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PRESENTING A CLAIM

(Editor's Note. Proper presentation of a claim is about a contractor's only method of obtaining a price increase on a fixed price contract. This is the last installment of four articles on claims where the other articles included discussions on what is a constructive change, express changes and delays and how to quantify them. We have relied on numerous articles and texts, especially those written by Carl Vacketta of the law firm of Piper & Marbury L.L.P. and our own experience preparing claims for clients).

Whether it is for an express or constructive change, a contractor cannot obtain an equitable price adjustment until it submits a well prepared claim. Under an express change, the change is normally ordered by the government and the government and contractor reach an understanding about the scope of the change and its effect by relating information to the change. When an express order is issued and the understanding is achieved, the contractor begins work.

When the change is constructive or the result of a delay the work has usually already been performed so the government may be less motivated to reach an acceptable understanding. The facts, their justification and documentation of the added costs must be carefully presented to a party who may be less than receptive. The following is intended to provide some general yet useful advice in preparing and presenting the claim.

Proper preparation involves several steps including analyzing the contract, investigating the facts, determining whether the government or contractor is responsible, preparing the actual claim and negotiating a settlement with the government.

♦ Analyzing the Contract

Since relevant parts of the contract will be cited, the contractor should identify the parts of the contract that provides for an equitable adjustment or an extension in the case of a delay. Contract requirements such as scope of performance should be identified and all relevant contract clauses allowing for equitable adjustments. "Contract" refers to those papers that collectively contain the parties' agreement. For Invitation for Bids, the contract is the invitation for bid that will include prices submitted by the contractor. When the contract results from a Request for Proposal, the contract is the request for proposal and the contractor's proposal that is expressly made part of the contract. The contract consists only of those documents that are physically contained in the contract package or are expressly referenced by the contract (e.g. terms of conditions). The contract usually includes only documents existing at the time the contract was awarded and except for formal contract changes, does not include items prepared at a later date.

♦ Investigating the Facts

Next it will become necessary to identify in what ways actual performance exceeded the contract requirements. It is quite common to reconstruct the events that took place earlier usually in the form of a detailed chronology.

There are two approaches identifying the existence of a constructive change: (1) identifying specific events, whether they be a problem or government action that caused the expanded work or (2) a comparison of bid price to the actual cost of performance measured by dollars, man-hours, units of material, etc. The second approach compares the costs bid for the contract to the costs actually spent performing. It is usually used when the contractor has identified the existence of overruns in the performance of contract work but not necessarily the specific events causing the overrun. The contractor can identify the areas of cost increases to pinpoint their causes and then determine whether those causes are the responsibility of the government. This approach can be time consuming and contractors often uses a team approach using people in different parts of the organization such as engineering, production, contract administration and quality assurance. Accountants and lawyers often review the results to determine who is responsible and to better quantify the impact.

Factual analysis should consider at least seven areas of data:

1. *Comparing "as bid" with "as built" drawing.* Comparing government-furnished contract drawings with detailed performance drawings will disclose any changes or dissimilarities between the as bid and as-built design. Investigation into the reasons for these differences should reveal the action or non-action of the government. For example, as built drawings often are a result of contractors' engineering documents that reveal additions, deletions or changes which often state the reasons for the changes.

2. *Reviewing technical specifications.* All technical specifications furnished by the government should be reviewed for inaccuracies, discrepancies and ambiguities. If the specifications are defective or impossible in any part, they may provide a basis for asserting a claim.

3. *Comparing the bid labor and materials with actuals.* When developing a bid, the contractor generally prepares estimates of labor and material costs even if they are not provided to government personnel. These estimates should be compared with actuals to quickly reveal high dollar problems of performing the contract.

4. *Reviewing purchase orders.* Purchase orders, vendor invoices and subcontracts should be compared with material quotes and subcontractor proposals that were obtained during the bidding process. Large difference need to be investigated. Correspondences between the contractor and their subcontractors and vendors should be reviewed to identify price, quantity or other modifications that may point to constructive changes.

5. *Reviewing correspondence, reports, memoranda and scheduling records.* Since personnel change frequently and memories shorten over time, a review of contract correspondence and other memos frequently provide performance problems that may provide the basis of a claim and represent good documentation. This data may be in files of contract administrators, plant managers, program managers, senior engineers, quality control managers, etc. For defense contracts, the government lists on a DD Form 1423 all technical data delivered to the contractor and this should be examined to identify other documents worth examining. In addition, there may be useful information in internal correspondences where, for example, program or production managers had to explain why budgets were not being met or other meeting minutes between job personnel.

6. *Reviewing records of quality assurance.* Correspondence concerning inspection matters and government actions in approving an inspection, quality control system or monitoring the contractor's own inspections and tests may give rise to claims. For example, when the government rejects certain work, it may be requiring a higher standard than called for in the contract.

7. *Interviewing knowledgeable people.* Interviewing knowledgeable people involved in contract performance will often highlight problems in performing the contract. It is usually advisable to interview in groups so additional ideas can be sparked from hearing someone else.

♦ Determining Who is Responsible

After a factual investigation has determined what cost increases have occurred because of work performed in excess of contract requirements or how work was delayed, the contractor needs to determine who is responsible. This analysis should be made or at least reviewed by an attorney knowledgeable in government contract law.

♦ Preparing and Submitting the Claim

A soon as a decision has been made to submit a claim, a contractor should give the government notice of their intent to file a claim. Such notice is commonly a short one or two paragraph note identifying (1) government action resulting in a change (2) indication the contractor considers this action an increase in scope (3) reminder of what the original contract requirements were (4) what the additional work will require under an express change (e.g. number of days of delay or increased cost of performance) and notice that supporting data will be submitted after completion of the work. Most clauses that grant adjustments require that timely written notice be made (FAR 52.243-1 to 52.243-7). The time requirements vary by clauses but many set short time limits. For example the standard changes clause in supply contracts under an express change order require a contractor to assert its right to an adjustment within 30 days of the receipt of a written order. Notice of a constructive change is ordinarily on time if it is made before final contract payment.

There is no prescribed form for a claim. If the matter is simple a short letter may suffice while more complicated justification and costs matters will require a more detailed submission. Whatever its length, the claim is logically divided into a five-section format.

Section 1. Summary of Claim. This is best left until the other documentation has been assembled. It should state the nature of the claim and the essential facts on which it is based.

Section 2. Contract Requirements. This section should specify the relevant contract requirements in order to establish the limits of the contract beyond which the contractor was not required to perform without additional compensation. This section should cite the terms of the contract and interpret their meaning. If available, citing case law may be effective.

Section 3. Specify the Additional Work (or for a delay, the work the contractor was unable to do). This section is intended to contrast the contract requirements identified in Section 2 with the government conduct that created the claim. It should refer to all supporting factual documentation such as correspondence, inspection reports, memos, etc. and they should be appended to the claim.

Section 4. Detail the Extra Work. The fourth section should detail and quantify the extra or changed work the contractor was required to perform as a result of the government's action. It should provide the factual support for the dollar values computed in Section 5 and should attempt to convince the CO the dollar amounts contained in Section 5 reasonably reflect the actual costs incurred as a result of the government action.

Section 5. Summary of Pricing the Claim. This should be a brief summary of the pricing of the claim which should be broken down into elements of increased labor and material costs, overhead and reasonable profit. The level of detail to append to this section is a judgement call – detail back up to the price summary can be persuasive yet too much may raise a red flag resulting in a request for a detailed audit that might not otherwise be sought. *(See GCA DIGEST Vol.2, No.2 for a discussion of methods used to quantify the claim.)*

♦ Certifying the Claim

The Federal Acquisition Streamlining Act of 1994 increased the dollar threshold for certifying contractor claims submitted under the Contract Disputes Act from $50,000 to $100,000. For claims exceeding $100,000, contractors are required to certify: (1) the claim is made in good faith (2) the supporting data is complete and accurate to the best of the contractor's knowledge and belief (3) the amount claimed accurately reflects the contract adjustment for which the contractor believes the government is liable and (4) the certifier is duly authorized to certify the claim on behalf of the contractor.

♦ The Government's Evaluation and Negotiation

The contracting officer may ask for additional supporting data and the contractor should provide it promptly and completely. The CO has 60 days to issue a final decision or provide a date when the decision will be made. The CO will rely on the advice of its technical, accounting and legal advisors. An audit is not always performed but one will often be performed if the CO is persuaded the claim has some merit. After the CO's review of the claim, formal negotiations with the contractor will begin. It is recommended that full effort to settle the claim be made at the CO level because court decisions have ruled other government personnel lacked authority to bind the government. If negotiations do not produce an agreement, a final decision should be requested from the CO so an appeal may be filed.

CURRENT RULES ON TRAVEL COSTS

(Editor's Note. We have reported on numerous proposed and actual changes to travel costs in the GCA REPORT. Some changes were proposed and withdrawn while other were passed, leaving many contractors confused over current rules. The following is a summary of the current status of the general rules. It is based on numerous articles and texts we have come across as well as well as our experience as government contract specialists.)

Costs related to transportation, lodging, subsistence and incidental expenses that are incurred by employees for travelling on business are generally allowable subject to limitations on first class air fare, "reasonableness" standards and on a daily basis, do not exceed per diem rates set forth in the Federal Travel Regulations, Joint Travel Regulations or Standardized Regulations. Costs incurred for the overall administration of the business or in support of more than one contract are allowable indirect costs while travel costs directly attributable to performance of one contract may be charged directly to a given contract.

Per Diem. Per diem rates applied to government contractors combine meals and lodging rates into one and are available on the web at www.policyworks.gov/perdiem. Per diem rate issues raised in recent times have been settled in the following ways: costs may be based on actual cost incurred, on rates such as per diem and mileage rates or a combination of actual costs incurred and rates. In determining which location limitation to use, most contractors use the location of the lodging rather than the business location. The per diem rates are to be applied on a daily basis not on an overall trip basis. Car rental costs are not included in the per diem rates except if the car is used for transportation to and from meals as opposed to travel to the work site.

"Reasonable" vs. JRT rates. In the Federal Acquisition Streamlining Act of 1994, Congress repealed the requirement that per diem costs be limited by the government travel regulations and substituted a "fair and reasonable" cost criteria. However, the following regulations did not provide any practical way of determining what was fair and reasonable so rates in the travel regulations became the objective way of making this determination. In 1999 a proposed rule to return to the "fair and reasonable" cost criteria was put forth but as of this writing the rule has been rejected on the grounds that use of different criteria for government contractor employees would result in unequal rates for government and contractor employees.

Room Taxes. Beginning January 1, 1999, application of the JTR changed by excluding any room taxes from the per diem amounts. Federal employees had been able to claim the room taxes as a separate expense in addition to the per diem rates and the change made the room tax exclusion applicable to government contractors. Alternatively, DOD and NASA issued blanket deviations that permitted contractors to retain 1998 per diem rates as well as previous definitions to allow contractors time to modify their cost accounting and administrative systems to accommodate the new rules.

Documentation. In 1996 the cost rules were amended to require contractors to provide the following information related to travel costs: (1) date and place where costs were incurred (2) purpose of the trip and (3) names of the individuals incurring travel costs as well as their relationship to the contractor. Requirements for receipts of expenditures should follow the contractor's established policies. With the exception of lodging expenses, where receipts are needed, requirements to provide receipts follow internal revenue service rules that limit the need to provide receipts for expenditures over $75.

Airfares. Air fares in excess of the lowest customary standard, coach or equivalent airfare during normal business hours are usually unallowable unless necessary to meet business requirements. Exceptions commonly accepted are if cheaper fares result in circuitous routing, travel during unreasonable hours, excessively prolonged travel, increased costs that offset transportation savings or accommodations that are not reasonably adequate for a traveler's physical or medical needs. We are seeing an increase in government auditors questioning even coach fares that do not take advantage of various airline offers such advance purchases, weekend layovers, off-peak flights, etc. Contractors should be prepared to convince the government that reasonable efforts were made to obtain the lowest possible fare at the time the reservations were made (e.g. a standing order with travel agents used to book the lowest fare available). Members of Congress have attempted to force a rule that limits contractor air fares to those available to the government through its contract with airlines but government agencies have resisted such efforts because there is no way to force airlines to extend the government rates to the commercial market.

In 1998 there was a proposal to place specific criteria on when business class travel is allowable but that was withdrawn. Business class airfares are allowable if customary and normal for the circumstances such as intercontinental flights. Contractors often find interesting ways to make sure employees are allowed to travel in ways consistent with reasonable business practices. For example, in *Data-Design Laboratories*, the government denied the differential for first class air fare for executives while the contractor stated security requirements justified the first class travel. To circumvent the disallowance, the contractor paid its employees for business travel conducted during non-working hours with the intention of permitting employees to purchase a first class upgrade with the payment. Though the government objected to this practice, the appeals board rejected their position stating the added payments were insignificant and employees' compensation had to be evaluated in their totality. The Board concluded the payments were applied consistently in accordance with established policies and the contractor benefited by employees travelling during non-work hours. Unfortunately, there is no consistent guidance auditors follow so what is considered perfectly acceptable by some offices and even individual auditors is frequently questioned by other offices or even other auditors in the same office. Unreasonable assertions should be challenged and taken up with auditors' supervisors and then the branch manager.

Limited Applicability of FTR. In the mid-1990s a FAR revision was published to clarify aspects of the travel rules. First, only three portions of the government travel regulation were incorporated into the FAR: (1) maximum per diem rates (2) definitions of lodging, meals and incidental expenses and (3) coverage of special or unusual situations that allow deviations from the maximum per diem amounts. The clarification was considered necessary because government representatives often attempted to apply other portions of the FTR to contractors. The second part of the revision established that for partial travel days it is not reasonable for the government to pay full per diem amounts. Contractors were permitted to establish their own rules for partial day travel with the condition that the full amount would not be acceptable.

Special Circumstances. Higher costs than the published lodging and per diem rates are allowable under special circumstances as long as they do not exceed the amounts permitted to federal employees. These higher amounts cannot exceed 300 percent of the per diem rate. The special circumstances cited by the federal regulations include: (1) if lodging and meals must be obtained at a prearranged meeting site for which the costs absorb most of the daily allowance (2) if short-term conditions such as a world's fair, convention or natural disaster cause higher costs or (2) if a superior or extraordinary accommodation is necessary due to the work assignment such as a meeting space. A responsible contractor official must approve any deviations and if they are frequent at a given location, advanced approval by the CO must be obtained.

Frequent Flyer Benefits. Though executive branch employees are prohibited from retaining frequent flyer benefits, most companies permit frequent flyer benefits for personal use. Though there have been occasional proposals to reduce reimbursement no such limitation currently exists. Government auditors frequently ask contractors to have a stated policy on these benefits – if the policy requires employees to relinquish frequent flyer benefits to the company they will insist the policy be enforced but a policy permitting employees to retain the benefits will not be challenged.

♦ Government Auditor Guidelines

If travel costs are significant, auditors are instructed to review procedures related to travel and select a sample of expense reports to review. Procedures examined should include instructions detailing that authorization and approval of the trip is made, the duration of the trip and number of travelers involved. The procedures should provide that advanced planning of travel is made to assure (1) required visits to the same geographic area are combined into a single trip (2) maximum use is made of the lowest customary standard, coach or equivalent during business hours and (3) coordination between organizational units are made to minimize the number of trips.

Auditors are told to review a sample of individual trips to determine if (1) the contractor is complying with its travel policies and procedures (2) the trip is for an allowable purpose and (3) the incurred travel costs are documented in accordance with FAR 31.205-46. The auditor is also to review the contractor's accounting procedures to determine whether they provide adequate controls for segregating unallowable travel costs (e.g. internal review of expense reports, accounts for unallowable costs). For individual trips reviewed, the auditor will determine if required information exists such as (1) date and place of the expense (city, town, etc.) (2) purpose of the trip and (3) name of person on trip and that person's title or relationship to the contractor. They are told that such information may be obtained from a book, diary, account book or expense report along with cancelled checks, credit card receipts and hotel billing.

FEDERAL INCOME TAXES CONCERNS OF GOVERNMENT CONTRACTORS

(Editor's Note. Though we generally focus on cost, pricing and contract issues, we decided to address some basic financial reporting and now tax issues commonly faced by government contractors since many of our readers are finance and accounting specialists. This article is intended to touch on some common tax issues and should not be considered a substitute for qualified tax advice. It is based on an article by Graig Langstraat, a professor of accountancy and taxation at the University of Memphis in the Mathew Bender "Accounting for Government Contracts" text.)

The accounting method selected for tax purposes usually has a significant impact. The general rule is that taxable income should be computed using the same method used for keeping contractors' books. The purpose of this requirement is to enable the Internal Revenue auditors to examine the contractor's books and records directly to find support for the numbers on the tax return. Different methods may be used if the contractor's books and records are kept consistently with the tax method used in which case the books need to be adjusted to prepare financial statements.

Under the cash method, items of gross income are recognized only upon actual or constructive receipt while deductions for expenses are taken only when actual payment is made. The cash method has the advantage of allowing contractors to control income and deductions by timing receipts and payment. Under the accrual method, income and deductions are recognized in accordance with an "all events" test. When all the events necessary to fix the right to income or establish the existence of a liability have occurred and the amounts can be determined with reasonable accuracy income or expenses are recognized.

Unfortunately, many government contractors cannot use the cash method because (1) books and records need to follow the accrual not cash method to be consistent with generally accepted accounting principles (2) when contractors have inventory, the accrual method needs to be used (3) the Tax Reform Act of 1986 requires regular corporations (not S corporations), partnerships with regular corporations as partners and tax shelters to use the accrual method. Exceptions (cash method is allowed) are for qualified personal service corporations (i.e. consulting, law and accounting) and entities having less than $5 million in the prior three years.

Long Term Contracts

Whether the cash or accrual method is used, IRC Section 460 provides for special treatments for long term contracts *(see GCA DIGEST Vol. 2, No. 1 for a discussion of financial accounting treatment of long term contracts)*. The statute defines a long term contract as "any contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable year in which such contract is entered into." Note the definition is not that the contract must take over a year to complete but simply the contract must begin and end in different taxable years. For manufacturing contracts there is one other requirement – either items produced must be unique and of a type not usually carried in the contractor's finished goods inventory or they are items that are not normally completed in 12 months or less.

Recent changes to the tax laws allow for the completed contract method only under very limited circumstances - general construction contracts estimated to be completed within two years from commencement as long as the annual gross receipts of the firm did not exceed $10 million over the three preceding tax years or home construction contracts if at least 80 percent of the total contract costs relate to buildings containing four or fewer dwellings. Otherwise the percentage-of-completion method is used where income or loss on long-term contracts are based on annual evaluations of the cumulative progress made on the contracts. Early recognition of income before actual completion of the contract is usually disadvantageous for tax purposes since it means the contractor must pay taxes on income sooner. Of course, it can be advantageous if the income can be used to offset losses on other contracts or the calculated loss can offset income on other contracts.

The gross income to be recognized for tax purposes in any taxable year under the percentage-of-completion method equals the estimated percentage of completion of the contract times the gross contract price (unreduced for any retainages, holdbacks or payment considerations). The percentage of completion of the contract is determined by comparing costs allocated to the contract that are incurred before the end of the tax year with the estimated total contract costs. Taxes rule changes in 1989 allow taxpayers to elect non-recognition of any income in the first year on a long-term contract if less than 10 percent of the total contract costs have been incurred.

Though gross income is estimated and recognized over the life of the contract, expenses can be deducted only in the taxable year they are incurred under either the accrual or cash method. In addition some expenses are disallowed such as material and supplies on hand at year's end and deductive costs associated with guarantees, warranties and maintenance and service contracts.

♦ Look-Back Method

Rather than revise estimates to complete when estimates of total contract costs change, the government now offers a new method called the look back method. Now actual contract price and costs, rather than revised estimates on contract price and costs, may be used on all years prior to completion year and any additional tax or tax refund that would have been due in the earlier years is subject to an interest payment by the taxpayer or government at the prevailing government rate for overpayments.

As an illustration: assume $200,000 was incurred the first year of a $1 million contract expected to have a cost of $800,000 then $250,000 ($200,000/$800,000 or 25% of $1 million) was declared as income. If actually costs are $600,000 then $333,333 of income should have been claimed the first year ($200,000/ $600,000 or 33% of $1 million). Then the contractor would owe interest on the higher income of $83,333 ($333,000-$250,000) for the first year as well as any other years the income was understated.

Recent changes have lessened the impact: (1) for partnerships and S corporations the look back method does not apply. When contracts are completed within two years and the contract gross price either does not exceed the lesser of $1 million or 1 percent of the contractor's average gross receipts for the past three tax years or (2) the taxpayer may elect not to apply the look-back method if the income (loss) reported each year of the long-term contract period is within 10% of the recomputed income for each year or the total reported income for the entire completed contract is within 10% of the recomputed income.

♦ Allocation of Costs

The amount of expenses claimed on long term contracts depends on the accounting method used to allocate costs. Direct costs defined in IRC Section 451 defines direct material and labor costs. Direct material includes material that is an integral part of the contract as well as materials consumed in the ordinary course of completing the items. Direct labor includes regular pay, overtime, vacation and holiday pay, sick leave, overtime payroll taxes and unemployment insurance. Indirect costs rules are similar to those encountered by government contractors and are considered those "incident to and necessary for" performance of the contract. Certain costs are required to be included such as indirect labor, rework, research, indirect materials, rent and repair. Other costs are optional such as marketing, G&A expenses, income taxes and interest. Indirect costs should be allocated to long term contracts using either (1) a specific identification method that might use a separate set of accounts or (2) burden rates based on computed ratios of direct and indirect costs. For those firms using the completed cost method, less costs are allowed to be allocated as indirect costs resulting in fewer current deductions.

Special Income Recognition Problems

♦ Retentions, Advance Payments and Progress Payments

Retentions (amounts withheld by the government pending final acceptance) are generally not included in income until the contractor has a right to them under the accrual method. Under the cash method, there is no recognized income until actual receipt. For long term contracts, recognition rules discussed above apply. *Progress payments* and *advanced payments* are most common on long term contracts. It is to the contractor's advantage to use the percent-of-completion method when progress or advanced payments are made so that income recognition does not have to be triggered upon the mere receipt of those payments.

♦ Research and Development Deductions

IRC Section 174 governs research and development (R&D) expenditures. Qualifying R&D are those R&D cost commonly used in the experimental or laboratory sense (e.g. new product development) where examples include cost of developing or improving an item, process, technique, formula or invention or obtaining a patent and both in-house and purchased costs qualify. One of two options for deducting R&D costs can be used: (1) deduct R&D expenditures as they are paid or incurred (depending whether a contractor uses the cash or accrual method) or (2) defer the costs and amortize them over a period not less than 60 months, beginning with the first month the taxpayer benefits from the expenditure (e.g. sells the first units of the item). The first method reduces current tax liability while the second is advantageous if the contractor is not in a taxable position or expects to be in a higher one later. Either option must be identified on a tax return and is binding on future taxable years. It is, of course, possible to have different amortization periods for different R&D projects.

Changes to the tax laws provide that R&D expense incurred in a tax year be reduced by the amount of the R&D tax credit (discussed below).

♦ Research and Development Credit

A credit is available at the rate of 20 percent of the excess of qualified research expenses for a taxable year over a base amount as well as for 20 percent of certain basic research payments. Other than for basis research, only the increased level of research activities generates the credit. The base amount is determined by multiplying the taxpayer's fixed-base percentage by the average annual gross receipts of the taxpayer for the prior four years. Example:

	Qualified Research Expense	Receipts
19X1	250,000	2,500,000
19X2	200,000	2,500,000
19X3	250,000	2,000,000
19X4	300,000	3,000,000
Total	1,000,000	10,000,000

Fixed Rate Percentage =
$1,000,000 divided by $10,000,000 = 10%

If the average annual gross receipts for the last four tax years is $2,500,000 the base amount is $250,000 ($2,500,000 times 10%). If the next years qualified R&D expenditure is $350,000 the incremental credit is $20,000 (20% X {$350,000 - $250,000}). Any unused amount may be carried back one year or forward 20 years.

In addition the taxpayer is eligible for a 20 percent research credit for basic research payments that are considered funding research for the advancement of scientific knowledge without a specific commercial objective. To qualify, it (1) must be paid in cash under a written agreement by a regular corporation (S corporations do not qualify) and (2) must be performed or controlled by a qualified outside organization (e.g. university, nonprofit scientific research organization).

Certain types of research are excluded form entitlement to the credit such as research related to style or cosmetics, beginning of commercial production, the social sciences or arts and research funded by another contractor.

♦ Purchased "Know-How"

Patents and computer software that are assets of a transaction where the assets of another business were acquired are considered a Section 197 intangible and may be amortized for tax purposes ratably over a 15 year period beginning in the month the intangible is acquired. If a patent is not subject to section 197 then the purchase price is amortized over the statutory 17 year life of a patent minus elapsed time at the purchase price. For computer software, non-Section 197 intangibles are written off over 36 months unless it is not separately stated from the cost of hardware in which case it is treated as costs of the computer hardware. If the non-Section 197 patent becomes worthless the un-amortized cost may be deducted in the taxable year in which it becomes worthless. Consideration of dispositions of assets and recognition of gains and losses are too detailed to discuss here but can be found in IRC Sections 1235 and 1221.

SMALL BUSINESS

(Editor's Note. Since there are numerous recent efforts to expand awards to small businesses we thought it would be a good time to review some of the rules affecting small business opportunities. An understanding of rules for contracting with small business is important not only for small businesses pursuing government business but also large businesses because they must establish subcontracting goals and often compete against or team with small businesses. In this second of two articles, we focus on (1) Certificates of Competency by the Small Business Administration (SBA) (2) protections against bundling and (3) eligibility requirements for the most common SBA programs. We have relied on a recent two part series in the October and November 1999 issues of Briefing Papers written by Stephen Ruscus of McKenna & Cuneo, L.L.P.)

Certificates of Competency

In addition to receiving award preferences, small businesses are granted special procedures for meeting responsibility determinations required before an award is made. To be deemed responsible all contractors, small or large, must meet the following qualifications: (1) adequate financial resources to perform (2) ability to meet delivery or performance schedules (3) satisfactory performance record (4) satisfactory record of integrity and business ethics (5) necessary organization, experience, accounting, operations controls and technical skills or ability to acquire them (6) necessary production, construction and technical equipment and facilities or ability to acquire them and (7) not prohibited under applicable laws and regulations. Normally a CO makes the final determination as to a firm's responsibility but a small business has the right to have the SBA make the final determination of responsibility if the CO's negative judgment would result in not receiving an award. The SBA does so by issuing a Certificate of Competency (COC) stating the holder is responsible for the purpose of receiving and performing a specific government contract.

If a Contracting Officer determines a small business otherwise eligible to receive an award lacks certain elements of responsibility the CO must withhold contract award and refer the matter to the cognizant SBA area office. The burden is on the offeror to apply for a COC. Upon receipt of a referral from the CO, the SBA has 15 business days (longer if CO and SBA agree) to inform the small business of the Contracting Officer's determination and offer it an opportunity to apply to the SBA for a COC. The Contracting Officer must proceed with award to another offeror if the SBA has not issued the COC within 15 days or longer if CO and SBA agree. If the SBA notifies the agency of its intent to issue a COC outside of the 15 day period and an award has not yet been made, the agency must award the contract to the COC applicant. The COC procedures do not apply to an agency's decision that (1) certain technical requirements are necessary (2) the offer is not technically acceptable (3) the bid is non-responsive or (4) an agency is deciding whether an offer is within the competitive range for negotiated procurements even though some factors may relate to responsibility. Unless there is clear fraud or bad faith, most protests of SBA's denial of responsibility are not successful.

Contract Bundling

"Contract bundling" describes the practice of combining several small government contracts into large ones and has expanded in the form of government-wide acquisitions of goods and services. Contract bundling is usually defended as a means to obtain economies of scale and improve contract management. Such actions may achieve these goals but still inhibit competition because fewer contractors can bid for such larger contracts forcing smaller firms to not compete or providing their services as subcontractors to a large business. In response, Congress passed the Small Business Reauthorization Act requiring agencies to justify contract bundling.

The statue requires agencies to conduct market research before proceeding with a strategy that can result in bundling. Five factors must be considered in its analyses: (1) cost savings (2) quality improvement (3) reduction in acquisition cycle time (4) better terms and conditions and (5) other benefits. If the agency head determines an acquisition strategy will result in substantial bundling, it must identify the benefits, impediments to prime contracting by small businesses and specific actions to be taken to maximize small business participation.

The decision to bundle two or more prior procurements into one must justify its decision and show that it is "unsuitable" to award to a small business. Unsuitability can result from a contract's diversity, size, specialized nature, dollar value, geographical coverage or any combination of these factors. In addition the agency must justify its decision by identifying sufficient dollar benefits. Sufficient cost savings are considered 10% for a contract valued at less than $75 million and 5% for a contract over $75 million. A reduction in administration costs alone will not be sufficient to justify bundling.

The new rules provide two means to assist small businesses to obtain work under bundled contracts. First, if the procurement offers significant opportunities for subcontracting the agency must make this an important factor in evaluating offers. The evaluation will include both the offeror's proposed rate of subcontracting to small businesses and the offeror's past performance in meeting subcontractor goals in other contracts. An offeror who is a small business will automatically receive the highest possible score. Second, two or more small businesses may submit an offer as a joint venture without regard to affiliation rules. By qualifying as a small business, the joint venture is exempt from subcontracting requirements but still receives the highest possible score for subcontracting.

Eligibility for Major SBA Programs

No discussion of opportunities for small businesses would be complete without a brief discussion of eligibility of some of the significant special programs – namely the 8(a), small disadvantaged and new HUBZone program (discussed in detail in GCA DIGEST Vol. 1, No. 4).

♦ 8(a) Program

Restricted to small businesses owned and controlled by socially and economically disadvantaged individuals, economically disadvantaged Indian tribes and economically disadvantaged Native Hawaiian organizations. The SBA regulations contain extensive definitions of these individuals. For example: Black, Hispanic and Native (including American Indians, Eskimos, Aleuts or Native Hawaiians) Americans are classified as "socially disadvantaged" where other individuals must establish they are socially disadvantaged by a "preponderance of the evidence" and must show (1) one objective distinguishing feature that has contributed to social disadvantage (2) personal experience of a substantial and chronic social disadvantage and (3) negative impact on entry into or advancement in the business world.

In addition, applicants are ineligible if the net worth of the individual upon whom eligibility is based exceeds $250,000, excluding personal residence and ownership interest in the business. Also the firm must have been in operation for two years in its primary industry classification before acceptance into the program and must possess potential for success based upon such factors as financial capability and record of performance. Rules preventing potential abuse include: (1) financial statements of spouses of applicant must be included in application (2) once accepted, the net worth of the individual must continue to be less than $750,000 during the period in the program (3) applicant or other socially disadvantaged individuals must unconditionally own 51% of the business and they must not own more than 20% equity ownership of any other 8(a) concern (4) the business must be managed by a disadvantaged individual who has either managed or has technical competency in the applicable industry (5) eligibility may be used only once where neither the firm or individual can re-enter the 8(a) program and (6) new owners must also be socially disadvantaged and new participants will require SBA approval for the firm. Extensive penalties including jail terms and fines, may be imposed if you misrepresent your firm's status.

If accepted, a firm may remain in the 8(a) program for nine years. During the first four years, the firm must make all reasonable efforts to attain a targeted dollar level of non-8(a) revenue while in the last five years, it must achieve non-8(a) revenue ranging from 15% in year five to 55% in year nine.

♦ Small Disadvantaged Business

To qualify for SDB preferences, your firm must be certified by the SBA. Self certification is not longer available. The qualifications for SDB status are almost identical to the 8(a) program qualifications except the limit on total net worth for the entry is higher (less than $750,000 compared with the $250,000 limit for the 8(a) program) and there is no requirement for SDB applicants to demonstrate potential for success.

♦ Veteran and Women-Owned

Both women-owned small businesses and businesses owned by veterans, especially service-disabled veterans, have benefited from recent legislation where contract and subcontract awards are to be made to the "maximum practicable opportunity." No set-aside programs are currently in place but the government has set a goal of 3% of its contracts and subcontracts awarded to small businesses be made to firms owned and controlled by service-disabled veterans and 5% of the total value of federal contracts and subcontracts to women-owned small businesses.

RECENT DECISIONS ON COST AND PRICING ISSUES

(Editor's Note. Since the practical meaning of most regulations are what the appeals boards and courts say they are the following are the important decisions during the last year affecting cost and pricing issues. Though some of the decisions have been reported in the GCA REPORT, we believe it is worth some risk of repetition. This article is based on the January 2000 issue of Briefing Papers written by Marshall Doke, William Whitehill and Neil Cannon of the law firm Gardere & Wynne, L.L.P. We have included the name of the case so additional research can be made. We intend to present recent decisions affecting contracting issues later.)

♦ Bids

Below Cost Bidding. There is no prohibition against submitting a *below-cost* bid or proposal for a fixed-price contract (*K.G. Inc. and Ventura Petroleum Servs.*). Even if a bidder bases its price on rates below those specified in a wage determination the bidder is still eligible for award as long as the Service Contract Act wages are not violated. Though protesters frequently argue a contractor cannot perform at their proposed low price, thereby adversely affecting the contractor's *responsibility* rating, the Board ruled responsibility determinations come under the discretion of the agency but is not, in itself, cause for reversal (*Ocean House Builders*).

Lost or Late Bids. If all or portions of a bid are lost after being received by the agency, there is generally no relief for the bidder even if they complied with all the solicitation's submission requirements. The exception to this general rule is where it can be demonstrated that the loss was not an isolated incident but was part of a systematic failure by the agency or a deliberate effort to exclude the offeror (*American Material Handling, Inc.*). Standard solicitation language in FAR 52,215-1 previously permitted agencies to consider late proposals sent by mail if the late receipt was due primarily to Government mishandling. The Comptroller General said this rule should apply to commercial items under FAR Part 12 as well even if the FAR clause was not included (*Russo & Sons, Inc.*). The Comptroller General further ruled that in simplified acquisitions where specific late quotation provisions are absent and merely call for a "due date", an agency normally should consider any quotation received before the selection decision if no substantial activity has transpired in evaluating quotations (*RMG Indus. Sales*). *(Editor's Note. We should remind our readers that a 1999 amendment to FAR Parts 14, 15 and 52 under FAC 97-14 eliminated "mishandling" as a criteria of accepting late bids or offers and substituted acceptable evidence establishing the offer was received at the government installation and was under control by the government.)*

♦ Entitlement to Equitable Adjustments

There were several decisions affecting how to quantify requests for an equitable adjustment and claims. It was made clear that a contractor that has incurred increased performance costs because of a contract change carries the burden of demonstrating the amount by which the change increased its costs of performance and is entitled to an adjustment of the difference between the cost of performing the work with and without the change (*B.R. Srvs., Inc*). The "Changes" clause provides that claims for equitable adjustments will not be allowed if asserted after final payment – even if the CO agrees with the merits of the claim the government's final payment defense is not waived (*Navales Enters., Inc.*).

As for getting unrecovered fixed overhead on the terminated portion of a partially terminated contract, the contractor is entitled to recovery of fixed overhead using a rate that accounts for the difference between the contractor's actual revenues and the revenues that would have resulted in the absence of the partial termination (*Jay Automotive Specialists, Inc.*). In a reversal, the Court ruled a subcontractor could recover through the prime contractor its costs of unabsorbed home office overhead under a delay even though the prime contractor was not delayed as long as the method of quantifying the amount due was appropriate and the government was aware of and had approved the delay (*Mitchell Const. Co.*).

Eichleay Formula. A significant decision clarified the murky issue of when it is appropriate to use the Eichleay method of computing unabsorbed overhead *(see GCA DIGEST Vol. 3, No. 1 for a discussion of the Eichleay formula).* In reversing a finding that use of the Eichleay method was inappropriate because the contractor could have taken on additional work (thereby having more direct costs to apply its overhead rate to), the Court ruled the lower court improperly focused on the contractor's ability to take on *any* other work. Instead, the correct inquiry should be whether the contractor was able to take on replacement work that was sufficient to make up for the suspended work not just any additional work. The Court established guidelines that must be considered when deciding whether it is proper to use the Eichleay method when a delay or partial termination occurs: (1) when the period of delay is uncertain and the contractor is on standby the contractor is effectively prohibited from recouping its overhead costs (2) the government may show the contractor was not injured by the delay because the contractor's inability to obtain other work may have been caused by, for example, poor market conditions rather than the government's delay (3) the government cannot rebut the contractor's claim of entitlement to Eichleay damages by simply showing the contractor continued its normal operations including bidding on and performing additional work (4) bidding on other work can help the contractor's position especially if the projects bid on could not be commenced or completed within the period of the government's delay (5) a replacement contract need not be identical to the delayed contract in terms of size, duration or type of work but the critical fact is whether the replacement contract absorbs indirect costs that would otherwise be unabsorbed solely as a result of the government suspension of work (6) a contractor may still recover Eichleay damages when it is able to obtain some replacement work but not enough to absorb all of the overhead costs that would have been absorbed by the government-caused delay and (7) the government cannot preclude recovery of Eichleay damages by showing *some* replacement work was obtained when the replacement work failed to offset fully the overhead shortfall caused by the delay (*Melka Marine, Inc.*).

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♦ Decisions of Selected Cost Issues

There were not as many important decisions as prior years but below are the most significant.

To recover for a cost overrun, the "Limitation of Cost" clause (FAR 52.232-20) requires the contractor to notify the CO in writing when it has "reason to believe" it will incur a cost overrun. The "reason to believe" has been clarified to mean that when circumstances or information is at hand to give the contractor "ample reason to be concerned" about the occurrence of a cost overrun. The contractor had such reason to believe when its billing rate was too low because (1) despite the difficulty in estimating its overhead costs during contract performance (the level of work to be ordered was uncertain) it was aware of the overhead shortfall when the ordering period expired and (2) the contractor was aware of an overall decline of available funds which gave it ample reason to be concerned about a potential cost overrun (*Marine Design Techs.*).

Though FAR 52.229-3, "Federal, State, and Local Taxes" provides that a contract price include all such taxes and duties and also provides the government will reimburse contractors for after-imposed *federal* taxes, the Board rules such reimbursement does not apply to after-imposed *state* and *local* taxes (*Cannon Structures, Inc.*).

Unamortized labor costs are a legitimate form of contractor recovery after a partial termination as long as the contractor can prove it experienced positive labor learning during contract performance. Such proof is based on a learning curve which shows the direct labor hours to produce a unit decline as more units are produced. When the government partially terminates a contract, the contractor looses the opportunity to amortize the increased early labor costs over the life of the contract (*VHC Inc.*).

Under the "CAS" clause the contractor agrees to an adjustment of the contract price or contract cost if the contractor or its subcontractors fail to comply with applicable cost accounting standards. When a subcontractor is in noncompliance with CAS the appeals board ruled (1) the government may not file a CAS claim directly against a subcontractor (2) the government's remedy is against the relevant CAS covered prime contractor and (3) the government may adjust the prime contract price or cost to the extent a CAS-covered subcontractor failed to meet it CAS obligations (*Astronautics Corp.*).

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