billing, claim or

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proposal applicable to a Government contract." This quote, in the "Fundamental requirement" section of the standard clearly provides that no unallowable cost will be charged to a government contract. "Expressly unallowable" costs are included where we have seen above the penalty provisions of the FAR apply. As we discuss above, that section explicitly refers to indirect costs.

The remaining section of the standard addresses types of unallowable costs and the accounting treatment of them. Though the examples are intended to illustrate associated costs, it does provide an example of indirect travel costs being unallowable. In the example an official of the company whose salary, travel and subsistence expenses are normally charged to general and administrative (G&A) pool takes associates on a business entertainment trip. Here the entertainment costs are expressly unallowable because they are clearly entertainment costs so associated costs such as travel and subsistence costs are to be identified as unallowable costs.

In commentary of CAS 405, Bender's "Accounting for Government Contracts – Cost Accounting Standards" makes it clear that the provisions of CAS 405 apply to both direct and indirect costs: "CAS 405 was intended to apply to all costs determined to be unallowable."

## DCAA Guidance

Our review of DCAA's guidance in Chapter 7-1000 does not explicitly distinguish between direct and indirect travel costs. It alludes to the FAR and CAS 405 and provides guidance but its guidance refers generically to travel costs, as opposed to direct or indirect travel costs. However, references to statistical sampling of travel costs does indicate the guidelines apply to indirect costs since indirect cost accounts are those normally applicable to statistical sampling techniques.

DCAA also provides two examples of proper screening for unallowables that normally pertain to indirect travel expenses: (1) Business luncheons in the context of applying a decrement for proposed indirect forward pricing rates and (2) home office travel where associated costs are discussed.

## Conclusion

In our opinion, the regulations and accounting rules applicable to travel costs apply to both direct and indirect costs.

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