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Case Study…

RESPONSE TO TIMEKEEPING FINDINGS

(Editor's Note. The following is a response to a DCAA draft report following a floorcheck audit of our client's timekeeping practices. We have decided to include a highly edited version of our response because it illustrates some common deficiencies DCAA is finding these days and it shows some effective responses where after receiving our response DCAA decided to rescind its report. We have changed a few facts and referred to our client as "Contractor" to prevent divulging their identity.)

DCAA states is has performed an attribute one-step sample of Contractor's labor timekeeping practices. Within its parameters of risk, if more than two deficiencies are observed in any one area then that area is considered to be deficient. The four areas DCAA states are deficient are:

1. Timesheets are completed in advance.

2. Exempt employees are not recording all hours worked.

3. Employees are not aware of the DOD Hotline which is a non-compliance with FAR and DFARS

4. Employees were alerted by the supervisor of an office that DCAA was conducting floorchecks, resulting in compromised results.

We disagree with most of DCAA's assertions and its conclusions. The floorchecks were conducted one year ago where some employees deemed non-compliant are no longer employed at Contractor but for those that could be contacted the following is based on their responses to DCAA's observations as well as our response to DCAA's conclusions.

Timesheets Competed in Advance

♦ DCAA Position

DCAA states that three employees improperly completed timesheets in advance which violated Contractor's timekeeping policy.

Contractor Response

DCAA is factually incorrect with respect to their observation that the three employees failed to follow Contractor policy and inappropriately filled out their timesheets in advance. During the day of the floorcheck, two employees worked part of the day at the base where there is no computer access to their timecards. Rather then fail to meet the company policy of not completing timecards on a daily basis, they simply completed the timesheet for the additional time they would be working that day at the base. If the hours turned out to be inaccurate, which has not occurred in our experience, they are instructed to correct the timecards the following day where if a correction is made, there is a clear audit trail of any changes. Since their work at the base is for only one final cost objective and the remaining hours left to charge are clearly known, there is no risk of inappropriately charging the wrong project number. This approach is preferable than failing to complete their timecard in the day worked since such requirements are strictly enforced whereas estimates of time under these circumstances does not violate any Contractor policy.

Second, DCAA's assertions that Contractor's policies require completion of timecards at the end of the day is not quite correct. Based on Contractor's policy, which is quoted by DCAA, Contractor employees have the option of completing their timesheets either at the end of the day or when the project is completed. The two employees' practice of completing their timesheets for the base projects best meet these objectives in so far as (1) timesheets are completed in the day worked and (2) estimates of time to be worked on the project during the day is subject to so little inaccuracy as to be, in effect, completed at the end of the job. Any inaccuracy would be corrected the next day providing a full audit trail.

Third, though we were unable to locate the third person DCAA asserts did not comply with its Contractor procedure we find that unnecessary since with the recognition that the two employees' timekeeping practice were prudent and did not violate Contractor policy, there would only be one person who did not adhere to the policy. Since the attribute

sampling plan considers failure to occur only when "more than one" deficiency is observed, the result of their survey would indicate there is no attribute failure.

Exempt Employees are Not Recording All Hours Worked

♦ DCAA

DCAA states they found five employees who did not record total hours worked. Two of those employees are direct while the other three are 100% indirect. The audit report references FAR 52.237-10 which basically defines uncompensated overtime (UOT) and interprets FAR 31.201-4, allocability as requiring all hours worked. Since five employees have been found not to be in compliance with FAR 31.201-4 Contractor is deemed to not be in compliance with this requirement.

♦ Contractor Response

First, the DCAA audit report incorrectly asserts that the regulations require total time reporting. The issue has a long history but suffice it to say that DCAA, interestingly, has been a long time proponent of not requiring total time reporting. The DCAA guidance explicitly states that total time reporting is not required but "may be required" if UOT is material in which case auditors are instructed to recommend contractors record total time. As discussed below, UOT does not exist at Contractor so the effect of not reporting total time would be insignificant.

Second, we believe that the audit report fails to distinguish the relevance of the issue of UOT to Contractor's direct versus indirect employees. This distinction is important because of the five employees singled out for not correctly identifying all hours, only two are direct and three are indirect.

♦ Contractor's Direct Employees

Though Contractor does have a policy to have all direct employees record total time, such a policy is unnecessary to protect the government. That is because Contractor, unlike most companies, does not have any uncompensated overtime. A direct employee may work overtime only after approval is received where they may not work without such approval. When a direct employee does receive such approval, they are paid for the extra time worked, without exception. Accordingly, there is no uncompensated overtime that must be accounted for by following one of the three approved DCAA methods (e.g. adjustment of hourly rate, prorate allocation of salary to multiple projects or adjustment of indirect cost pools). Though it is possible an employee could work a small amount of time without recording it (a few minutes past the hour to complete a task), such occurrences would be rare and immaterial so as not to even require a policy for them. After all, an employee and the company is incentivized to record all time worked since they would be paid. If there is an immaterial amount of time worked on a project, in accordance with DCAA's own policy, such time would not need to be recorded since it is immaterial. In addition, one employee unequivocally denied telling the auditor he worked overtime where we suspect the communication problem was a result of his heavy accent.

♦ Indirect Employees

Though direct employees do not work unless given permission, this is not true for indirect employees. The three other employees singled out during the audit are indirect employees who are 100% indirect whose time is charged exclusively to their cost centers, home office, IT and Finance, respectively. They may work UOT to accomplish certain tasks but such uncompensated overtime does not affect charges or billings of contracts or projects that DCAA correctly states is the only rationale for properly treating UOT. It matters how many salary dollars are charged to their cost center, not how many hours. Since they do not charge any direct projects nor any other indirect cost centers that may affect how these costs are allocated to indirect cost pools, it does not matter how many hours they work. That is why it is not Contractor's policy to require total time reporting for 100% indirect employees and why it should not be of concern to the government. These points were repeatedly expressed during the floorcheck but we received no response.

Employees Not Aware of the DOD Hotline

♦ DCAA Position

DCAA has apparently interviewed employees to determine whether they are aware of Contractor's DOD Hotline posters and found that four employees stated they were not. The DCAA report goes on to state such a condition "may" be the result of poor training and conclude that such apparent lack of "this information" is a violation of FAR 52.203-14 and DFARS 252-203-7002. DCAA goes on to

recommend Contractor "re-emphasize its employee training to effectively increase the awareness of the DOD Hotline."

Contractor Response

First, the regulations cited address proper *posting* of the hotline posters. It does not address whether or not an employee may or may not be aware of such posters.

Second, as you can see from our photos which we attached, the requirements of the cited regulations were clearly met. Namely, the hotline posters are displayed in common areas at all company facilities. We believe the meeting of this requirement, not what was in the head or awareness of an employee, is the proper inquiry to make.

Third, the auditor has apparently taken it upon himself to impose a different criteria to determine whether the two cited regulations are complied with – whether the employee is aware of the postings. We have no way to verify the accuracy of the auditor's assertions about the awareness or lack of awareness on the part of the employees but such an area of inquiry is irrelevant to determining whether the regulations were complied with i.e. whether the hotline posters were displayed properly.

Fourth, as for DCAA's recommendation to "re-emphasize" the hotline policy in its training, we are in agreement that should be done though we disagree with any statement (which is not asserted by DCAA) that it is not done.

Employees Were Alerted by Their Supervisor That DCAA was Conducting Floorchecks, Resulting in Compromised Results

♦ DCAA Position

DCAA expresses the opinion that for an effective floorcheck to occur, "the element of surprise is an important criteria when conducting unannounced labor floorchecks" where if announced, "it provides the opportunity to complete or update current timecards and also to review labor policies in order to answer questions correctly." The audit report states it found an email from a supervisor warning employees to update their timecards where DCAA asserts that such communications "compromised" the floorchecks of eleven employees." Quoting the employee handbook stressing ethical and honest behavior must be the cornerstone of Contractor practices it made the startling statement its practices were "unethical" and "dishonest."

Contractor Response

We disagree with DCAA's characterization of the email, believe ensuring floorchecks are not compromised lies with DCAA actions, not contractors, and most significantly, we strongly object to the insinuation that Contractor's actions are "unethical" and not "honest." We find such a statement to be, quite frankly, reckless and irresponsible.

First, as for Contractor communications with employees about floorchecks. It is true Contractor personnel communicate constantly with each other about a large variety of issues including the need to properly complete their timesheets and warns employees that the government performs unannounced floorchecks to ensure compliance. Such a warning is considered by Contractor, as well as most other companies, a significant inducement to encourage proper timekeeping.

Second, with respect to the email in question, DCAA had been conducting floorchecks at Contractor facilities for about a month and though no date for future floorchecks was indicated it did inform employees DCAA was conducting floorchecks and reminded employees to follow company procedures. During this era of immediate electronic communications (e.g. email, texts, twitter, etc.) an expectation that employees will not inform others about floorchecks or any other event, for that matter, is unreasonable. If it was the intention of the government to prohibit such communication it could have done so through regulations and Contractor would have incorporated such prohibitions in its policies but there is no such regulation. Real time communications between employees on just about any issue is simply a fact of life that DCAA and government contractors must live with.

Third, though we sympathize with the desire of DCAA to conduct surprise floorchecks we disagree with DCAA putting the burden of "compromising" its floorcheck on Contractor rather than itself. It is the role of DCAA to carefully plan and execute its floorchecks so as to minimize inevitable communications between a contractors' employees where conducting floorchecks over a period of a month is hardly conducive to effective, surprised

floorchecks. However, to blame contractor employee communications rather than DCAA's lack of adequate planning and execution is totally inappropriate.

Fourth, and most disturbing, is the egregious assertion that Contractor's actions are unethical and dishonest. DCAA alludes to general statements in its employee manual, which it attempts to strictly enforce, and then uses those statement as "evidence" of unethical behavior. We stand by our opinion that DCAA's assertion of unethical behavior is reckless and irresponsible.

We look forward to seeing a revision of the floorcheck report in light of our response.

ADMINISTRATIVE ASPECTS OF SPECIAL ALLOCATIONS

(*Editor's Note. Judicious use of special allocations provides an important tool to create pricing flexibility on specific contracts. We have addressed the issue of special allocations in the past but in working with several clients to establish and get them approved we have confronted many administrative problems. Since both contractors and government officials are usually unfamiliar with special allocations, we thought it would be a good time to both review the basic requirements and address some of the administrative issues such as when is it appropriate to use, is it considered to be an accounting change, disclosure requirements, is it limited to one contract, timing of its negotiation and who should approve it. We have used a recent article by Karen Manos of the law firm of Dickson, Dunn and Crutcher in the September 2011 issue of CPA Report as our primary source. Though Ms. Manos explicitly deals with the subject from the perspective of what the cost accounting standards say we believe most of the insights apply to*

Basic requirements

The topic of special allocations is addressed in four cost accounting standards – CAS 403, allocation of home office expenses, CAS 410, allocation of segments general and administrative costs, CAS 418, treatment of direct versus indirect costs and CAS 420, treatment of independent research and development/ bid and proposal costs. So the explicit coverage in the CAS covers a great many types of costs.

The CAS emphasizes consistency, all four standards recognize the need on occasion to adopt a special allocation to achieve a more equitable result – a method different than that normally used - and they prescribe the same technique for applying it. A special allocation occurs where a certain amount of costs are taken from the normal pool of allocated costs and assigned directly to a specific segment or contract. When this occurs the special allocation amount is subtracted from the indirect cost pool and the amount of the allocation base for the contract is subtracted from the indirect cost pool base. So, for example, if a normal G&A rate includes $100,000 in the pool and $1,000,000 in the base and $20,000 of the pool is a special allocation for Contract A where Contract A has a total cost base of $50,000 then the remaining pool and base of costs for calculating the new G&A rate is $80,000 ($100K minus $20K) and the base is $950,000 ($1 million minus $50K). The new G&A rate is not applied to Contract A under a special allocation.

Sometimes a special allocation is confused with a direct allocation where, in fact, there is a big difference. When there is a direct allocation, that allocation is assigned to Contract B and the resulting G&A rate is applied to all contracts including Contract B whereas under a special allocation, the new G&A rate would be charged to all contracts except Contract B.

One other basic concept is that under three of the standards – CAS 403, 418 and 420 – a special allocation is *permitted* when an allocation using the contractor's normal indirect cost allocation method produces inequitable results whereas under CAS 410 a special allocation is *required.*

Examples of Circumstances When A Special Allocation May Be Called For

Several of the standards as well as the FAR, DCAA and DOD CAS Working Papers provide illustrations of when a special allocation is warranted. Below are some examples.

CAS 403. A special allocation of residual home office costs (the remaining amount after direct and indirect methods have been applied) may be called for when a specific segment receives more or less that may occur when a contractor uses is normal way to allocate such costs (e.g. three factor formula). Foreign subsidiaries, government owned contractor operated or domestic subsidiaries with less than a majority ownership are examples where a special allocation may be called for. Indications where special allocations may be desirable is when different uses of home office services or size affects the equitability of allocating the residual pool. A special allocation may apply when, for example, a segment performs on its own many of the functions

that are included in the residual pool or conversely, unlike the other segments, it may have an unusually high reliance on the home office services. Another indication is where due to its small size it may have little to no allocation of costs or due to its large size, may have an inequitably large allocation.

CAS 410. This standard requires use of a special allocation for G&A costs when a particular contract receives more or less of its fair share using normal G&A allocation. An example in the standard calling for a special allocation is when there is a total cost input G&A base for a construction firm that receives an unusually high amount of equipment and vehicles in addition to its normal construction costs. Or, under the same TCI base, a contract incurs an unusual amount of subcontract or material costs where others do not then a special allocation may be needed.

CAS 418. CAS 418 is kind of a catch all standard that covers allocation of costs not covered in the other standards. Though the standard does not provide illustrations, the FAR 31.203(d)(1)-(d)(3) provides numerous example of circumstances where a special allocation may be called for such as significant changes in the nature of the business, extent of subcontracting, fixed asset improvement programs, inventories, volume of sales and production, manufacturing processes, contractor products or existence of off-site locations.

CAS 420. An inequitable allocation of IR&D/B&P may occur at the segment or contract level where a special allocation may be called for. The standard cites a circumstance where a segment may not receive any IR&D benefit while the allocation scheme of the home office costs call for allocations to all segments where the special allocation would occur by eliminating the non-benefitting segment(s). Though the standard does not provide an example, Ms. Manos states that circumstances applicable to a business unit's G&A expenses may apply to IR&D/B&P costs.

Is a Special Allocation a Cost Accounting Change

Whereas CAS covered contractors are often required to go through burdensome steps when an accounting changes occurs, non-CAS covered contractors are often required to go through similar actions (e.g. communications with the government, reasons and justification for changes, cost impacts on relevant contracts, etc.). Ms. Manos states that neither the illustrations of what constitutes a change found at CAS 9903.302-3 nor the regulatory history suggests the CAS Board ever intended a special allocation to be an accounting change. The author cites two cases that confirm this assertion.

Is Disclosure of a Change Required

The author states because a special allocation is not considered an accounting change then no change to disclosed practices should be required. She presents arguments why no such disclosure should be required. Nonetheless, DCAA takes the position that a special allocation must be described in at least a CAS Disclosure Statement, which the DOD CAS Working Papers agreed to, where failure to do so constitutes an inadequate description of practices.

Can a Special Allocation be Applied to More Than One Contract

Disclosure Statement section 4.5.0, Application of Overhead and G&A Rates, provides for recurring special allocations so the author states it is "self-evident" that more than one contract may be subject to a class of transactions and cost elements where a special allocation is applied. The author argues that Working Group Item 78-21 addresses a "class of contracts" and that the standards do not place an expressed limitation to the number of special allocations. Nonetheless, at some point, the absolute limit may indicate the need to revise the indirect cost pool or base.

What is the Timing for Negotiating a Special Allocation

Normally, if a special allocation is necessary for a given contract then ideally it should be negotiated as part of the contract price. However, since it is not an accounting change there is no limitation in FAR 30.603-2(d)(3) to provide retroactive changes. Neither the FAR nor CAS provide any guidance on the *timing* of negotiation of a special allocation. Even the provisions in FAR 31.109 covering advance agreements state they *should* be negotiated before costs are incurred but not that they *must* be.

What Official Should Approve the Special Allocation

Normally the cognizant agency official – the administrative contracting officer – is responsible for CAS administration matters. But since the special allocation affects the pricing of a contract and does not constitute an accounting change the author states

the procuring official of the impacted contract, as opposed to the ACO, is the most appropriate official to approve a special allocation. The author points out that the AM General case substantiated this position.

ADOPTING SOUND BUSINESS DECISIONS IN MANAGING PROJECTS - IMPLICATIONS FOR CONTRACTORS

(Editor's Note. Though most of our readings relate to the specialized area of cost, pricing and contracting rules affecting government contractors we also like to keep abreast of general business thinking. Along those lines one of our favorite newsletters we subscribe to is The McKinsey Quarterly, the journal of the notable general management consulting firm McKinsey & Co. where we occasionally address how adoption of sound management practices they advocate affect government contractors. In this issue we address concerns related to managing longer term contracts where the McKinsey article we used is "Managing Capital Projects for Competitive Advantage" in the June 2008 issue of the Quarterly.)

1. *More risk calls for higher price premiums.* Managing large projects have increased risk. Today, larger projects call for more investments by contractors where their larger projects include greater magnitude of risks, especially in a fixed price environment, where hefty premiums to meet worst-case scenarios are more common.

Implications for Government Contractors. Government contractors are expected to invest more of their own assets and convert flexible type contract vehicles into fixed price projects. Like commercial firms, government contractors need to consider worst case scenarios that involve an analysis of contingencies. However, such contingencies are considered unallowable so contractors must be able to bid the highest possible price to address risks without proposing unallowable contingency costs. This involves use of profit guidelines that explicitly address risk and analysis of different indirect cost rates for highest possible cost recovery.

2. *Shortage of highly skilled project managers.* Project managers are in short supply in many industries. Such shortages drive up costs in many unforeseen ways. For example, a dearth of project managers with relevant operations experience weren't able to join in early during the design of a new plant. The project team selected specifications mainly to reduce cost and ensure speedy installation without recognizing these benefits would be negated over the long term by lower operating efficiency that good project managers would have been in a position to see. These shortages will require higher salaries and fringe benefits to incentivize the key managers.

Implications. Similar shortages of experienced "baby boomer" project managers in highly concentrated government related industries have put them in high demand. Recent audit guidelines have resulted in government auditors expanding their evaluation of contractors' salary payments to not just senior executives but more employees. In our experience, surveys of project managers have not kept up with market demand for them so they are far below what the true salary ranges should be in critically short areas. To prevent survey results from disallowing salaries paid to such key people you will have to utilize surveys unique to your industry that have a better chance of reflecting employee market realities. Persuasive challenges to DCAA findings will be needed to find and pay for the best personnel. In addition, creative solutions may come into play where, for example, more generous fringe benefits may result in less salary expenses that can be questioned. In addition, hiring of project managers early in the process may result in a company incurring precontract costs that under the proper conditions and documentation can be allowable costs, even before a contract award is made.

3. *Overreliance on engineers without commercial skills.* McKinsey addresses the common situation where there may be too much reliance on highly specialized engineers where though they may have deep, technical skills in the project or service areas nonetheless lack necessary commercial skills. For example, engineers may define the parameters of a new plant so narrowly as to allow for the purchases of a critical piece of equipment from only two suppliers rather than say 25 that may have been possible with a more sensible approach.

Implications. The existence of such deep technical skills and shortage of commercial skills is particularly acute in relatively insulated companies with a tradition of doing business with the government. Utilization of new engineering skill sets may involve finding such skills in unusual places which affect the billing rates to charge such people. Attracting commercial skills

may mean utilizing people from different segments of a multi-segment company or finding people outside the company. One of the keys here is to be able to charge such individuals at commercial rates rather than a burdened cost base that could withstand audit scrutiny. Documentation of their being "commercial items" allowing for billing the government at commercial (e.g. higher) rates needs to be carefully considered.

4. *Standardization is often better*. McKinsey alludes to the tendency of companies to look at projects in isolation where they seek to optimize engineering, costs and timing without considering implications for other interrelated current projects or future ones. They contrast this tendency with high performing companies who have an understanding of how today's projects will affect those undertaken later. For example, oil companies use a standardized approach to the engineering and construction of their floating offshore production vessels where these efficient, repeatable platforms are not as efficient as those tailored to individual oilfields. However, this standardization allows them to develop a number of fields faster which is more profitable given high oil prices (more than seven months faster). Standardization also cuts costs. For example, one shipbuilder cut costs by building a series of four similar ships in the same facilities, allowing for one third less labor due to learning benefits.

Implication. The unique product and service underlying many government contracts may provide for a high level of engineering precision which may compromise costs, timing, quality, etc. Opportunities for tailoring specifications at both the initial and economic change orders will help realize the benefits of standardization. Proposals allowing for significant cost savings with design assumptions, especially when such specs are not precisely defined, offer opportunities to win proposal points and offer lower bids.

5. *Benefits of limiting subcontractors may conflict with competition goals*. McKinsey documents the benefits of working with the same subcontractor that often helps optimize efficiencies, lower costs and spark innovation.

Implications. The use of fewer but better subcontractors is contrary to the current emphasis on expanding competition where now even auditors are getting into the picture. Taking advantage of fewer subcontractors will require greater ability to justify less competition and even sole sourcing. With increased scrutiny over procurement practices expected in the near future (it is now one of the seven "business systems" the government is tasked with evaluating) contractors' written policies should reflect and justify the wisdom of using less subcontractors rather than merely maximizing competitive procurements. In addition, new creative teaming arrangements will need to be explored to realize the benefits McKinsey discussed.

6. *Creative contracting relationships with subcontractors can optimize performance*. McKinsey emphasizes that at the project level, the prime and their subcontractors have a variety of strengths and weaknesses calling for a variety of arrangements. They stress that the best model for delivery can vary widely, considering what participant can best execute each of its individual requirements where financial risk for the suppliers can be minimized and hence "contingency pricing" reduced. McKinsey considers three models to choose from:

a. The Prime contracts individually with its subs (Engineering - E, Equipment - P and Construction - C) where it integrates all tasks.

b. Prime contracts with a subcontractor to manage all three E,P and C functions but Prime still is contracted with the EPC subcontractors.

c. Prime contracts with separate EPC subs who, in turn, are responsible for all EPC subcontractors.

For example, a steelmaker (1) determined who the "natural owner" of every task during each stage of the project should be (2) identified opportunities to bundle jobs which were attractive to suppliers (3) for infrastructure, a weak area for the prime, it worked with a renowned local engineering firm (4) it managed the equipment and related procurement itself since it was strong in that area and (5) handled overall management using a local construction management firm with great knowledge of local suppliers helping to guarantee high quality. Results were great.

Implications. This type of analysis on a project by project basis will call for unique teaming arrangements where deep knowledge of each potential participants' strengths and weaknesses and communications with all parties will be at a premium. Traditional contracts management and cost/pricing personnel will need to develop skills to provide added value. These arrangements will contribute to both lower prices and probably higher source selections scoring potential so significant communications and understanding by the prospective client will need to be made early.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2011

(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, what is considered proper evaluations of proposals and selected cost issues. This article is based on the January 2012 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 them.)

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 included where the solicitation called for a cost/technical tradeoff as opposed to lowest price and protester offered the third lowest price (Technology Concepts), offeror is forced to recomplete for a contract it had already won (Jacobs Technology), challenging decision to in-source future work (Santa Barbara Applied Research) and where protester complains the bid was not properly competed it would had bid on the contract (Google). Examples of cases where it was ruled the protester was not an interested party include it was ranked eighth and had no chance to win (Seaborn Health), the parent company of a wholly owned subsidiary cannot protest being eliminated from the competitive range where the subsidiary is a separate and distinct legal entity (Integrated Systems) and it does not have the capability to provide the products or services sought by the RFP (RELM Wireless).

Competitive *prejudice* is a necessary element of being an interested party where the protester needs to show that but for the agency's actions it would have had a substantial chance of receiving the award. No prejudice exists where the protester does not allege it would have done anything differently if it was aware the agency would accept a longer delivery schedule (Pacific Lock). Protester claiming prejudice must show more than a mere possibility it would have received the contract but for the error – it needed to show a "substantial chance" (Vanguard Recovery Assistance).

♦ 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 (Ceres Environmental). Below-cost pricing is not prohibited and the government cannot withhold an award merely because its fixed price low offer is or may be below costs (Vizada Inc.). But unbalanced bids were held to exit when the agency believed the low price presented a potential risk of failure (Gael Svcs.) or the same with unrealistically low labor rates (D&S Consultants).

♦ Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals where grounds for judicial review of agency decisions is quite limited to (1) either the procurement official lacked a rational basis or (2) the procurement proceedings involved a violation of regulation or procedure (Commissioning Solutions Global). Procuring agencies have broad discretion in the selection of evaluation criteria and the GAO will not object as long as the criteria reasonably related to the agency's needs (Valor Construction). 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 (Progressive Svcs.). Agencies must evaluate proposals according to criteria established in the RFQ (Glenn Defense) and when its needs change it must issue an amendment to notify offerors (Fulcra Worldwide). An agency is not required to identify the various aspects of each factor it might take into account provided those aspects are reasonably related to the selection criteria (Global Computer Enterprise).

Agencies may properly take into consideration specific experience in making qualitative distinctions between proposals as long as it is related to RFP requirements (Bulltrack Wats II). Agencies must apply evaluation criteria in the solicitation equally and where the record

showed the protester proposed qualities comparable to the awardee and the agency failed to show why the two comparable proposals were not the GAO concluded they were not treated equally (Raytheon Technical). Agencies may not induce offerors to prepare and submit offers based on one premise then make source selection decisions based on another (Commandeer Construction).

Agencies must consider *cost or price* in evaluating competing proposals (IM Systems Group). Even when a solicitation emphasized technical merit over price an agency may properly select the lowest price when it reasonably determines the price premium is not justified (NetStar 1). Where in a best value procurement the agency finds proposals to be essentially equal it is proper to make price the determining factor (AMEC Earth & Environment).

♦ 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 where courts are defining this new area. 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 (Raytheon). Communications to allow an offeror to submit a missing portion of a proposal would be a discussion not clarification (Tetra Tech Tesoro) and no discussions are required for an offeror that is outside the competitive range (Logmet).

Discussions must be meaningful, equitable and not misleading and must identify deficiencies and significant weaknesses in each offeror's proposal that can reasonably be addressed in a manner to enhance the offeror's potential to receive the award (Clark/Caddel JV). Meaningful discussions were not held when the agency identified significant weaknesses in protester's proposal and conducted discussions with other offerors prior to establishing the competitive range without conducting discussions with protester (Raytheon Co.). However, the agency is not required to offer a protester "all-encompassing" discussions (Vizada) or every aspect of a proposal that receives less than a maximum score (L-3 STRATIS) but rather the legal requirement is they point the offeror into areas of their proposal that need amplification (ACS Federal Solutions). An agency had no responsibility to tell the offeror its costs or price is too high when they are not considered excessive or unreasonable (Tech Systems) or the price is not considered to be a significant weakness or deficiency (Patriot Taxiway) nor is an agency required to reopen discussions to give offeror an opportunity to remedy a weakness that arose first in a revised proposal (KBS, Inc).

Costs

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. Though contractor did not start work it was nonetheless entitled to startup costs but because there was no bad faith asserted, it was not entitled to anticipatory profit (NCLN20). Contractor was not entitled to costs related to upgrading its equipment because they were deemed precontract costs and incurred to get a higher score in the competition (OK's Cascade). However, it is entitled to recover direct costs, equipment costs, general and administrative costs, pretermination profit, subcontractor claim costs and settlement expenses (White Buffalo Construction). The termination for convenience clause under a commercial item contract allows for recovery of a percentage of the contract price based on the percentage of work performed at the time of termination plus any costs resulting from the termination plus settlement costs (Red River Holdings).

Damage Claims Against the Government. Though the actual costs is highly preferred in a claim, the *total cost basis* can be justified if the contractor can show impracticality of identifying actual costs, the costs are reasonable and the contractor is not responsible for the costs where it was shown it could not identify the costs (Reliable Contracting). Recovery on the *jury verdict* (generally, any method other than showing costs incurred) is possible if the contractor can show (a) clear proof of injury (b) there is no more reliable method of computing damages and (c) the evidence is sufficient to allow a fair and reasonable approximation of damages where the contractor showed loss of productivity due to there being differing site conditions (States Roofing).

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).

Direct vs. Indirect Costs. Though it normally charged its dock repair work as an indirect cost the contractor sought reimbursement as a direct cost saying it was chargeable directly to its Navy contract on the grounds it would not have incurred the expense "but for" the contract. The Board disagreed saying it "pertained to more than one cost objective" and hence must be charged indirect (Todd Pacific Shipyards Corp).

Penalties on Unallowable Costs. Though the Board ruled that under FAR 42.709-5(b) the government was required to waive the penalty on expressly unallowable costs for *individual* items allocated to covered contracts if they were less than $10,000 but on reconsideration the board reversed its position holding the waiver is not required unless the total amount of unallowable costs is less than $10,000 (Thomas Assocs.).

Cost Impacts Under CAS. When an accounting change causes costs on some contracts to increase and other to decrease, they must be offset because to not do so would result in the government recovering more than the increased costs in the aggregate (Raytheon).

WHAT CONSTITUTES AN ADEQUATE BILLING SYSTEM

(*Editor's Note. The need for demonstration of an adequate billing system and increased audits of invoices are making sound billing practices more important than ever. Direct billing privileges and use of quick closeout procedures can be withdrawn when a contractor is cited for having significant deficiencies in its billing system which are increasing at an alarming rate. Given its increased scrutiny over billing practices, DCAA recently issued a new billing system audit program May 2012, modified its audit program on internal controls over billing and added a new audit program "Contractor Compliance with Billing Instructions." We thought the best way to help our readers would be to provide a brief overview of these new audit programs and then identify the internal controls DCAA will be examining to determine whether major and non-major contractors have adequate billing systems which have not significantly changed since we visited this area several years ago. We have applied our experience as consultants and used the DCAA Contract Audit Manual and DCAA new audit programs as sources for this article.*)

An assertion of significant deficiencies in its billing system can result in a range of problems: contractors can loose their privilege to direct bill, the government may suspend acceptance of invoices on flexible type contracts and progress billings and an adverse finding can contribute to an assertion that a contractor's accounting system is inadequate, resulting in failure to be awarded a contract. A relatively new unfortunate trend we are seeing is referrals to criminal fraud investigation units of cognizant agencies such as DOD and Inspector General offices where a referral usually must be followed up with an investigation. Since their guidance is, by far, the most comprehensive, we will identify the many elements that DCAA considers to be an adequate billing system and suggest our readers use their judgment to determine what is appropriate for your business. For example, detailed written policies and procedures addressing each element below may be overkill for a small, low risk contractor whose government business is minor. Contractors whose main business is cost type or time and material government contracts or large businesses with significant progress billings on fixed price contracts are considered higher risk and would likely need more controls. Unfortunately risk assessment of specific contractors and corresponding criteria of what is acceptable varies widely between auditors. We will identify what the guidance considers adequate and leave it to the reader to determine the level appropriate for them.

Auditors are tasked with determining whether a contractor's billing system provides reasonable assurance that billings applicable to government contracts are prepared in accordance with laws, regulations and contract terms and that material misstatements are prevented or are detected in a timely manner. In order to make this determination the auditors will either conduct a separate billing system review or more commonly, examine the billing system as part of other audits like invoice audits, accounting system reviews, forward pricing rates or incurred cost submittals.

The new Billing System Audit Program has been substantially revised. It now applies to both major and non-major contractors where auditor judgment will determine what steps to take. The guidance provides sections on planning the audit, preliminary steps, a methodology in selecting invoices to test and brand new sections addressing prime contractors'

monitoring of subcontracts as well as detailed review steps to take under various types of contracts (e.g. cost type, T&M, progress billing and performance based payments under fixed price). The relatively new audit program "Contractor Compliance with Billing Instructions" is used normally when DCAA is requested by a contracting agency to audit the billings from one or several of its contracts which emphasizes contract briefings to become knowledgeable about the specific contracts to be reviewed with an emphasis on billing instructions, ensuring the specific invoices selected for review follow the billing instructions. The guidance references both the DCAM and Billing System Audit Program so relevant steps included there will be followed.

When reviewing the contractor's billing system as opposed to auditing specific invoices under a particular contract, the substance of the audit will focus on "internal controls" over billing no matter what type of contracts are reviewed and the auditor will make a determination of whether they are adequate, deficient or inadequate. The following internal controls will apply to all invoice reviews:

1. *Prime Contractor Monitoring of Subcontracts.* Prime contractor (and upper tier subcontractors) monitoring of its subcontracts has become probably the greatest area of emphasis in the last couple of years. Auditors are told to identify high risk subcontracts (e.g. cost type, T&M, fixed price when billings have cost elements), see if the prime has determined and monitors on an on-going basis whether the subcontractors' billing and accounting system is adequate (or if denied access, has requested ACO assistance and reviewed whatever information it was able to receive.

2. *Management Reviews.* The contractor should demonstrate it monitors its billing process. This should include (a) a regular compliance review to ensure its billings are made in accordance with both regulations and contract terms and (b) periodic reconciliation of contract costs identified in the cost records to costs billed.

3. *Written Policies and Procedures.* Several adequate practices along with written policies and procedures should be, when appropriate, in place in the following areas:

a. *Training of employees.* Ensure appropriate personnel are specifically trained to prepare and submit government billing requests. Outside training courses, internal courses and on-the-job training are options. Programs might include an overview of the accounting system, information on specific billing procedures, an overview of written policies and procedures, instructions on briefing contracts (discussed below), understanding of the approval process, guidance on relevant contract clauses and knowledge about quick closeout procedures. If specific procedures are not followed the auditor will ask what type of training is provided and will likely follow it up with interviews of selected people.

b. *Contract briefings.* Government contracts often have unique requirements related to billings such as withhold criteria, cost exclusions, etc. We are seeing a significant increase of audit attention on how well contractors keep up-to-date briefings of contracts and the procedures should document the process (e.g. forms used, checkmarks for FAR clauses, contract type, billing rates for individuals or labor classes, ceiling indirect costing rates, project set up information, etc.).

c. *Review and approval.* The contractor should have procedures in place, preferably written, to demonstrate that there is a management review and approval of billings before they are submitted. Progress billing requests require management certifications. Adequate procedures should demonstrate that contract briefings require management review, managers review billings prior to submission and even better, that certain items or elements in a billing receive specific review if certain thresholds are exceeded.

d. *Reconciliation of recorded and billed costs.* The contractor should be able to demonstrate that its billings are prepared directly from the cost accounting records or from other records (e.g. spreadsheets) that are reconciled to cost accounting records. If billings are prepared from subsidiary ledgers or memorandum reports then they should be reconciled to the general ledger. Periodically, contract costs as identified in the cost records should be reconciled to costs billed. This is a good idea not only to demonstrate good internal controls but will help prepare timely final vouchers detailing allowable costs by year.

e. For *electronic data systems* the contractor should have written procedures and/or flowcharts identifying the appropriate inputs, control points, ancillary EDP applications and related transactions. The automated system needs to have the capability to input billing ceilings, withhold requirements or automatically code

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items that are not billable and then identify these items included in cost records but excluded from billings in a separate attachment. For *manual systems*, the contractor may want to consider attaching the job cost ledger or verification to the billing record for management review before billings are sent.

f. *Adjustment of cost and rates*. We are also seeing increased audit attention on whether contractors adequately monitor interim indirect cost rates. Billings on cost type contracts are usually based on projected rates for the year which often change. Procedures should be in place for monitoring actual rates (required by FAR 52.216-7(e) and FAR 42.704)) and if billing rates differ significantly from actual rates, adjustments to the billing should be made either during or at year end to ensure amount reimbursed is close to that claimed. The contractor should have procedures in place to ensure yearly rate computations are easy identifiable, are made at least annually and that approval for changing billing rates are in place (and prevention from unauthorized changes to billing rates also exist).

g. *Exclusion of certain incurred costs from billings*. Examples of costs that may be reflected in books of account that should not be included in billings are (1) unallowable costs defined by the FAR, supplemental agency's regulations, OMB circulars or contract terms (2) withholding costs that are appropriate adjustments such as costs in excess of ceilings or liquidated progress payments (3) adjusting submissions for claimed or audited rates that differ from contractors' current applied rates and (4) certain costs that require contracting officer approval such as special purchases, overtime authorizations, etc. Appropriate written procedures should be in place to ensure these costs are excluded from billings (e.g. special coding) and what occurs when they are reclassified as billable (e.g. amounts were paid, CO authorized payments at a later date).

h. *Estimates to complete*. For progress payments, the contractor should have in place procedures to ensure it keeps its estimates of cost to complete current and that these estimates reconcile with other reporting requirements such as EVMS and status reports provided to upper management. The contractor should demonstrate it has EDP controls or tickler files identifying that estimates have not exceeded the 6 month requirement.

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