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DCAA ISSUES ITS FY 2014 ANNUAL REPORT

(Editor's Note. We find DCAA's annual report to be interesting because it shows what is likely to be its greatest priorities which will affect what types of audits to expect.)

The Defense Contract Audit Agency issued its fourth Annual Report to Congress report March 25. The 18 page report provides statistics on its audit performance, identifies audit priorities and recommendations to help provide more data to audit.

Audit Performance

1. *Incurred cost years closed*. Dedicated incurred cost teams were created in 2012 where they were in full action in FY 2013 where there has been a steady increase in incurred cost years closed, exceeding 11,000 in FY 2014.

2. *Net Dollar Savings*. Whereas there was an average of $2.6 million in net savings during the period 2004-2009, the amount has steadily increased where in the last three years the savings amount was on average about $4.6 million.

3. *Return on investment*. This is the key statistic for DCAA that has traditionally been used to justify its expenditures. The ROI, amount of savings for each dollar spent, has steadily increased since 2009 going from $5.10 to $7.25 in FY 2013 where it dipped to $6.89 in 2014. The report states that DCAA takes a "conservative" approach in calculating this figure using only reported savings that have been realized by government contracting officers, not those reported as potential or future savings.

4. *Questioned costs*. This is the amount of costs questioned of audits or either claimed or proposed costs and is expressed as a percentage of dollars examined. Whereas 2013 was the highest reported amount at 9.8%, 2014 fell to 5.9%, the lowest since 2008. The significant decrease is explained to be caused by a lower amount of forward pricing activity which is the area of highest questioned costs.

- **Audit Reports**

The report provides a table identifying number of audits in different categories, questioned costs and unsupported costs. There are no comparisons with prior years. Questioned costs are defined as costs the auditor believes are not acceptable for either negotiating a contract cost or for reimbursement under existing contracts. Unsupported costs denote instances where the contractor has not provided specific evidence or documentation to support assertions of future work. This category applies only to forward pricing audits.

1. *Forward Pricing*. These are considered to be audits before contract award where DCAA evaluates the contractor's estimate of future costs of providing its products and services. There were 1,089 reports issued where $7.1 billion was questioned and $6.0 billion of costs were unsupported.

2. *Special Audits*. These audits are usually in response to requests by contracting officers on either a specific element of a contract or on a contractor's accounting system. Special audits conducted after contract award are usually for changes or terminations (partial or complete). These specially requested audits are considered to be high priority. 1,627 audit reports were issued with questioned costs of $658 million.

3. *Incurred Cost*. These audits are conducted after contract award and apply to flexibly priced contracts (e.g. cost reimbursable, time-and-material). 1,919 audit reports were issued with questioned costs of $2.7 billion.

4. *Other audits*. These audits are performed after contract award and are initiated either from CO requests or by DCAA when there is "high risk" such as inadequate accounting system. The majority of these audits include adequacy of CAS Disclosure Statements, compliance with CAS, audit of cost impact statements when accounting changes occur, review of contractors' accounting systems, compliance with Truth in Negotiation Act (i.e. defective pricing audits) and real time testing of labor

and materials costs. 1,053 audit reports were issued with questioned costs of $164 million.

- **Pending Audits**

The report notes that beginning in 2010 DCAA made a conscious decision to defer incurred cost audits so that auditors could work on other audits that were more time sensitive. In 2013 it reduced this backlog of incurred cost audits with further reductions in 2014 where at the end of 2014,DCAA had 11,324 adequate annual submissions in and valued at $419 billion with an additional 6,861 worth $403 billion either awaiting receipt or waiting to become adequate in accordance with FAR 52.216-7(d)(2)(iii) requirements.

- **Prioritization of audits**

The report states DCAA uses a risk based approach to deciding on audit priorities. "High risk" typically involves significant costs, poor contractor performance in the past or circumstances where there may be less incentive to control costs such as cost type contracts. In 2014, the high priority audits were those related to Overseas Contingency Operations (OCO) and Forward Pricing. OCO audits are considered high priority because a foreign contractor may not be as familiar with US laws and rules as US contractors and such contracts have large amount of subcontractors which is historically a high risk area. Forward pricing audits are a priority because they are highly time-sensitive, needing to be completed before price negotiations begin. Beyond these two priority areas DCAA assigns priorities to individual contracts and risks to the government. Non-backlog incurred cost audits are not considered to be high risk because they are performed after contract award while back log incurred cost audits are high risk because of their age. Special audits are high priority when requested by the CO and Other Audits may be a priority when DCAA or the CO identify high risk areas such as an inadequate accounting system.

- **Length of time to complete an audit**

The report does not explicitly address wide-spread complaints within government about excessive time to complete an audit but instead states DCAA does not have specific or mandatory time requirements but rather assesses what is necessary to meet audit standards and will provide value to the CO in negotiating fair and reasonable prices. It states DCAA works with buying commands to meet set priorities, milestone plans and agreed-to dates. The report provides a table for average elapsed time to complete the four different types of audits for the last three years where there has been a small decrease in some while in the "Other Audit" category a significant decrease in time to conduct an audit.

Significant Deficiencies and Recommended Actions

Forward Pricing. The report speaks highly of the recent DFARS rules for a forward pricing rates in its adequacy checklist (Dec. 2014) and an individual proposal adequacy checklist (March 2013). But it states "additional work is still required" to obtain adequate support for proposed commercial item prices. The report state that now with subpoena authority for "certified cost or pricing data" DCAA can now better help support negotiated acquisitions. However, the absence of express authority to review "data other than certified cost or pricing data" will adversely affect DCAA's ability to obtain sufficient data to perform audits of commercial item procurements (recent rule changes expands the opportunities to ensure commercial item procurements result in fair and reasonable prices including requests for non-certified cost and pricing data.). Accordingly DCAA is asking to create subpoena authority to obtain this cost data.

Access to Contractor Records. The report expresses the need to understand contractors' accounting practices and obtain documentation to better adhere to auditing standards. It is continuing its requests in the 2012 and 2013 reports to congress to have better access to records – specifically internal audit reports and contractor employees. The report complains that it is being impeded from gathering sufficient information to conduct its audits because contractors are asserting that access to records in accordance with FAR 52.215-2(d) does not include access to employees.

Our Conclusions

Audits priorities will be (1) forward pricing proposals since these proposals generate the highest percentage of questioned and unsupported costs for dollars examined, you can expect to see even higher amounts of these audits to improve DCAA's ROI statistics (2). special requests by contracting officers such as audits of equitable adjustment requests and termination settlement proposals (3) incurred cost audits (4) accounting system reviews (5) defective pricing and (6) compliance with cost accounting standards including compliance audits, cost impact proposals and adequacy of disclosure statements

Highly publicized criticism of its backlog of incurred cost audits together with DCAA's recent stated goal to limit its backlog to 12 months of inventory in 2016 will likely result in a higher number of audits at "high risk" contractors with a corresponding increase of write offs of this backlog to "low risk" contractors. Some comments we have seen state there will be increased determinations that submitted proposals are deemed "inadequate" to keep inventory low. In addition we can expect to see increased pressure for contractors to provide non-certified cost and pricing data on commercial item proposals to ensure pricing on these items are fair and reasonable with a corresponding increase of audits of this data. Also, expect to see continued pressure to interview employees and have contractors provide internal audit reports.

TACTICS TO RAISE BID PRICES

(Editor's Note. We have occasionally addressed how contractors can lower their cost based prices to be more competitive (e.g. see our article in the 4th Qtr. 2003 Digest issue, "Tactics to Lower Bid Prices" where we presented twelve ideas for lowering bid prices). However, many contractors also want to establish prices that maximize their cost recovery so we tried reversing the ideas in that earlier article and the result appeared reasonable so here it is,)

Some of the tactics we discuss below represent real overall cost increases to contractors while others shift costs away from some contracts to the proposed contract being sought.

1. *Shift average direct rates to the higher end of the spectrum.* Rather than using an average rate for a given labor category (or even the lower end citing the ability to use less years of experience, for example), price rates at the higher end with the intention of using higher paid employees on the contract.

2. *Don't use and bid uncompensated overtime.* Even if uncompensated overtime is a significant factor for your firm, make sure your proposed hourly rates are not based on uncompensated overtime (i.e. dividing salary by a higher number of hours). For example, you can be sure that employees exempt from FSLA do not work overtime on this contract or pay them for any overtime effort worked to be able to claim uncompensated overtime is not a factor.

3. *Propose a higher escalation rate.* For out years, you often have the ability to propose higher costs on direct costs such as labor, material, subcontracts and travel as well as indirect costs using an escalation factor. The government does commonly recognize escalation factors provided by such firms as Producer Price Index (PPI) but you can increase the factor by computing your firm's actual historical practices or use other factors supplied by other firms including ones commonly found within your industry. Achieving higher escalation rates might include can be accomplished by assuming higher skilled employees used to work on the contract or not using new, usually lower paid employees in comparable skill categories.

4. *Don't use "temporary" or "variable" employees.* Increasingly, many companies' new hires are individuals who are paid only for direct billing time or who do not receive the same types of fringe benefits that current employees receive. These employees should not be used on proposed contracts, citing need for higher seniority employees who happen to be paid higher fringe benefits. If the company computes a company-wide fringe benefit rate that consists of all types of employees, consider establishing a different fringe benefit rate for the class of employees working on this contract or establish a separate fringe benefit rate for the variable employees.

5. *Reclassify certain indirect functions as direct.* Certain functions like contract and subcontract administration, purchasing, materials inspection, etc. can be identifiable with specific contracts rather than included in an indirect cost pool spread over all contracts. You often have the ability to consider these functions as direct. You will, of course, need to justify different treatment of these normally indirect functions as direct by showing they are incurred under "unlike circumstances" where you need to demonstrate consistency with the way you account for costs versus the way you propose them unless they are not similar or circumstances are dissimilar. You will also want to be able to show that allocation of the full overhead rate is justified under this contract where it still receives indirect function support. For example, direct HR efforts incurred for one contract (e.g. hiring a dedicated manager) are different than normal indirect HR services for the company as a whole.

6. *Change the G&A base.* If, for example, government contracts are likely to have a relatively lower subcontract or material component compared to other contracts, you may want to shift from a total cost input base to a value added base (e.g. calculating and applying G&A

costs to labor and overhead only). That way, the G&A rate will increase due to the lower G&A base where you can apply this higher rate to direct labor and overhead. Alternatively, you can alter the G&A base by some but not all types of costs that are ordinarily included in the G&A base. For example, we are seeing many examples of contractors excluding certain types of subcontract or material costs from their otherwise total cost base demonstrating that they are simply pass-through costs that do not require indirect support effort arguing their inclusion results in an inequitable cost allocation.

7. Increase costs. Ensure that all allowable and allocable costs are included in your indirect cost pools. We commonly find that different types of otherwise allowable costs are excluded because a prior decision was made and the habit of excluding these costs simply continue without being reviewed. The exclusion of these categories of costs may no longer be valid (e.g. FAR changes, court decisions, revised DCAA guidance) or they may not have been valid at the time the decision to exclude them was made. Make sure you re-assess all unallowable costs that are screened to ensure they still should be. We also find that "management concessions" may have been used to lower indirect cost rates in the past where now they should be discontinued or at least discontinued for the new contract being proposed.

8. Increase proposed profit/fee. Propose higher fees or increased fees on certain types of costs (e.g. subcontractors) showing that higher risk is involved. Several cases and revised profit guidelines have been issued that may support higher fees.

9. Create a new business unit (or avoid it). A separate business unit or joint venture can significantly affect proposed prices where they offer tools to either lower or increase prices, depending on pricing strategies sought. Tools available for either lowering or increasing prices include using different categories of labor, payment of different fringe benefits or providing for a disproportionately lower or higher allocation of home office expenses. Just as the creation of a new segment or joint venture can significantly affect prices, decisions not to create such entities should also be considered for their effect on pricing.

10. Aggressively increase indirect cost rates. Though it can be risky, assume a smaller business base (e.g. denominator) to spread indirect costs over. This is particularly effective if business prospects are uncertain. Also, be liberal in assuming increases of certain categories of costs (e.g. increased marketing effort, bonuses, legal/consultant efforts).

11. Find outsourcing opportunities. Using outsourcing is more commonly associated with cost savings (e.g. shifting less critical functions to more efficient subcontractors) but it can also be used for higher priced improved quality or faster delivery.

12. Revise indirect rate structure. The accounting rules provide great flexibility where you can, for example, create a subcontract and/or material handling rate, change the overhead base or change the composition of the overhead and G&A pools. These changes can significantly increase the amount of indirect costs allocated to your new contracts. For example, creating the subcontract/material handling base results in an increase in G&A and overhead rate so if the new contract has relatively lower amount of subcontract costs and higher amount of direct labor then you would allocate more of those labor oriented indirect costs to your new contract. Or if you keep the total cost G&A base, you very often have the opportunity to shift costs considered to be G&A to overhead (e.g. HR, accounting, legal, contract management, purchasing) that allows for greater allocation of costs to the overhead base costs (e.g. direct labor). (*Editor's Note. For more information on methods of revising your indirect rates, we have written many articles over the last twenty years so use our word search function to find them. Also, feel free to call us since this is one of our consulting specialties.*).

13. Base pricing on less aggressive performance improvement estimates. Instead of using normal estimates of performance (e.g. history), price the proposal according to less optimistic estimates of improvements being planned. These new estimates should be reflected in project budgets.

Some of these measures will create changes to current accounting practices. If your firm is covered by cost accounting standards some form of cost impact analysis on your other contracts may be required. If not CAS covered, there is considerably more leeway in making these changes. Careful planning and communication with government auditors and your CO will likely avoid problems associated with these accounting and pricing actions.

NEW CASES SHOW USE OF THE 'JURY VERDICT" METHOD IS ALIVE AND WELL

(*Editor's Note. One of the most difficult issues contractors and the government face when attempting to determine the value of an equitable price adjustment is what method should the contractor use in quantifying the amount of damages it is entitled to. It is very common for a contractor to not be able to document the amount of damages it is entitled to by, for example, establishing an account that segregates costs of changed work, so even when there is no dispute about there being out-of-scope work performed they nonetheless may lose all compensation. One method to identify amount of entitlement, with varying results, is the so-called "jury verdict" method. Since the Dawco case (discussed below) has established limits for its use there have been at least 16 additional cases where the jury verdict method did allow for some, though highly limited recovery. We have used an article written by Professor Ralph Nash in the March 2015 issue of the Nash & Cibinic Report that addresses opportunities to use this method. We identify cases in case our readers find themselves under similar circumstances.)*

The jury verdict method of measuring an equitable adjustment is used only when a more exact calculation of the actual costs incurred in performing a change in the contract cannot be made. After considering the evidence in a case the board or court determines, usually in an imprecise way, what amount should be paid as the equitable adjustment. Typically, averages or percentages of computed amounts are used where it is common to use discount percentages and other offsets to arrive at a "fair" number. In a seminal case, *Dawco Constr. Co. v U.S.* the court established the standard for use of the jury verdict: First, it must determine that (a) clear proof of injury exists (b) there is no more reliable method for computing damages and (c) the evidence is sufficient for a court to make a fair and reasonable approximation of the damages. Dawco further established the jury verdict method is not supposed to be used where there is a total failure of "proof" by the party bearing the burden of proof. Unless the contractor presents enough evidence to allow the trier of fact to estimate with a reasonable degree of accuracy the cost resulting from the change the jury verdict method is not to be used.

The following post-Dawco cases provides expanded opportunities to use the jury verdict method, sometimes not meeting the Dawco criteria for its use, under different categories of damages that occur under changes to a contract.

Loss of Productivity

It has generally been established that there is no way to record the actual costs of loss of productivity but in *States Roofing Corp (ASBCA 54860)* the board found it could award a jury verdict for "disruptive damages" where the evidence showed "it would be remiss" not to award damages caused by differing site conditions. However, only 10% of the amount claimed by the contractor was awarded which raises the question about the clarity of the data provided by the contractor.

Constructive Changes

In *RLB Construction (ASBCA 57638*) the government conceded it had changed the work but offered only $447,000 of the contractor's claim of $2,864,000. Both parties agreed there was no way to segregate the costs of the changed work because it was just more of the same work so the board rendered a jury verdict of "65%" amounting to $2,149,000. Since there was no explanation of how the board arrived at its decision it is difficult to determine whether the award was based on sharing the cost of the extra work or an allocation of the total costs.

In *Gray Personnel (ASBCA 54652)* the government admitted it had changed the contract requirements for nursing services but disputed the contractor's calculation of the equitable adjustment because it was based on a comparison of originally estimated labor hours with incurred labor hours. The board concluded the changes were not reflected in the recording of hours and awarded a jury verdict of 85% of the claimed hours where there was no explanation of why 85% was used.

In *Reliable Contracting Group vs Depart. Of Veterans Affairs (CBCA 1539)* the parties stipulated that a change had occurred but the government disputed the contractor's calculation of costs because it did not have actual cost records. The Board rejected the government's assertion about material costs because while its invoices did not clearly identify the added material costs the contractor's witness "clarified" the invoices. The Board also granted the amount estimated for direct labor costs citing *Environmental Safety Consultants (ASBCA 53485)* for the proposition "where a contractor does not accumulate cost data and cannot identify actual costs attributable

to changes, estimates may be used to quantify the increased costs a contractor incurred." The results of this case seem to contradict the segregation of costs requirements of the Dawco case but the board seemed to be influenced by the fact the government put in no evidence of its calculation of the amount due.

In *Maggie's Landscaping (ASBCA 56748),* the contractor did not submit its accounting records but based its claim for the extra work on estimates of $456,000. The government disputed most of this amount where the board made its own calculation of amounts of extra work at $24,000. The authors state this decision meets the Dawco test because the added mowing work was of exactly the same nature as the original mowing work.

In *HomeSource Real Estate Asset Services vs HUD (CBCA 859)* the contractor alleged the agency changed the work and put forth claims for the additional work but provided no proof the costs were related to the claimed additional work. The board granted no compensation because of a lack of proof of causation. This is a rare case where a significant lack of proof gave the board no basis for arriving at a jury verdict even if it found that changes had occurred.

In *KiSKA Construction Corp. & Kajima Engineering (ASBCA 54613)* the board found several changes had occurred and the contractor submitted detailed estimates of the costs backed up by some actual data. The board rendered a jury verdict adjusting some of the contractor's estimates where supporting data was missing but generally based its award on the contractor's proposed amount finding the project manager's testimony "generally persuasive." This is another case where the government did not put into evidence its own but rather confined its arguments to challenging the contractor's estimates.

In one *States Roofing Corp.* case *(ASBCA 55506)* the contractor reviewed time cards to determine the amount of time the workers expended on changed work. The Board looked at this calculation, considered the government's detailed objections to some of them and arrived at a decision as to the number of hours that should be attributed to the change. The decision contains no discussion as for the requirement for segregation of costs.

In another *States Roofing Corp.* case *ASBCA 54854)* the government argued that actual costs incurred by the contractor in performing changed work was unreasonable and submitted an estimate of the costs the contractor should have incurred. The Board found the government's evidence unconvincing and awarded actual costs. This result is not really a jury verdict in the sense of arriving at a compromise but rather acceptance of actual cost as the best and most convincing way to measure the cost of added work.

In *New South Associates v Dept of Agriculture (CBCA 848)* the board used the jury verdict technique to determine the amount of time a contractor had expended in performing extra work because of inaccurate information provided by the government. While the contractor asserted it had expended $40,000 the board concluded the government was responsible for 46.6% of this work, awarding $18,000. It appears as if the contractor's number was arrived at by comparing the number of hours it used in its original proposal to the number of hours it actually incurred. The board did not discuss the fact this was a type of total cost approach which has been subject to considerable criticism.

In *Fru-Con Construction (ASBCA 55197*) the board used the jury verdict to determine the amount of costs incurred by a subcontractor in responding to a change, including the contract administration costs incurred for preparing the equitable adjustment. As for the subcontractor's claim, the board justified using a jury verdict on the ground there was no reliable way to calculate the adjustment.

Deleted Work

In *EJB Facilities (ASBCA 57547*) the agency deleted a portion of the work and argued the contractor should have segregated the costs of the deleted work. Prof. Nash states this is a strange decision because it is impossible to segregate costs of work that will not be done. Nonetheless, the author states the board arrived at the correct conclusion by accepting the contractor's technique of estimating the cost of the deleted rather than relying on the government's assertion that the proper measure of the adjustment was the contractor's original proposed price for the work.

In another *State Roofing* case *(ASBCA 55507*) the controversy was between the estimate that the two parties made for the deleted work. The board found that the contractor's estimate on RS Means was more credible because it was "an accepted construction estimating guide." There was no discussion of a requirement for actual costs since all that was being priced was deleted work.

Government Delays

In *Allen Ballew (VABCA 6987*) the board used the jury verdict method to determine the daily amount of field office overhead even though the contractor had not submitted data supporting some of the costs. The Board stated it was familiar with the typical field office overhead costs and their daily rates to make a determination according to the jury verdict.

Termination for Convenience

In *Silver Enterprises v Dept. of Transportation (DOTBCA 4459*) the board used the jury verdict method to determine the amount of time a contractor had expended before termination for convenience stating the contractor had proved it had incurred the costs and there was no accurate way of making a definitive determination of the damages since it did not track its costs. In this case, it was rationale to conclude this small contractor with a $48,000 fixed price contract need not have kept track of time expenses since such records would not be required to earn the contract price. Nonetheless, the board assessed the contractor's estimates and reduced the claim for $60,000 down to $18,000.

Conclusion

Prof. Nash derives several conclusions from the cases. First, the jury verdict is, indeed, alive and well. Second, though it is alive contractors should not expect to receive a price adjustment without any supporting data but rather the boards are willing to use imperfect data to determine the amount a contractor is entitled to. Third, the quality of the data will have a significant influence on the amount of compensation granted where the weaker the data the lower percentage of the contractor's claim will be granted. Fourth, the justification for use of the jury verdict technique once a board judges the contractor has a valid claim is that the contractor is entitled to an equitable adjustment where if there is any evidence supporting the costs claimed the judge will likely resort to the jury verdict method to arrive at some compensation. Fifth, if a contractor wants more than "some compensation" good documentation of the costs is essential. This entails asking the question that when any event occurs that alters the expected contract performance does it make sense to set up a separate account(s) to collect the costs of the events? If it does, then the costs should be segregated to provide strong proof while if it does not make sense the contractor should place a memorandum in the files showing it considered the issue while stating the reasons why segregation of costs was not practicable. Even if segregation of costs is not practicable records should be kept where showing the contractor made efforts to allocate costs between contractor and government responsibility.

RECENT FAR MODIFICATION ON UNCOMPENSATED OVERTIME IS CREATING CONFUSION

(*Editor's Note. How to account for it or how to price work when employees work uncompensated overtime has been a hot issue for several years. A recent modification to the FAR has shined a bright light on the issue once again. Some comments emerging assert the modification represents a significant change while others claim little change has occurred. The feature article in the January 2015 issue of the CP&A Report takes the first position where they spell out some of the history of the issue which we find quite interesting and summarize here while Tom Lemmer of the newly merged law firm of Dentons-McKenna claims the modification does not represent much of a change but nonetheless includes some potentially confusing language where contractors should take steps to minimize adverse results.)*

A final rule published January 29, 2015, effective March 2 (*Fed. Reg. 4992*) is creating considerable confusion within government contracting circles and may lead to significant audit issues. "Uncompensated overtime" refers to the hours worked in excess of the standard 40 hour work week by employees who are exempt from the Fair Labor Standards Act (FSLA) and therefore are not entitled to additional compensation for overtime work. The final rule is a FAR modification which addresses the labor hours and rates that must be included in a proposal. However, the modification is somewhat unclear and may have unintended consequences that is likely to resurrect the issue of whether contractors, at least service contractors, are required to use full time labor reporting accounting practices and how they must price their proposals.

What Was the FAR Rules before the Recent Modification

Before the new rule took effect, there was no requirement in the Federal Acquisition Regulation for contractors to

record or account for uncompensated overtime (UOT) for their FSLA exempt employees.

What the Regulations Say. The FAR mentions UOT only in FAR 37.115 and FAR 52.237-10. Identification of Uncompensated Overtime. Among other things, the regulations must require offerors to identify any UOT included in a proposal and in addition, establish criteria to ensure proposals for contracts for technical and professional services are evaluated on a basis that does not encourage offerors to propose UOT. FAR 52.237-10 is a mandatory clause for contracts for professional or technical services that are acquired on number of hours to be provided. The clause requires offerors to identify any proposed labor rates that are based on a regular work week exceeding 40 hours, including UOT on indirect cost rates. It also requires the cost accounting practices used to estimate UOT be consistent with the practices used to accumulate and report such hours. Accordingly, before the new rule took effect, even when the FAR 52.237-10 was included in a contract, it did not require a contractor to record UOT. To the contrary, as long as the proposed labor rates did not include UOT the clause required the contractor to *exclude* UOT in accumulating and reporting its labor costs. In fact, an appeals board decision ruled that even if a contractor records UOT under a time-and-material contract, if its proposed labor rates do not include an UOT labor adjustment the contractor is entitled to bill at the fixed hourly (unadjusted) rate specified in the contract for all hours worked including UOT hours.

DOD IG and DCAA. The DOD IG persistently asserted over the years that contractors should be required to record total time stating that most contractors are not required to do so resulting in them charging only to those activities that benefit them resulting in being "highly manipulative and contribute to inequities in the costing and pricing of government contracts." As a result of this perceived risk, the IG suggested it would direct DCAA to question a contractor's accounting system if it refused to implement full-time accounting but Director of Defense Procurement Eleanor Spector successfully fought against this.

Though DCAA acknowledges that neither the FAR or CAS expressly requires contractors to record UOT, DCAA has long taken the position that contractors should account for all hours worked, whether compensated or not. It cites potential risks of "gaming the system" by, for example charging only 8 hours to cost type work and no hours to commercial contracts or bid and proposal work. However, DCAA is not as insistent as the DOD IG in requiring total time recording. It recognizes that materiality must be considered - "materiality is the governing factor whether noncompliances should be cited." The DCAM instructs auditors to pursue the issue only if a preliminary evaluation determines *both* (1) UOT could materially impact labor cost allocations *and* (2) a significant amount of UOT exists.

Impact of the New Rule

The CP&A author's conclusion is the new rule is a significant change over the old rule where it "appears" that now total time reporting will be required while the McKenna attorneys state the new rule, though "somewhat unclear," does not "on balance" require full time labor reporting.

Though there is little difference of opinion on what the rules meant before, there is definitely a difference of opinion on the impact of the new rule going forward. The CP&A article stresses the policy has been significantly changed where the change was inappropriately issued without any public commentary because the modification stated it only "clarifies policy that already is stated in the FAR," an assertion which is "dubious at best." The new rule starts out innocently. The existing definition from FAR 52.237-10 are added to FAR 37.101 where the definition of "uncompensated overtime rate" is changed to "adjusted hourly rate (including uncompensated overtime)." The definitions remain unchanged: "uncompensated overtime" means the same and "adjusted hourly rate (including uncompensated overtime)" (formerly known as "uncompensated overtime rate") is the rate that results from "multiplying the hourly rate for a 40-hour work week by 40 and then dividing by the proposed hours per week." For example, 45 hours proposed on a 40-hour work week basis at $20 per hour would be converted to an uncompensated overtime rate of $17.78 per hour ($20 x 40 divided by 45).

The final rule also leaves unchanged paragraph (c) of the FAR 52.237-10, which states "the offerors accounting practices used to estimate uncompensated overtime must be consistent with its cost accounting practices used to accumulate and report uncompensated hours."

But the CP&A article says the rules change when a new paragraph (d) is added to FAR 37.115-2 and revised paragraph (b) of FAR 52.237-10 to *require* contractors to

apply the adjusted hourly rate (including uncompensated overtime) rather than the regular hourly rate, to all proposed hours "whenever there is uncompensated overtime." Before the change, the offerors were required to identify only those "proposed hours against which an uncompensated rate is applied." i.e. those hours for which the contractor was proposing to use adjusted hourly rate (including UOT). Offerors that that did not propose to apply adjusted hourly rates were not required to identify UOT hours, let alone adjust their hourly rates.

However, by contrast, the revised clause requires the contractor to *apply* the adjusted hourly rate to all proposed hours "whenever there is uncompensated overtime" i.e. whenever the contractor's direct charge, FLSA-exempt employees work more than 40 hours. In addition, since FAR 52.237-10 is a mandatory flow down clause, it applies to all proposals, whether the labor hours are at the prime or subcontract level. It also applies to all UOT hours that are in indirect cost pools for personnel whose regular hours are normally charged direct. Because paragraph (c) requires an offeror's accounting practices used to estimate UOT be consistent with its accounting practices used to accumulate and report UOT hours, it appears that the revised clause will require contractors to record all hours worked and apply the adjusted hourly rates (including uncompensated overtime.)

The writer states we can only hope the revised clause does not mean what it appears to say since it would be ironic that the many years that the DOD IG and DCAA spent fighting without success total time reporting that now the final rule requires it. Since this is a clear change, the new act violates the requirement that all procurement regulations be published for public comment before they are implemented.

Contrary Opinion

The Mckenna Long attorneys do state the modification is "somewhat unclear and may have unintended consequences" but believe on balance it does not require full time labor reporting. The authors allude to the prefactory comments in the modification that state it "clarifies policy that already is stated in FAR Part 37 and FAR 52.237-10." They believe this statement supports the assertion that there is no intent to alter the current absence of a requirement to record UOT and base labor and indirect costs on both compensated and uncompensated labor hours. They state the modification does have a requirement that *if* the proposal is based on uncompensated overtime *then* the proposed hourly rates must be consistent with the total time proposed, including UOT. For those contractors that estimate, accumulate and report labor costs based on a standard number of hours (e.g. 40 hours) for the salary paid within a period, the clause should not impose a requirement to propose or record UOT. This lack of a requirement for full time reporting is confirmed in the DCAA Contract Audit Manual which identifies several appropriate methods of accounting for UOT in addition to full time reporting. Despite their interpretation of the modification, the attorneys state that unfortunately the government and bid protesters may not agree where they admit the clause is sufficiently imprecise to permit a conclusion that full time reporting and adjusted labor rates must be used whenever it is anticipated that UOT will be worked

Given the ambiguity of the language and potential harmful effects of the incorrect interpretation, the McKenna authors recommend contractors should consider taking the following steps: (1) have clear policies and procedures regarding time recording and estimating, accumulating and reporting labor hours, labor rates and indirect costs (2) comply with these policies and procedures for all proposal whether the contract is for services or not in order to demonstrate compliance with CAS 401 (consistency between estimating and accounting) (3) ensure that the proposal disclosures state clearly whether the proposed labor hours include UOT and labor rates reflect UOT and (4) ensure that contract billings include labor hours that are consistent with the proposal and that labor rates are consistent with the labor hours proposed and negotiated.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2014

(*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 2014 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

The author puts forth some general guidelines for protests based on certain cases including: (1) be prepared to show that "competitive prejudice" exits – but for the error there was substantial chance that you would have been awarded the contract (*Rush Construction*) (2) be prepared to provide the specific information the CO unreasonably failed to consider (*FCt Federal*) (3) if a task or delivery order is being protested make sure it is over $10 million, including all options (*Goldbelt Glacier*) unless you can show the order increases the scope, period or maximum value of the contract for which the order is issued (*Orbis Sibro*) (4) make sure to file a protest on a timely basis where now GAO and Court of Federal Contracts have the same timeliness rules such as before the date for submission of proposals *(Potamac Electric, B-409710*), within 10 days after the basis for the protest is known (*Avaya Gov Sltns, B-409037*) or within 10 days of the debriefing (*C.I.R. Dev. Group, B-409398*) (5) agencies must prepare a full and complete documentation of evaluation decisions or otherwise the protest will be sustained (*Gaver Technologies*) and (6) if you are successful in your protest make sure you itemize your costs, document your claim carefully, provide detailed evidence in support and present to the agency within 60 days (*Loyal Source Gov. Svcs*).

- **Bait and Switch**

Several cases addressed "bait and switch" tactics where a protester must show a firm knowingly or negligently represented it would rely on specific personnel that it did not expect to furnish during contract performance *(PricewaterhouseCoopers, B-409072*). Bait and switch was not held where the RFQ contemplated the awardee might have to replace personnel and recruit incumbent workers (*AlamoCity Engrg Svcs, B-409072*), a firms' recruiting efforts to augment personnel resources do not in themselves indicate improper bait and switch and the record did not show awardee negligently or knowingly supplied sample bags that were not representative of bags it was expected to furnish (*Custom Pak, B 409308*).

- **Unbalanced Bids and Below Cost Prices**

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 agency's acceptance of a proposal with substantial unbalanced pricing is not, in itself, improper provided its estimates are reasonably accurate and the prices it will pay are not unreasonably high (Staples Contract & Comm'l, B-409528). Unbalanced pricing is held not to exist where the protester does not show that any prices offered are overstated (*MSC Industrial, B-409585*) or that the government could pay unreasonably high prices for contract performance (*CGI Federal, B-410330*).

Below cost pricing is not prohibited and the government cannot withhold an award from a responsible bidder because it is low or below cost (*Sea Box*). An offeror can, in its business judgment, submit a low or below cost offer (*Sea Box*), can submit a below price on a fixed price contract (*NJVC, B410035*) and questions about whether a contractor can perform when it submits a below cost offer is a matter of responsibility (*JCMCS, B409407*). An agency's price realism analysis did not show the proposed prices were either unrealistic or demonstrated a lack of understanding of performance requirements (*Booze Allen Hamilton, B409250*). However, the protester failed to provide an adequate explanation how it would achieve its low rates and high discounts without impairing performance (*Alamo City*),

Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals where agencies have broad discretion in the selection of evaluation criteria and the GAO will not object if they are reasonably related to the agency's needs (*SEK Sltns, B-406939*). Though agencies must disclose evaluation criteria and their relative importance they need not state the rating method to be used (*Mgt System, B-409415*). There is a difference between undisclosed evaluation methodologies and unstated evaluation criteria where an agency can rely on the former as long as the methodology provides a rational basis for source selection (*Bonner Analytical Test, B409582*) but it is clear that offerers must be advised of the bases upon which their proposals will be evaluated (*AeroSage, B-409627*).

Several criteria for proper evaluation of proposals have been established:

1. Agencies must treat all offerors *equally* and evaluate their proposals *evenhandedly* against the solicitations requirements and evaluation criteria (*Bahrain)*.
While source selection official may disagree about ratings and lower level evaluations they are required to have their independent judgments be reasonable, consistent

with evaluation factors and adequately documented (*Aplus Tech., B 408551*).

2. Agencies must consider *cost or price* in evaluating competing proposals (*Constellation NewEnergy, B-409353*). Several protests were sustained when there was no evidence the agency meaningfully considered cost or pricing even though price was of less importance than nonprice factors.

3. 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 non-responsible (FAR 9.104). Normally, the courts will not disturb a responsibility determination unless the protester can show the agency had no reasonable basis for its determination (*Communication Constr. Svcs., v US*).

- **Past Performance**

Past performance is one evaluation factor that must be considered in all negotiated procurements. FAR 15-306(b)(1)(i) and (d)(3) provides for discussions in negotiated procurements and gives offerors the opportunity to clarify adverse past performance information (PPI) *(Erickson Helicopters, B409003*) while awards without discussions in FAR 15.306(a)(2) provides that offerors *may* be given the opportunity to clarify adverse PPI. Significant pas performance considerations include:

1. Agencies are not required to request clarifications of PPI when awards are not made without discussions *(iGov, B-408128*).

2. An agency has broad discretion to determine the relevance and scope of an offeror's PP history and the Courts will not substitute its judgment for that of the agency *(Global Integrative Sec., B-408916*).

3. It is the contractor's responsibility to provide sufficient evidence to establish its performance history (*West Sound Svcs, B-406583*).

4. An agency may properly attribute the experience or PP of a parent or affiliated company to an offeror where the firm's proposal demonstrated the resources of the parent or affiliate will affect performance (*West Sound*). Unless prohibited by the solicitation agency may properly consider the PP of offerors' proposed subcontractors (*United Facilities, B408749*) as well as joint venture partners of awardee joint venture (*Raytheon, B-409651*).

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 (*Lewis-Price & Assocs., B-409851*). 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 (*Metal Craft Marine, B-410499*). Agency's decision to allow revised proposals to evaluate the offerors' most up-to-date information does not constitute discussions (*CliniComp Intn'l, v US*). Communications requesting an offeror confirm what it had already confirmed in its proposal, questions that did not allow for revisions of proposals (*IAP-Leonardo, B408890*), allow offeror to explain an aspect of the proposal that was vague (*L & G Tech Svcs, B-408080*) or allow agency to facilitate its understanding of how protester presented its pricing (*Windstream Communications, B-408258*) were all considered to be clarifications, not discussions. An agency may not hold discussions with one offeror withhold offering a similar opportunity to all other offerors (*Marathon Medical, B 408052*). There is no requirement for all areas of a proposal having a competitive impact be discussed, only significant weaknesses or deficiencies (*Nuclear Production, B407944*). Discussion of a neutral past performance rating (*Wolf Creek Fed. Svcs, B-409187*) or number of guard posts in protester's experience (*Paragon Systems, B-409066*) were not considered significant. Also, discussions must be meaningful, equitable and not misleading and must address deficiencies and significant weaknesses in offeror's proposal that can reasonably be addressed in a manner to enhance the offeror's potential for receiving an award (*Epsilon Systems Sltns, B409720).* The GAO found that agency's discussions were not meaningful when despite several rounds of discussion it did not address the one requirement the firm's quote did not meet (*Kardex Remstar, B409030*) and overall staffing was identified to be a weakness but not specific areas in which staffing was insufficient (*Native Resources Devel. Co., B409617*). However, discussions were considered meaningful where discussions did lead protester into areas of its proposal that needed correction (*CEdge Software Consultants v US*) or request for more information of pricing was made (*Dyncorp Intn;l, B-406523*), Also, agencies have no requirement to conduct discussions

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in competitive Federal Supply Schedule or task order procurements but when they are held the GAO will review proper standards were adhered to (*Kardex*).

Costs

Termination Settlement Costs. The T for C clause at FAR 52.249-2 requires a contractor to file a termination settlement proposal within one year of a termination. A T for C 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. The contractor that has been terminated for convenience is entitled to be reimbursed for the costs related to price changes, constructive changes, suspensions of work, differing site conditions, defective specifications and even some work that might not have been complied with in a respects of a contract (*ACM Constr & Marine Group, CBCA No. 2245*). The Board ruled on general guidance that the contractor is not limited to a percentage of the physical work performed prior to termination but to work fairly performed and preparations made for the termination portion of the contract (*ACM*) and for work in preparation for a commercial item contract as well as settlement costs (*SVVIt, ASBCA No. 56708*)..

Contract Administration Costs. The courts have long distinguished between unallowable costs related to prosecuting claims and allowable costs of contract administration where costs related to negotiating a resolution of a problem during contract performance are allowable where if they are incurred to begin the process of litigating a claim they are unallowable. The court ruled the contractor can recover costs of preparing requests for equitable adjustments since they were prepared in furtherance of resolution through negotiation (*Moshe Safdie & Assocs, v. GSA. CBCA No. 1849*). However costs are not recoverable where they are incurred to prosecute a claim (*Amaratek, ASBCA 59149*).

Cost Accounting Standards. The Court ruled that Sikorsky's use of a direct labor base to allocate material overhead costs complied with CAS 418-50(e) and was an acceptable means of measuring the resources consumed as required by CAS 418-50(e) (*Sikorsky Aircraft v US*). The ASBCA dismissed a CAS non-compliance claim against a joint venture partner as "legal nullity" because the joint venture and not its partners was the named contractor (*Worley Parsons Intl, ASBCA No. 57930*).

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