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Knowing Your Cost Principles… TAXES

(Editor's Note. Recent cases focusing on allowability and allocability of various taxes have made accounting treatment of taxes for contract costing purposes a hot issue. We have used the most recent editions of various texts including Mathew Bender's Accounting for Government Contracts, prior articles in the GCA REPORT and DCAA's Contract Audit Manual (DCAM).

Cost Allowability

The following taxes are unallowable contract costs in accordance with FAR 31.205-41(b):

1. Federal income and excess profits taxes.
2. Taxes related to financing, refinancing, refunding operations or reorganizations.
3. Taxes for which exemptions are directly or indirectly available. These are exemptions available not to the contractor but to the federal government. For example, a contractor might claim an indirect tax exemption for property owned by the government but in contractor's possession even though the federal government is exempt from state and local taxes even if in the contractor's possession. However, if the CO determines obtaining an exemption is too great an administrative burden, the tax is allowable.
4. Special tax assessments on land to pay for capital improvements.
5. Taxes on real and personal property not used in connection with government contracts.
6. Taxes related to funding deficiencies and prohibited transactions under deferred compensation plans.
7. Tax accruals to recognize the difference between taxable income and pretax income recognized in the financial statements.

Generally, taxes not declared unallowable by the FAR are allowable if recorded in accordance with generally accepted accounting principles (GAAP).

♦ State and Local Taxes

State and local taxes, including property, franchise and income taxes are allowable costs. However, if the taxes are paid late or in error, any penalty or interest assessed by the state or local government is unallowable unless the contractor followed direction from the contracting officer.

Sometimes disputes arise over applicability of state and local taxes levied on inventory in the contractor's possession to which the government has legal title because state and local taxes cannot be levied on the federal government. However, the government's title to property that is obviously in possession by the contractor may be disputed by the local taxing authority. In such cases, the contractor should not pay the tax before asking the CO's advice.

Tax accruals arising from differences between state and local taxable income and the expense reported for financial purposes are not allowable. The government accepts only those taxes reflected on the tax return – taxes actually paid. In addition, a contractor cannot allocate state and local taxes to a government contracts in excess of taxes actually paid. In *Physics International Company (ASBCA No 17700*) the board held though the contractor paid a minimum tax of $100 due to losses at a commercial division, the taxes allocable to the profitable government division based on the taxes that would have been due had it been a separate entity were unallowable.

Some states like New Mexico and Washington impose on the seller revenue based state taxes that are computed by multiplying the total revenues received from doing business by the applicable rate. Unlike many state sales taxes, the seller is not exempt from paying these revenue based state taxes. Though allowable, DCAA has imposed certain allocation restrictions. Since the revenue-based state taxes are levied on the contractor's revenue form doing business in the state, which generally comprise many contracts, these costs are not identifiable to specific contracts and hence not a direct charge. Even though these

taxes are overall costs of doing business and hence akin to G&A expenses, DCAA asserts these taxes, if they are material, should not be included in the G&A pool. Because the usual base of allocation of overhead and G&A are normally costs rather than revenue, they should be allocated to contracts on a different base than cost. Furthermore, DCAA states these revenue based state taxes should be included in the total cost input base for G&A allocation.

♦ Other Taxes

A recent case ruled that a Subchapter S corporation's state income taxes incurred on its corporate income but paid by the shareholders is an allowable contract cost *(Information Systems & Networks Corp. v US, Fed. Cl. No-98-663C*). Subchapter S corporations do not pay taxes but flow income to shareholders who, in turn, pay taxes. FAR 31.205-41 provides that when a contractor pays taxes from which it is exempt the taxes are unallowable but the court held that though the contractor was technically "exempt" from paying state income taxes due to its subchapter S status, the court concluded that this is not a tax exemption in the normal sense of the term. Normally an exemption results in the complete absence of payment of the tax but here the burden shifted to the shareholder and the FAR does not require that any specific part of the corporation pay the state income taxes in order to qualify for reimbursement. Neither does the FAR intend that certain organizations should be denied allowability of the tax simply because of its tax election or corporate structure.

When a contractor performs work in a foreign country the host country commonly imposes taxes on the contractor and since they are analogous to state or local taxes they are considered allowable contract costs. When a contractor has paid an income tax to a host country it can claim a foreign tax credit against its federal income tax resulting in a reduction in federal income tax by the full amount of the foreign credit. DCAA considers this a duplicative recovery of a foreign income tax expenditure – first as a contract cost and then as a reduction in its federal income tax liability. In 1991 the FAR was revised to require contractors to credit government contracts for foreign tax credits claimed on US income tax returns when these allowable foreign income taxes are claimed on contracts. Even for fixed price contracts, FAR 52.229-6(h) requires that if a contractor receives a reduction in its US tax because of any tax or duty which was included in a contract price, the amount of the reduction shall be paid or credited to the government.

The ability of a state government to tax a federal government contractor for purchases related to the contract has been a controversial matter and the outcome depends on the state involved. When sales tax refunds are made, the government's share is dependent on the type of contract and specific terms and conditions in the contract. The government is entitled to a share of any refund allocated to a cost reimbursable contract. However, for fixed price contracts, any government share is dependent on two contract clauses – progress payments based on costs and property title provisions. If a contract does not contain a progress payments clause and the contractor purchased property does not become government property when purchased, the government will not receive a share of such refunds under fixed price contracts (*ASBCA No. 49339*).

Cost Allocability

Because tax exemptions might exist for government-owned inventory held by a contractor special rules on the allocation of taxes have been developed. Taxes on property used solely for government work must be allocated only to government contracts and taxes on property used solely for non-government work must be allocated only to non-government work. If property taxes are insignificant or if separate allocations do not differ significantly from a combined allocation, then separate allocations are not necessary. If property is used for both government and non-government work, taxes should be allocated to all work based on relative use of the property.

Refunds of allowable taxes, fines or penalties have to be credited ratably to the government to the extent the government participated in the original cost. Contractors should expect refunds will be carefully reviewed to assure that proper credit is given to the government. Normally, refunds can be credited in the year the refund is received but this may not be acceptable to the government if the mix of contractor business has substantially changed from the time the tax was charged (*Hercules Inc. v US 49 Fed Cl 80)*..

State and local income and franchise taxes are allowable costs. However, the allocation of state and local taxes to business units and ultimately to government contracts is one of the most controversial tax issues in government contracting. Though the government has long preferred allocation of these taxes on a three factor formula (payroll, revenue and assets), a rather complex landmark case (*US v Lockheed Corp. CA FC No. 86-1177*) held the three factor

method is not necessary to comply with FAR or CAS. In this case, the company's various segments conducted business in several states and California required the business income within the state be determined by applying the three-part formula to total company income (no matter where it was derived) and then apply the applicable tax rate to the computed California income. DOD contended that each segment's share of the tax should be computed on the identical basis (i.e. the application of the three-part formula to each segment individually) while the Court concluded the computed tax should be allocated to profitable segments only and be based on the segment's booked income.

DCAA Audit Guidelines

Allocable to government work. The primary emphasis of DCAA guidelines in Chapter 7-1403 of the DCAM is to make sure that taxes are allocable to government work. The guidance stresses any taxes leveled on non-government work (e.g. inventory, real property, personal property) is unallowable because it is not allocable to government work. The exception to this is if the amounts involved are insignificant or if comparable results would otherwise be obtained.

Erroneous computations of taxes. The guidance indicates auditors need to be alert for whether there are questions about how claimed taxes were computed. The amounts of the errors are to be identified and reported and if the error is subsequently confirmed a credit or refund should be pursued. Auditors are to follow up to assure that a proper share of credits or refunds received by the contractor are passed on to the government.

Penalties. Penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. However, FAR 31.205-41(a)(3) provides a specific exception to the disallowance of penalties when incurred as a result of following the contracting officer's direction or permission not to pay taxes assessed by a state or local government.

Interest. Generally interest associated with an intentional (i.e. intentionally paying less than is reasonably estimated to be due) underpayment of state or local taxes is unallowable per FAR 31.205-2 because the interest is considered to be "interest on borrowings." However, interest associated with an underpayment of taxes where the contractor's intent to borrow cannot be shown is allowable. Also, if the contractor's underpayment was directed or agreed-to by the CO, FAR 31.205-41(a)(3) allows any resulting interest. Interest incurred as a result of late payments (e.g. not paying financial obligations by the due date) is considered "interest on borrowings" and is therefore unallowable per FAR 31.205-20.

NEW DEVELOPMENTS IN PAST PERFORMANCE EVALUATIONS

(Editor's Note. Past performance evaluation has become a major factor for award selection decisions. We often stress that the practical meaning of most regulations are not so much what is written in the regulations as what the GAO and Appeals Boards/Courts say they mean and this is particularly true in the relatively new area of past performance and experience determinations where the ground rules are evolving. An understanding of the ground rules is essential in providing the best possible face in a competition. The following article addresses these evolving ground rules in the light of recent decisions made by the General Accounting Office over the last couple of years. Our article is based on one written by Michael Golden, Assistant General Counsel for the Procurement Law Division of the General Accounting Office published in the April 8, 2003 issue of Federal Contracts.)

Experience Vs. Past Performance

Both the FAR and GAO decisions distinguish between prior experience and past performance even though agencies sometimes evaluate the two together. For example, an agency reasonably evaluated the comparative degree of relevance of the past contract experience of offerors under the experience factor but not under the past performance factor as outlined in the solicitation's evaluation scheme (*Oceaneering Intl. Inc. B-287325*). In any evaluation, evaluators should be aware there is a distinction between experience and past performance where experience is an objective evaluation because the issue is whether the firm previously has performed the requisite work. Past performance, however, is considerably more open to interpretation. For example, in a competition for operating, maintaining and repairing Pentagon heating and refrigeration plant, the GAO held the agency unreasonably eliminated the protester's proposal as technically unacceptable based on the firm's lack of past performance in performing the services in a facility comparable to the Pentagon. The GAO held that under the RFP's past performance evaluation

factor, the agency appeared to be more concerned with the protester's alleged lack of relevant experience rather than the quality of its performance since the agency neither received nor was aware of any negative past performance reports (*Consolidated Eng'g Servs. Inc. B-291345*). The procurement regulations also differ. Although evaluation of prior experience is one of the factors that may or may not be evaluated to satisfy the contract requirements, past performance must be evaluated in all source selections for negotiated competitive acquisitions expected to exceed $100,000 (FAR 15.304(c)(3)(ii)

Disclosure of Evaluation Factors

In drafting a solicitation, a contracting agency is required to clearly set forth in the solicitation all evaluation factors and significant subfactors that will affect contract award as well as the relative importance of these factors and subfactors. An agency may not give importance to specific factors, subfactors or criteria beyond that which would reasonably be expected by the offerors under the solicitation terms. So, for example, the GAO held that an agency was required to disclose that an apparently minor subfactor that was intended to evaluate a particular type of experience actually constituted 40 percent of the technical evaluation (*Lloyd H. Kessler Inc. B0-284693*).

Even if law or regulations do not require disclosure of factors and the weights assigned to them, fundamental fairness may dictate the disclosure of some information. For example, in spite of the fact the solicitation stated that simplified acquisition procedures were being used and that FAR 12.602 indicated an agency need not disclose the relative weight of evaluation factors it was unreasonable for the agency not to disclose relative weightings since basic fairness dictated such disclosure when the agency required offerors to prepare detailed written proposals addressing unique government requirements. However, the agency's decision to assign a weight of 5 percent to a solicitation's past performance evaluation factor did not violate FAR 12.206 because the provision is discretionary, not mandatory (*Finlen Complex Incl. B-288280*).

In determining evaluation factors and the weights to be assigned to them an agency has broad – but not unfettered – discretion. An agency's determination in this regard is not objectionable as long as the factors "reasonably relate" to the agency's needs in choosing a contractor that best meets the government's stated requirements. For example, a solicitation's past performance evaluation criteria required offerors to list at least five contracts within the $5 million to $10 million range. The GAO ruled the listings were not unnecessarily restrictive even though it would exclude small emerging businesses because the record showed the provision was reasonably related to the agency's needs because it was held the five contracts allowed the agency to evaluate a contractor's overall performance and performance trends (*C. Lawrence Constr. Co. Inc., B-289341*). In another example, the agency's decision to limit the past performance evaluation factor to corporate experience and not the key personnel was considered reasonable since the history of the corporate entity was considered more indicative of performance success since key personnel might not stay long enough (*Olympus Bldg. Servs. Inc., B-282887*). Finally there is no limitation on the weight an agency can assign particular factors in an evaluation and there is nothing improper in placing additional emphasis on past performance under other technical evaluation factors as long as the approach is stated in the RFP (*American Med. Info. Servs. B-288627*).

Evaluation Issues

The agency's evaluation of past performance and experience must be reasonable and consistent with the evaluation criteria and applicable statutes and regulations. The contracting personnel awarding a contract must base an evaluation upon information sufficient to make a reasonable determination of the offeror's relevant information close at hand or known. For example, an agency's determination that the corporate experience of the awardee was equivalent to that of the incumbent was reasonable where the awardee performed contract work very similar to the work required under the solicitation and where the awardee's proposed key management personnel possessed significant relevant experience (*Oceaneering Intl. Inc.*).

Attribution. In determining whether one company's performance should be attributed to another company, an agency must consider the nature and extent of the relationship between the two companies – in particular, whether the workforce, management, facilities or other resources of one may affect contract performance by the other. The GAO has stated the key consideration is whether the past performance identified by the offeror can be considered predictive of the offeror's performance on the contract. For example, it would be inappropriate for an agency to consider a company's performance record where that

record does not bear on the likelihood of successful performance. In contrast, an agency should consider a company's performance record where it will be involved in the contract effort or where it shares management with the offeror (*Lynwood Mach. & Eng;g Inc. B-285696*).

An agency may look beyond past performance history of the offeror and look at key employees, the corporate management or a predecessor company if it is reasonable to do so under the circumstances. For example, an agency properly considered the performance record of a company other than the one submitting the quote where the company submitting the quote intended to rely heavily on the other company's personnel in performing the job (*Al Hamra Kuwait co. B-288970 and MCS of Tampa Inc. B-288271*). In evaluating the experience and past performance of a joint venture under a mentor-protégé program, the agency properly considered that the small business protégé which would be performing the majority of work had no relevant experience (*Urban-Meridian Joint Venture, B-287168*). An agency is not required to impute to the protégé the totality of its proposed mentor's experience and past performance where the mentor was not proposed to play a major role in the contract performance (*BioGenesis Pac. Inc., B-283738*). Finally, an agency may properly consider the experience of supervisory personnel in evaluating the experience of a new business but there is no legal requirement that an agency attribute employee experience to an entity if again it is not reasonable to do so (*Blue Rock Structures Inc. B-287960*).

Relevance of Past Performance Information. When a solicitation requires evaluation of past performance an agency has discretion on the scope of performance history to consider as long as all proposals are evaluated on the same basis and consistent with the solicitation's requirements (*Symtech Corp. B-285358*). The GAO found the agency reasonably determined that experience on full food service contracts was less relevant than experience on mess attendant services (*Ti Hu Inc., B-284360*). For a solicitation for a quantity of leather, the agency reasonably disregarded non-leather supply contracts (*Power Connector, B-286875*). In a procurement for construction of a bearthing wharf for nuclear power aircraft carriers, the GAO denied a protest where offeror asserted it should have received a higher rating based on numerous smaller projects and stated the agency reasonably concluded that an offeror with no comparable large project experience presented higher performance risk (*Marathon Constr. Corp., B-284816*).

An agency may disregard past performance references that in its view are not relevant. For example, the GAO rejected the protester's contention the agency improperly excluded two references submitted by the firm finding the contracts were not relevant to the procurement (*Symtech Corp.*). The GAO confirmed that contract dollar value is a reasonable consideration where the agency found a firm's proposal as technically unacceptable where it had not performed three projects with a contract dollar value comparable to that being required (*Knightsbridge Constr. Corp. B-291475*).

Use of Scoring or Formulas. An agency's evaluation should be based on a reasonable assessment of the past performance information where evaluations based on formulas or mechanical scoring can often cause problems. The GAO reversed an award for a federal supply schedule contract because the record showed the agency's evaluation of past performance, which had relied on a mechanical comparison of past performance scores for incumbent contractors, was unsupported and unreasonable (*OSI Collection Servs, Inc., B-286597*). Another award was reversed for freight transportation services where it was found past performance was unreasonable when (1) the agency focused on the absolute number of problem shipments without considering the number of shipments the offeror had made in the relevant time period (2) the evaluation documents contained no evidence the agency had complied with the solicitation instructions to "look for reasons, explanations or clarifications" for past performance problems and (3) in determining on-time delivery percentage the agency failed to consider the wide variance in the offerors' shipping volumes over the relevant periods (*Green Valley Transp. Inc. B-285283*).

Neutral Ratings. An offeror without a record of relevant past performance or whom information is not available may not be evaluated favorably or unfavorably. Where the record showed the firm failed to submit in its proposal detailed information showing it had performed contracts relevant to the solicited effort, the GAO concluded that the evaluators had reasonably rated the firm as "neutral with unknown confidence" (*Boland Well Sys. Inc. B-287030*). Under a solicitation calling for no fewer than three questionnaires of an offeror's past performance references the agency reasonably assigned a neutral/unknown confidence rating when it received only one reference (*Thomas Brand Siding Co. B-B286914*). However, the award of an order at a significant price premium based on the reason the

vendor quoting the lower price had no prior performance history in supplying the item was unreasonable where the award decision was not made in accordance with the stated evaluation scheme (*National Aerospace Group Inc. B-281958*).

Risk Assessments. A firm's lack of experience can be part of a risk evaluation. An evaluation of a protester's experience for risk-rating purposes properly took into account the fact the protester had not performed contracts that were similar in size and scope to the contract contemplated (*Molina Eng'g Ltd/ Tri-J Indus Joint Venture (B-2842895*).

Unequal Relaxation of Requirements. An agency must not relax the requirements of a solicitation for one but not other offerors. An agency improperly relaxed the awardee's minimum qualification requirement that key personnel have experience in the operation and maintenance of a comparable government functional activity of the same or similar scope where the awardee's key personnel lacked requisite government experience (*Meridian Mgmt.Corp, Johnson Controls World Servs. Inc. B-281287*).

Responsibility Versus Past Performance. An agency may use traditional responsibility factors as technical evaluation factors in a negotiated procurement as long as the agency performs a comparative evaluation of these factors. The GAO found an agency did not convert its technical evaluation process into a responsibility determination where the record showed the award was based on a comparative evaluation of past performance of the offerors (*Goode Constr. Inc. B-288655*). In contrast, when using the lowest price, technically acceptable source selection process, past performance must be evaluated in accordance with FAR 15-305 but the comparative assessment discussed in FAR 15.305(a)(2)(i) – currency, relevance, source and context of the information as well as general trends in the contractor's performance - does not apply. If a CO determines the past performance of a small business is not acceptable, this matter must be referred to the SBA for a certificate of competency determination in accordance with procedures in FAR Part 19.6 (*Phil Howry Co. B-291402*).

Source of Information. An agency is only required to make a reasonable effort to contact a firm's references. When an agency's reasonable efforts to contact a reference are unsuccessful the agency may proceed with its evaluation without the benefit of the reference (*Lynwood Mach. & Eng'g Inc.*). Despite repeated efforts the agency could contact only one of the protester's three listed references. The agency's evaluations of the past performance was considered reasonable when it was based on the one reference and the agency's assessment of the protester's subcontract performance under a prior contract (*North Am. Aerodynamics Inc. B-285651*). An agency is not required to contact all of a firm's references but it must act reasonably in determining which references to contact (*Lynwood*).

An agency may consider information obtained from a source not identified by the firm in its proposal. There is no requirement that the agency go beyond the reference information identified in the firm's proposal (*Lynwood*). Finally, an agency may rely on information retrieved from an electronic database to evaluate past performance without giving the firm an opportunity to comment on negative information in the database where the record shows the contractor had previously been given ample opportunities to clarify adverse past performance information in the database and there was no reason to question the validity of the information (*TLT Constr. Corp., B-286226*).

History of Filing Claims and Protests. While the GAO has recognized it is appropriate to consider a contractor's "combative" attitude, absent some evidence of an abuse of the contract disputes process agencies should not lower an offeror's past performance evaluation based solely on the firms pursuit of claims or protests. In one decision the GAO found the evaluation of a protester's past performance was unreasonable because the agency improperly considered the protester's legitimate exercise of rights under its contract to be evidence of negative past performance (*OneSource Energy Servs. B-283445*).

Exchanges Concerning Past Performance

FAR 15-306(a) defines clarifications as limited exchanges between government and offerors that may occur when an award without discussions (as in a simplified acquisition) is contemplated. When award without discussion is anticipated, the contracting officer must give an offeror an opportunity to clarify adverse past performance it had not previously had an opportunity to respond to only where there is reason to question the validity of the past performance information. In the absence of a clear basis to question it, the CO has the discretion to not ask for clarification (*A.G. Cullen Constr. B-284049*).

Under FAR 15-306(b) communications are exchanges between the government and offerors after receipt of proposals leading to the establishment of the competitive range. Communications are for the purpose of deciding whether a proposal be placed in the competitive range and must address adverse past performance information to which an offeror has not had a prior opportunity to respond. However, communications do not provide an opportunity for an offeror to revise its proposal but may address information related to relevant past performance.

FAR 15-306(d) states that negotiations are exchanges in either competitive or sole-source circumstances and they are undertaken with the intent of allowing an offeror to revise its proposal after the competitive range is set. COs must conduct "meaningful" (e.g. tailored to each bidder's proposal) discussions with offerors in the competitive range. At a minimum, proposal deficiencies and significant weakness need to be brought up and the CO must inform an offeror of adverse past performance it had not been able to respond to. The GAO ruled an agency must raise an offeror's lack of experience during discussions if this is a major concern and if not discussed the agency has failed to conduct meaningful discussions (*Cotton & Co. LLP B-282808*). However, in meeting its obligation to conduct meaningful discussions an agency is not required to point out every element of an acceptable proposal that receives less than the maximum evaluation rating (*Digital Sys. Group Inc., B-286931*). For example, an agency was not required to conduct discussions regarding two weaknesses involving the firms past performance where the two weaknesses were not considered significant and the protester's past performance was rated acceptable overall (*Pflow Indus. Inc. B-289970).*

FAR 15.306(e)(1) prevents exchanges that "favors one offeror over another." An agency's exhanges with the awardee regarding its delivery records when viewed with its failure to conduct similar exchanges with the protester was considered improper and unequally favored the awardee (*Martin Elects. Inc. B-290846*).

Source Selection Decisions

Price/technical tradeoffs may be made and to the extent one is sacrificed for the other only the test of rationality and consistency with evaluation factors may be considered. The GAO has ruled on numerous protests that under negotiated procurements source selection officials will have broad discretion how they will make the technical versus price tradeoffs. Even when price is the least important evaluation factor, the agency's decision to grant the award to a lower priced, lower rated offeror was justified when the higher priced, higher rated proposal was not considered worth the premium price (*NAPA Supply of Grand Forks Inc. B-280996*).

RECENT CHANGES TO THE 2003 DCAA CONTRACT AUDIT MANUALS

(Editor's Note. The Defense Contract Audit Agency Manual (DCAM) is a two volume guide that is revised twice a year. Though it is not authoritative, the interpretations of cost and pricing regulations offered to its auditors provide useful insights into how DCAA, other audit agencies and prime contractors' reviewing subcontractors will interpret the rules we all have to live with. We frequently report on significant guidance issued during the year in the GCA REPORT and the twice yearly updates incorporate both these changes as well as other changes DCAA chooses to make. In this article, we will report on the most significant changes made to both the January 2003 (our copy came late) and the July 2003 editions.)

January 2003

Chapter 5 Internal Controls. Section 5-1005 emphasizes the need to have auditors focus on other direct costs as well as indirect costs in incurred cost and proposal audits. Also, when inconsistency between treatment of ODCs is suspected (e.g. direct charging expenses that are normally charged indirect) auditors are encouraged to review the internal controls over these costs.

Chapter 6. Incurred Costs Reviews. Section 6-609 provides an unambiguous statement that all unallowable costs subject to a penalty, no matter how small, must be identified in the audit report. It clarifies that first-level penalties (equal to the amount of unallowable cost) will apply only to expressly unallowable costs identified in either FAR 31.205 or applicable agency supplements (e.g. DFARS, DEARS) while second-level penalties (equal to 3 times the unallowable cost) applies to any unallowable costs determined to be unallowable or mutually agreed to be unallowable before the submission of the indirect settlement proposal.

Section 6-1007 is changed to identify the requirement to perform annual examinations of paid vouchers to determine continued participation in the direct billing program. This examination may be conducted either as part of another audit or a separate one.

Chapter 7 Selected Areas of Costs. Section 7-1004.1 incorporates recent changes to FAR 31.205-35, relocation costs effective on contracts awarded on or after July 29, 2002. The new guidance defines relocation costs as costs incident to a permanent change of duty assignment for a period of 12 months or more for either an existing employee or upon recruitment of a new employee. Several new sections emphasize the 12 month requirement and requires the contractor to credit relocation costs if the employee resigns for voluntary purposes before 12 months (termination for illness, disability or death do not apply). The guidance adds a description of the type of expenses normally associated with relocation expenses and explicitly states many of the costs that were previously unallowable are still unallowable such as (1) loss on the sale of a home (2) continuing mortgage principle (not interest) on the residence being sold (3) certain costs incident to acquiring a new home (FAR 31.205-35(c)(2) and (4) costs incident to furnishing or obtaining equity, non-equity or lower-than-market rate loans.

The new guidance also draws attention to the fact that the new provisions of FAR 31.205-35 are significantly different now than before July 29, 2002: (1) Payments for house hunting trips and temporary lodging trips that were limited to a maximum of 60 days for employees and 45 days for spouse and dependents prior to the change are now limited only through general reasonableness provisions in FAR 31.201-3 (2) Payments for increased employee income or FICA taxes related to relocation reimbursements (commonly called gross-ups) were unallowable before the change and are now allowable (3) Payments for spouse employment assistance were unallowable and now are allowable and (4) Lump sum reimbursement for miscellaneous expenses were limited to $1,000 and now the limit is raised to $5,000.

Chapter 10 Audit Reports. Section 10.212.2b clarifies what is to be provided to the contractor at an exit conference. In efforts to expedite issuance of audit reports, auditors are reminded to provide details of audit findings as they are discovered (not to wait until the end of the audit) and provide draft audit reports to contractors at the exit conference. The only exception are audits of forward pricing actions (e.g. individual proposals, forward pricing rates, equitable adjustments, termination settlement proposals) used to generate a negotiation position or "sensitive" audits that identify suspected "irregular conduct." The guidance provides a "reasonable" time to respond and incorporate the response in the audit report but states this time should be "minimal" and if not received the audit report should be issued stating the contractor was given a chance to respond but no response was received. (*Editor's Note. The guidance demonstrates that if contractors want to challenge an audit position they should not wait until the exit conference but should begin compiling their position as soon as they become aware of an audit position. This is sometimes difficult since some auditors are not emphatic about their positions and contractors are quite often surprised at the exit conference, or even worse, upon reading the draft audit report, to discover there are problems*).

July 2003

Various Chapters. Various sections of the DCAM are amended to reflect DCAA's responsibility to ensure relevant contractors are registered in the Central Registration database when they do business with the Defense Department or NASA. Auditors are instructed to ensure the contractors are registered when they are performing reviews of billing system internal controls (Chapter 5-1103), reimbursement claims (Chapter 6-1006) and proposals (Chapter 9-102.2.3).

Chapter 5, Internal controls. Section 5-1209.3, Review of Subcontract Proposals is amended to instruct auditors they need to ensure that contractors' policies and procedures require them to (1) conduct cost or price analysis of subcontractors' proposals to establish reasonableness of proposed subcontractor prices (2) include the results of these analyses in the price proposal and (3) when required by FAR 15.404-3(c) – when the subcontract price is either $10 million or more than 10 percent of the prime contractor's proposed price - submit subcontractor cost or pricing data to the government as part of its own cost or pricing data.

Chapter 6, Incurred cost audit procedures. Section 6-705 is revised to ensure that billing rates for interim payments on cost type work are adjusted for (1) accrued indirect costs the contractor is delinquent in paying in the ordinary course of business per FAR 52.216-7 (2) accrued costs of pensions, post-retirement benefits and profit-sharing or employee stock ownership plans that have not been paid at least quarterly (within 30 days of the end of the quarter)

(3) amortized restructuring costs that have not been certified per DFAS 231.205-70 and (4) costs covered by advanced agreements.

Chapter 7, Selected costs. Chapter 7-1702, Business combinations, has been amended to reflect the impact of Financial Accounting Standards Board No. 141. The guidance states a business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more businesses to obtain control over them and the new entity carries on the activities of the previously separate, independent enterprises. It also restates the lengthy prescription for how to value acquired assets under the purchase method. Under FASB No. 141 all business combinations concluded after June 30, 2001 must be accounted for using the purchase method where any excess of the fair value of the identifiable assets purchased over the fair value of liabilities assumed will be recorded as goodwill which is expressly unallowable as both a cost and an element of the facilities capital employed used to compute cost of money. Simply put, the government will not recognize for cost allowability purposes any costs resulting from the increase in value of acquitted assets (or creation of new assets) as a result of a business combination. The guidance also seeks to reconcile FAR 31.203(c) that requires the full amount of assets be included in the allocation bases (e.g. total cost input base, three factor formula for allocating home office expenses) so as to cause the unallowable portion of costs to absorb a portion of indirect costs and a class deviation issued by DOD in 1999 and effective through September 2005 which provides that indirect costs allocable to the stepped-up asset value following a business combination will not be disallowed.

Chapter 7-2105. A new section on Professional and Consulting Services has bee added. Auditors are reminded to carefully consider such factors of allowability as to the nature and scope of services rendered in relation to the services required, whether the service can be performed in-house more economically and whether retainer agreements are reasonable and customary and are reasonable in comparison with in-house capability. They also need to be alert for "irregularities" such as concealment of unallowable political donations or bribes disguised as consulting costs. The new guidance states that professional and consulting costs are addressed primarily in FAR 31.205-33 but also related activities are addressed in other cost principles and that properly supported costs are generally allowable unless they are for otherwise unallowable activities. Unallowable activities identified in FAR 31.205-33 include (1) services to obtain and distribute or use information or data protected by law or regulations (2) services intended to improperly influence the content of a solicitation, evaluation of proposals or selection of sources for contract award (3) violation of statute or regulations for improper business practices or conflicts of interest (4) services performed that are not consistent with services contracted for or (5) costs that are contingent on recovery from the government. Unallowable activities covered by other cost principles are (1) costs of planning or executing an organization or reorganization (2) cost of resisting or planning to resist a reorganization (3) costs of raising capital (4) cost of financing and refinancing operations, preparation of prospectuses and preparation of stock rights (5) costs related to bad debts (6) costs related to legal and other proceedings (7) unreasonableness of costs (31.201-3) or (8) costs not allocable to government contracts (31.201-4).

Also auditors are reminded that in addition to supporting evidence of consulting costs such as invoices/billings and consultant's work products a third area of review is to compare all agreements (e.g. work requirements, rate of compensation and nature of other expenses) with actual services performed. Where failure of providing work product was often considered sole grounds for disallowing consulting and professional services costs in the past, the new guidance softens this strict requirement by stating "other evidence may also suffice." Auditors are told not to insist on a work product if other evidence provided is sufficient to determine the nature and scope of actual work performed. But if the contractor refuses to provide work product and the auditor cannot determine the nature and scope of work, auditors are told to still question the costs.

Chapter 14, Other Audits. Chapter 14.301 is amended to emphasize the need of auditors to be alert to conditions indicating unfavorable or adverse financial conditions that impede the contractor's ability to perform on government contracts. Rather than wait to be requested by the CO or other agencies, auditors will now self-initiate an annual assessment of contractors' financial condition to see if there is the need to perform a financial capability audit. These risk assessments, which we will discuss in the next issue, can be conducted either as a separate audit assignment or as part of another assignment such as a preaward review, adequacy of accounting system survey or audits of advanced or progress payments.

CONSIDERATIONS ON ID/IQ CONTRACTS, CLAIMS AND PROTESTS

(Editor's Note. The following is a guest article by Tim Power of the Law Offices of Tim Power (925-975-0330). We asked him to provide some practical insights and discuss recent developments he encounters in the bidding and awarding of contracts. We have worked with Tim on numerous claims and terminations for clients and have been quite successful in recovering entitled funds.)

Bidder Beware: IDIQ Contract Risks

Indefinite Delivery Indefinite Quantify contracts provide the government flexibility for requirements that cannot accurately be anticipated. An IDIQ Request for Proposal typically provides estimated quantities as well as a guaranteed minimum ordering quantity. The RFP may require the contractor to maintain the ability to meet these estimated quantities but the government is only required to order whatever minimum is established by the RFP. When pricing such contracts, the contractor needs to be aware that they bear the risk that only the small minimum amount may be ordered. When the minimum is not ordered, the contractor can only recover the profit it would have made if the minimum was ordered, not the difference between what was ordered and the minimum. Estimated quantities are just that and are often developed with an eye toward soliciting the best possible pricing and responsiveness from the contractor. *(Editor's Note. If you are a subcontractor and in a strong negotiating position you may be able to negotiate more favorable terms with your client. For example, you might use a schedule of unit prices where unit prices are higher if overall quantities are lower while offering lower unit prices where overall quantities ordered are higher. Just because the prime contract may be limited to ID/IQ restrictions does not mean all subcontracts need be.)*

Two cases decided by the Court of Appeals for the Federal Circuit point out risks contractors face when bidding on IDIQ contracts and they also indicate important distinctions between IDIQ and requirements contracts. In *Travel Centre v. Barram, CAFC Nos. 00-1054 and 00-1126* the General Services Administration solicited bids for a base period and four option years for travel management services. The RFP stated the terms would be an IDIQ contract with a "guaranteed revenue minimum of $100." Bidders were told that several agencies would be ordering through the GSA contract and to base their offers on expected revenue commissions of $2,500,000. The GSA learned before offers were submitted that half the agencies would not be ordering through the GSA but did not divulge the expected reduction in orders. Travel Centre was awarded the contract and received only $500,000 in ordered services over nine months before the contract was terminated. It claimed the GSA had breached the contract by failing to disclose the estimated quantities were overstated and sought recovery in lost business damages. The Court ruled against Travel Centre where it stated unlike a requirements contract that mandates the contracting government entity fills its actual needs for supplies and services from the contract awardee, an IDIQ contract provides only that the government orders only a stated minimum quantity of supplies and services which was $100. The fact the estimated quantities were incorrect made no difference because Travel Centre had no right to rely upon them. The lesson of the case is that contractors have no right to rely on the estimates given in the solicitation and that bidding on IDIQ contracts is often a gamble. Even though a lower court ruled that Travel Centre was improperly induced to base its proposal on quantities the GSA knew were overstated and hence breached its contract, the higher court rejected this position stating the government is free to include estimates of work in a solicitation that it knows are wrong. A few savvy questions asked in the pre-bid phase of the solicitation can help decide if it is worth pursuing or if there is too great a gamble. For example, How were the estimates developed? When were the estimates developed and has anything changed? What are the estimates for option years?

In *Verilease Technology Group Inc. v. United States CACF No. 01-5114* the contract called for a base year plus four one year option years to provide maintenance to identified computers for a maximum of $50,000,000 and a minimum of $100,000 for the base period only. After award the government replaced several of the identified computers, canceling some orders placed and stopping the placement of new orders. The contract was terminated in the second option period where orders were $3 million in the base period and total orders were $10 million. Because there was only a minimum amount for the base period and none for the option years Verilease argued its contract was a requirements contract not IDIQ where a minimum amount is mandatory and if it prevailed the government would have been required to order all its

requirements from it rather than just the minimum amount. The Court ruled against Verilease saying option periods are not the same as a new contract but that there is only one contract for the base period and option years so the $100,000 minimum for the base period covers the entire contract period. Once this minimum is met, there is no obligation of the government to order anything in the option years.

US v. Delta Construction Intl, CAFC No. 01-1253 addresses how much the government has to pay if the minimum guaranteed amount is not met. In the contract to replace rotten lumber in various areas of a military base, the base period plus several option years provided for a minimum of $200,000 of guaranteed work. After the first option period the contract was not renewed and Delta filed a claim of $125,000 for the difference between the value of orders placed and the $200,000 minimum guarantee. Though the Board sided with Delta ruling the contractor was entitled to the difference between the value of orders place and the minimum the higher Court rejected the Board's position asserting such a position put the contractor in a better position than if the government had ordered the minimum. The Court stated the Board's position would have provided the contractor with an additional $113,000 without any reduction to reflect Delta's additional costs of performing the work. Thus when the government does not order the minimum guaranteed amount the contractor is entitled to recover the difference between what was ordered and the minimum less the costs associated with performing the work that should have been ordered to meet the minimum. Thus contractors need to track the costs of performing the work. An attempt should be made to identify the period of greatest profitability to use to calculate the damage. For example, use of a period where there is a shortage of orders might result in lower efficiency and low profit where in a period of high level of orders, work is more efficient and so is profit.

Disclaimers are No Defense for Defective Design Claims

When design specifications are wrong contractors are entitled to recovery of extra costs while performance specifications do not entitle contractor to such recovery. It is quite common for the government to attempt to disguise the existence of design specs by inserting different types of disclaimers in order to lessen the government's liability. In *White v. Edsall Construction Co.,CAFC No. 01-1628* the contract to construct a facility to house helicopters included specifications for hanging doors weighing 21,000 pounds. A government structural engineer inserted in the drawings a statement saying contractors "must verify prior to bidding." Though the contractor saw nothing obviously wrong with the specs before bidding it discovered after award the door design would not work and submitted a claim of $70,000 to correct the design.

After determining the contract contained design and not performance specifications, the Court stated there was an implied warranty the design specs are free from design defects. General disclaimers to check drawings do not overcome this warranty. The drawings noted in this case only required the contractor to verify the details listed. It did not warn the contractor the design might be flawed nor require the contractor to verify the design would work. This argument is frequently put forth by the government, apparently believing that general disclaimers can transfer the government's responsibility for design accuracy to the contractor.

Reliance on Bid Documents are Necessary for Winning a Differing Site Condition Claim

In order to win a differing site condition claim, it is not enough to merely prove the government provided incorrect information about a site. *Comtrol, Inc. v. United States, CAFC No. 01-5115* ruled a contractor also must have relied upon pre-award representations made by the government about site conditions in order to make a claim for a differing site condition.

Though the solicitation made general remarks about the soil there were no specific references about the soil but it did say a soils report was available at the architect's office. The Court rejected the contractor's claim for differing site conditions ruling since the contractor did not read the report it could not meet the condition for a differing site condition claim – reliance on the bid documents.

The case makes obvious that examination of any documents referenced or incorporated into a solicitation can be crucial if the information contained becomes important for performance. Failing to review information incorporated into the contract, but not provided with bid documents holds two dangers. Even if the report contains misleading information the contractor cannot base a claim on it

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unless the contractor relied on the misinformation during bid preparation. If the report contains information abut a problem area, the contractor cannot base a claim on the problem because it would have learned of it if the report was read.

Don't Wait for Contract Award to Protest the Solicitation

A protest can be either pre-award or post award. Examples of pre-award protests include omissions of required provisions in the RFP, ambiguities or indefinite evaluation factors or elimination from the competitive range before award is made. Post-award protests are ones filed after an award is made and is usually to protest the award itself. Many contractors make the mistake of waiting until the award is made to protest improprieties in the solicitation and when they do so they find they are too late.

The RFP for a commercial services landscaping contract broadly defined the type of relevant experience that could demonstrate an offeror's ability to successfully perform the required services. When the incumbent, Bella Vista Landscaping lost the bid to a lower rated, lower priced proposal it protested the award stating its past superior performance was "unique" and its higher price offered greater value to the government. In rejecting its protest, the GAO ruled Bella Vista did not challenge the commercial services nature of the procurement prior to the closing time for submitting proposals and it is untimely to do so now. To the extent Bella Vista contends the solicitation should have included additional consideration of its experience as the incumbent its protest was too late since it concerned an alleged impropriety of the RFP and was not raised prior to the closing time for submission of proposals.

The general protest time limit rules are:

General Rule 1. Ten days from adverse agency action including denial of agency protest if agency filed within time allowed by GAO rules.

General Rule 2. Ten days from the date you know or should know of the basis for the protest. A timely (within 5 days) request for debriefing can extend the time to protest until 5 days after the debriefing.

General Rule 3. Before submission date for bids or offers if the protest concerns something wrong with the solicitation. A solicitation defect that was not apparent must be protested within 10 days after it becomes apparent.

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