GCA DIGEST

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Classic Oldie…

TACTICS TO LOWER BID PRICES

(Editor's Note. Though much of our consulting activity used to focus on ways to **increase** *cost recovery, the tougher competitive government market has changed some of our efforts to help clients* **lower** *their price proposals. Since a key to a successful proposal is to anticipate what your competitors may offer, the following common pricing tactics may be used by other offerors or you may want to consider them for yourself. We have incorporated some of the ideas of Brian Fischer in the May 1997 issue of Contract Management and added some of our own.)*

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

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

2. ***Use and bid uncompensated overtime.*** Lower the hourly rate by dividing the yearly or monthly salary by a number larger than the normal 40 hour work week with the intention of having salaried employees working more hours. Remember that protests are common when only some offerors bid uncompensated overtime but they have rarely been successful when the uncompensated overtime is not excessive.

3. ***Propose a low or negative escalation rate.*** For out years, most current labor rates and other costs are multiplied by an escalation factor supplied by such firms as DRI McGraw Hill. In price sensitive competitions, proposing a low or negative rate can be highly favored by selection personnel. Common ways of achieving these low escalation rates include (a) promoting employees over the contract period from lower to higher paid categories while hiring new employees at the floor level (b) proposing as a base rate an estimated average rate over the period of performance or (c) freezing wages.

4. ***Hire "temporary" or "variable" employees.*** Increasingly, many companies' new hires are individuals who are paid only for direct billing time or who do not receive all of the fringe benefits current employees receive. Real cost saving are achieved not only by lower costs but also reduction of disguised idle time (often charged to "marketing" or "administration").

5. ***Reclassify certain indirect functions as direct.*** Certain functions like contract and subcontract administration, purchasing, materials inspection, etc. can be identifiable with specific contracts rather than included in an indirect cost pool spread over all contracts. Many of these costs can be charged to other contracts and excluded from overhead.

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

7. ***Exclude costs.*** This might be desirable if winning a government contract can substantially benefit commercial work or reimbursement at less than cost might help retain highly skilled labor during a lull. Alternatively, you may want to consider a bottom line reduction from the indirect cost pool in the form of a "customer concession". This one time concession would not be considered a precedent on other contracts but care should be taken to make sure other contracts do not absorb these deleted costs.

8. ***Reduce proposed profit/fee.*** Propose lower fees or eliminate fees on certain type of costs (e.g. subcontractors).

9. ***Create a new business unit.*** A separate business unit (e.g. producing only for the government or one product or service) could justify a disproportionate

allocation of home office expenses such as marketing, research and development, etc. Also, a new unit could be staffed with personnel having lower direct rates and fringe benefits without impacting other business units.

10. ***Aggressively reduce indirect cost rates.*** Though it can be risky, assume a larger business base (e.g. denominator) to spread indirect costs over. This is particularly effective if cost reduction measures or aggressive pricing is expected to generate more business.

11**. *Find outsourcing opportunities.*** In addition to the cost savings benefits of shifting less critical functions to more efficient subcontractors, a lower subcontract rate could be developed and applied to outsourcing costs. This would shift some indirect costs out of overhead or G&A and still achieve a lower cost than applying the old, higher indirect cost rates to the direct labor replaced by subcontractors.

12. ***Base pricing on aggressive performance improvement estimates.*** Instead of using normal estimates of performance (e.g. history), price the proposal according to aggressive estimates of improvements being planned. You can use these prices as a project budget and, if you wish, develop compensation bonuses that if attained, can be included in fringe benefits.

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

(Editor's Note. For other cost reduction ideas and how to present them to help favorably sway source selection officials, see our last issue.)

Knowing Your Cost Principles…

NEW INTERPRETATION OF IR&D COSTS

(*Editor's Note. We have been receiving inquiries from clients and subscribers about a recent case we reported on – US v. Newport News Shipbuilding – that disallowed Independent Research and Development costs. The case significantly changes the ground rules on when costs can be charged to IR&D and when they must be charged direct to a single contract which has the effect of narrowing the conditions when research and development effort may be allocated indirectly to all of a contractor's work. Now, many of these costs must be allocable to specific contracts whether or not the related costs are recoverable. Before discussing the case, we thought it would be a good idea to present the basics of the cost principle and review some of the legislative history and decisions affecting the issue of when R&D costs may be charged to IR&D and when they need to be charged directly to a cost objective. For the background material on the IR&D cost principle and the legislative/board history we have relied on an article in the November 2003 Briefing Papers by Karen Manos of Howrey Simon Arnold & White. The discussion of the Newport News case and comments are an amalgam of recent published articles and private position papers we have encountered, all of which are all highly critical of the decision.)*

The Basics of the Cost Principle

FAR 31.205-8, IR&D/B&P costs must be read in conjunction with Cost Accounting Standard 420, "Accounting for independent research and development costs and bid and proposal costs" which is incorporated in its entirety in the FAR cost principle. IR&D and B&P costs will be allocated to final cost objectives (e.g. contracts, subcontracts, funded task or delivery orders) in the same manner as G&A expenses for that business unit unless it results in an inequitable allocation. IR&D/B&P costs are generally allowable as indirect costs provided they are otherwise reasonable and allocable. The Armed Services Board of Contract Appeals has consistently rejected government arguments that IR&D/B&P costs are not allocable when incurred in conjunction with commercial work. To qualify as IR&D, the effort (a) must fall within one of the following four categories (1) basic research (2) applied research (3) development or (4) systems and other concept formulation studies and (b) not be "sponsored by a grant or required in the performance of a contract."

It is the part (b) above – "sponsored by a grant or required in the performance of a contract" - that is the source of controversy of whether costs must be charged direct to a contract or can be charged indirect to IR&D and it is that feature we will address in this article.

The History of the Regulation

The development of the cost principle has had a controversial history in determining when IR&D effort is "required in the performance of a contract" or "sponsored by a grant or cooperative agreement."

The Armed Services Procurement Regulation 15-205.35 in 1959, which predated the FAR, provided that IR&D "is that research and development which is not sponsored by a contract, grant or other arrangement." The ASPR Council considered changing "not sponsored by" to "not sponsored by or in support of a contract" but industry opposition prevailed when it asserted the change could be interpreted as including IR&D work completely unrelated to a contractor's government contracts. The ASPR was changed in 1971 to state that IR&D "is that technical effort which is not sponsored by, or required in the performance of, a contract or grant."

In 1974, the General Accounting Office attempted to broaden the type of development effort not allowable as IR&D to exclude not only that technical effort *explicitly* required by the terms of the contract but also the effort *implicitly* required to fulfill the contract's objectives. Both industry and the Department of Defense opposed GAO's interpretation where the DOD stated the concept that all work *implicitly* required by a contract should not be allowed as IR&D leaves "a great deal of impreciseness in the definition."

Case Law History for "Independent" vs. "Sponsored" or "Required" Effort

In interpreting the term "sponsored" as used in the cost principle, the Armed Services Board of Contract Appeal (ASBCA) has held that the cost of research projects in excess of contributions from outside sources are allowable as IR&D costs because, at least to that extent, the projects are not "sponsored" by outside sources (*General Dynamics Corp., ASBCA No. 10254*). In that case the Board adopted the contractor's "common sense" argument that because there was no question the costs were allowable if the contractor had undertaken the research without any financial assistance from outside help, the contractor should not be penalized for obtaining private contributions that effectively reduced the government's cost.

Cases that construe the term "required by" are not consistent. One case involved costs incurred under a cost-plus-fixed-fee contract where after reaching the funds limitation amount the contractor continued to work, charging the costs to its IR&D account. The government argued the effort was "required" under the terms of the contract and therefore should be an unallowable cost overrun. The ASBCA disagreed holding the costs were properly charged to IR&D because the contractor was not contractually obligated to perform the work (*Unisys Corp., No. 41135*).

In another rather famous case, the contractor was working on a firm fixed price (best efforts) contract to develop two prototypes for the Divisional Air Defense System (DIVAD) where the nature of the contract required the contractor to only provide its "best efforts" to meet the contract requirements and had no obligation to continue work so when it did so it charged its IR&D accounts. Apparently not aware of the difference between a firm fixed price contract and a firm fixed price (best efforts) contract, the government erroneously claimed the contractor mischarged over $8 million asserting even if the work was not required the costs had to be charged directly to the DIVAD contract because the work could be *specifically identified* with that contract and hence could not be charged to IR&D. The Court disagreed stating the IR&D regulations state work required in the performance of a contract cannot be charged to IR&D but they never use the term "specifically identifiable" nor do they in any way suggest the term has significance with respect to what is and is not IR&D. The Court stated that the proper inquiry into determining whether something should be charged direct to the contract or to IR&D is to determine what is required under the contract's statement of work (*General Dynamics Corp. v. United States, No. CV89-6726).*

The Newport News Case

This is the first case that squarely addresses the issue of whether work implicitly required by a contract qualifies as IR&D. Newport News Shipbuilding (NNS), a long time government ship building contractor, was charged with violating the False Claims Act because it included total IR&D costs in its G&A pool for development of a line of tankers intended for the commercial shipping market after it received two commercial contracts for the new tankers. The total IR&D cost at issue was $74 million and the basis for the questioned costs and fraud allegation is that NNS knew such costs were "required in the performance of a contract" and therefore could not properly be characterized as IR&D costs.

The Court acknowledged that the meaning of "required in the performance of a contract" has been a subject of much controversy and it stated there were three potential interpretations of that language. First, the phrase could be read narrowly, such that only those efforts "explicitly called for in the contract" would be subject to exclusion under the cost principle. Second, the phrase could be read more broadly, to exclude "everything implicitly necessary to carry out" the contract. Finally, the phrase could be read as not focusing on whether the contract requirement was explicit or implicit but rather whether the effort was required by more than one contract. That is, if the effort was required by more than one contract, it could not be said to be required by "a" contract and therefore the cost would be an allowable IR&D expense.

After noting no case law squarely addressed the issue the Court adopted the second interpretation which had the effect of imposing the greatest restriction on IR&D cost allowability. The Court said the costs of efforts "required in the performance of a contract" must be read to include efforts which are not explicitly stated in the contract but are nonetheless necessary to perform the contract and thus implicitly required by it. The Court continued, saying the practical effect of its interpretation is the "required in the performance of a contract" exclusion is to create a temporal dividing line between IR&D and direct work that must be billed to a contract at the point the contract requiring the effort is signed. Prior to such a contract the research and design effort is independent and is eligible to be charged to IR&D provided the effort meets the definition of IR&D. Once a contract is signed, the research and design efforts that are explicitly or implicitly required in the performance of that contract are no longer IR&D. Thus, once a contact is signed the performance of which requires, explicitly or implicitly, a certain effort then that effort may thereafter no longer be charged as IR&D even if it also stands to benefit other existing contracts, potential future contracts or class design.

Commentary

The commentaries say though this is only a single decision by a single district court it is the only definitive decision of the issue and hence will likely be relied upon heavily by DCAA, contracting officers and the Department of Justice. They state not only will the "explicitly required" or "multiple contracts" (e.g. benefiting more than one contract) interpretations used by so many contractors change but now contractors who rely on legal interpretations of the IR&D cost principle that are not challenged are subject to False Claims Act liability. Further, since it is highly unlikely the government would accept R&D related costs allocated to a government contract that were formerly charged to IR&D, the effect is to disallow such costs once a contract is signed.

The commentaries believe the NNS decision adopts a "remarkably simplistic and entirely unworkable timing rule" for application of the IR&D cost principle. The Court's decision that cost-charging should proceed along a "temporal" path – that is, the effort can be charged to IR&D up to the point a contract is signed and then must be charged to that contract – runs counter to the history and purpose of the IR&D cost principle. It was created so contractors and the government can derive the benefits of contractual R&D and closely-related IR&D efforts and both will suffer if closely related R&D efforts can no longer be pursued in parallel.

As for guidance to contractors, Ms. Manos offers a few suggestions: (1) ensure your employees understand the importance of appropriately characterizing and charging IR&D efforts (2) before undertaking an IR&D project determine and document your determination that the effort is not required in the performance of a contract or grant (3) when in doubt about the appropriate characterization of certain efforts, consider making a written disclosure of your plan to the cognizant ACO or auditor and if possible, seek an advance agreement and (4) when performing on IR&D projects, ensure there is a mechanism in place for determining whether (and when) you are awarded a contract that requires the same effort.

In addition to Ms. Manos' guidance, we recommend to our clients they:

1. Either draft or revise existing policies on IR&D to provide full disclosure of accounting for IR&D to avoid the type of fraud claims encountered by Newport News. The policies should address questions like (a) when was the IR&D project established (b) which cost objectives is the IR&D project intended to benefit and which objectives actually benefit (c) what technical objectives does the IR&D project fund and (d) are contract requirements clearly defined.

2. If contractors choose to follow their prior practices then they should be prepared to demonstrate why the

facts surrounding their IR&D costs are different than those faced by NNS (e.g. materiality of the costs, contract mix results in different allocation – NNS had primarily cost type work, new products are intended for sale to the government rather than the commercial market, the efforts are continuing while NNS soon dropped the commercial tanker business).

3. If contractors choose to change their practices to conform to the NNS decision, they should stipulate in their forward pricing and incurred cost proposals that allocability of certain IR&D costs are not settled and hence the contractor reserves its right to claim such costs in the future.

FINANCIAL DATA COMPARING PROFESSIONAL SERVICES CONTRACTORS

(Editor's Note. Most firms want to know how they compare with others. Unfortunately, most useful information is proprietary and almost all surveys we encounter are limited to generally useless financial data extracted from annual reports of publicly traded companies. The exception to this rule is an annual survey published by Wind2Software, Inc. Wind2 Software is a software development company providing accounting and information systems to government contractors and though we do not endorse products we believe their accounting software should be considered in any purchase decision. The survey is unique because it surveys actual firms of varying sizes and offers very relevant data for government contractors. It surveys a broad range of professional services companies such as engineering, architecture, environmental, etc. and we find the results closely mirror those of most professional service organizations. This is not surprising since most labor intensive businesses incur similar costs. For a copy of the survey, contact Nick Bettis of Wind2 Software at 800-779-4632)

The Wind2 Software survey presents a wide range of useful information: comparison of data for each year from 1978-2003, profit and loss statements, key financial ratios (e.g. current ratio, average collection periods), identification of key overhead cost elements (e.g. all fringe benefits, insurance, indirect labor, depreciation, marketing costs etc.), key measures of productivity, and other financial measures (e.g. work-in-process incurred but not billed, number of firms that charge interest on late accounts). The following table and explanations represents a selection of measurements for 2003 we chose that will provide interesting comparisons for our government contractor readers. For those who (like us) forget statistics terms, "mean" refers to an average while "median" refers to a midpoint.

	Mean	Median
1. Net Profit on Total Revenue Before Tax & Distribution	6.6	7.7
2. Net Profit On Net Revenue Before Tax & distribution	7.9	9.8
3. Contribution Rate	60.8	63.7
4. Overhead Rate (Before Distribution)	151.5	150.5
5. Overhead Rate (After Distribution)	166.4	168.7
6. Net Multiplier	2.89	2.92
7. Unallowable Overhead as a Percentage of Direct Labor	18.6	12.1
8. Unallowable Overhead as a Percentage of Total Overhead		
-Before Distribution	25.0	8.0
-After Distribution	23.2	6.6
9. Net Revenue Per Total Staff	$90,710	87,381
10.Net Revenue Per Technical Staff	$111,563	108,483
11.Chargeable Ratio	63.1	62.2
12.Marketing Per Total Revenue	3.4	2.6
13.Marketing Per Net Revenue	4.2	3.1
14.Errors and Omissions (E&O) Insurance as a Percent of Total Revenue	1.2	1.1
15. Health Insurance as a Percent of Net Revenues	3.7	3.5

1. Net Profit on *Total* Revenue before Tax and Distribution. Total revenue includes revenue generated from in-house labor (representing 85-90% of total revenue) as well as consultants or subcontractors and billable reimburseable expenses. Before distribution is before bonuses and profit distribution – since these items vary widely, the survey compares results before and after such distributions.

2. Net Profit on *Net* Revenue Before Tax Distribution. Net revenue refers to revenue generated only by employees and may be more relevant for firms having unusually high outside consultants and/or large reimburseable expenses.

3. Contribution Rate. This measures the portion of each dollar of net revenue remaining after all direct project costs (both labor and expenses) are covered.

4. Overhead Rate (before distribution). This is the percentage of total office overhead to direct labor. What the survey calls "office overhead" is really what many contractors call overhead and G&A including the portion of employees labor not direct charged to

projects. Adjustments for unallowable costs are addressed below.

5. Overhead Rate (after distribution). Same as above but the overhead includes bonuses, employee profit sharing and other distributions but not distribution of profit.

6. Net Multiplier. This is the effective multiplier achieved on direct labor and is calculated by dividing net revenue by direct labor. Consultants and reimburseables are excluded in order to determine an actual multiplier achieved by the firm's own efforts. The figure indicates participating firms received $2.89 for each $1.00 of direct labor spent.

7. Unallowable Overhead as a Percentage of Direct Labor. This consists of total overhead that contractors either voluntarily delete or government auditors disallow as a percentage of direct labor.

8. Unallowable Overhead as a Percent of Total Overhead Before and After Distributions. Looking at unallowable costs from a different vantage.

9. Net Revenue for Total Staff. This rough productivity index measures net revenue for each employee or part-time equivalent. It is calculated by dividing net revenue by average total staff, including principles and part time equivalents.

10. Net revenue Per Technical Staff. This is probably more relevant because it measures revenue by those directly responsible for generating it.

11. Chargeable Ratio. Measures the percent of total staff time charged to projects (whether billed or not) and is calculated by dividing total direct labor by total firm labor (direct labor plus indirect labor, vacation, sick leave and holidays actually paid).

The Survey seeks to identify key overhead cost components expressed in numerous ways such as percent of direct labor, gross revenue, net revenue. A few examples are:

12. Marketing Costs Per Total Revenues. Takes all marketing expenses (principal and staff salaries plus expenses) divided by total revenue.

13. Marketing Costs Per Net Revenues. Net revenue is the denominator.

14. Errors and Omissions (E&O) Insurance as a Percent of Total Revenues.

15. Health Insurance as a Percent of Net Revenues. This new measurement reflects the relative increase of this significant insurance cost that now far exceeds E&O insurance.

RESPONDING TO A DCAA DISALLOWANCE OF "PUBLIC RELATIONS" COSTS

(Editor's Note. Advertising and public relations expenses represent"hot" areas for audit scrutiny. These costs are often significant and since they are considered "expressly unallowable" often include penalty provisions. The regulation covering "public relations" expenses is one of those cost principles that can be subject to many interpretations. FAR 31.205-1 defines public relations costs as functions and activities dedicated to enhancing an organization's image or products and maintaining or promoting favorable relations with the public and intends for such costs to be unallowable. But the same regulation makes certain public relations costs allowable so disputes will arise on whether a given transaction is an unallowable public relations expense or meets one of the many allowable activities. Below is a summary "case study" of a response our consulting group made to a DCAA draft audit report that questioned certain vendor charges as unallowable advertising and public relations expenses. The client is an engineering firm and we will refer to it as "Contractor."

Background

During its audit of two years of incurred cost proposals, DCAA examined numerous transactions and isolated the invoices of one vendor that produced the material discussed below. The invoices included design and production of the material and DCAA questioned over $250,000 of the invoices in each year. It referenced FAR 31.205-1 as grounds for disallowing the costs stating the design and production costs associated with the material was "unallowable advertising and public relations costs." Also, since FAR 31.205-1 "expressly disallowed the costs" DCAA recommended imposition of penalties on the questioned costs.

The costs being questioned relate to various printed material Contractor produces and makes available to whoever asks for information. Contractor receives numerous requests from a large number of constituents to provide information about its technologies, capabilities, nature of its projects, experience of personnel, analyses of risks, contacts for follow-up technical questions, etc. Rather than respond individually to these requests, Contractor

prepares material in advance to provide the requested information. The constituents who regularly request information include actual and potential clients (government and non-government), actual and potential vendors, various community groups, actual and potential teaming partners, security analysts, representatives of the media, etc.

The disputed material includes the following:

1. *Statement of Qualification*. These are spiraled notebook-like items consisting of 10-50 pages printed on two color paper. The cover sheet is full colored and glossy while all the pages inside are either one or two colors printed on plain paper. All contain a description of Scope of Services, Project Profile and Professional Profiles for distinct engineering specialties (e.g. OSHA, environmental services, etc.).

2. *Comprehensive Resources Strategic Solutions*. These are full colored items printed on glossy paper usually including photographs. They are either in the form of a one page foldout with six individuals pages or a small spiraled notebook. For the 6 page foldouts, there is a cover page followed by page(s) containing a list of services (1-5 pages). Some have additional information such as list of offices and information about the company. Like the Statement of Qualification there is separate material for various industries.

3. *Financial Reports*. These include annual reports for various years.

4. *Environmental Regulatory Agency Atlas*. This is a 192 page, three color 5" by 3" small manual that lists agencies with maps and directions.

5. *Information Sheets*. One or stapled four page information sheets that are primarily two color plain sheets that cover a wide range of information. For example, a random selection of five Information Sheets included Environmental Site Assessment, Community Outreach In Oakland, Representative Client List, List of Nevada Offices and Projects and Bioremediation Services

6. *Folders*. These are two page two colored folders printed on glossy paper which are intended to hold the other material.

The material is usually located in one back area of each office so employees may collect and distribute relevant information to their constituents.

Our Response

♦ Allowability

Though DCAA's reference to FAR 31.205-1 is appropriate, we believe sections FAR 31.205-1(e)(2)(i), (ii), (iii) and (f)(3) are the relevant sections of the cost principle to consider. Specifically:

FAR 205-1(e)(2)(i). "Allowable public relations costs include costs of responding to inquiries on company policies and activities." Rather than respond to large numbers of inquiries with individualized responses, Contractor believes it is prudent to anticipate inquiry areas and have ready responses that can be selected and sent out quickly. All the material in question is material used to respond to inquiries about Contractor's policies and activities.

FAR 205-1(e)(2)(ii). "Allowable public relations costs include costs of communicating with the public, press, stockholders, creditors and customers." The material in question is used frequently to communicate with each constituent identified in the above FAR section, especially customers and creditors (e.g. vendors).

FAR 205-1(e)(2)(iii). "Allowable public relations costs include costs of conducting general liaison with news media and Government public relations officers…" The material in question is also frequently distributed to representatives of various media (e.g. numerous industry publications, various media groups) and government representatives including government public relations officers, project managers, technical and contracting personnel. The material is provided either when requested or when Contractor decides the public needs to be informed about its experience or capabilities.

FAR 205-1(f)(3). "Costs (are unallowable) of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information." The nature of the material in question can most accurately be characterized as "dissemination of technical information."

♦ Discussion of Material

In our response, we selected a broad range of samples of the materials and discussed in detail the nature of each type of publication. Whereas some of the material clearly related to dissemination of technical information other were not so we, at the least, hoped

to demonstrate where a majority of the costs were allowable so there would be only a minimal amount of questioned costs. We summarize our presentation below.

The *Statement of Qualification* meets the allowable function of "dissemination of technical information." The *Atlas* is primarily used by Contractor personnel and the *folder* is merely a vessel to hold the information distributed to constitutes. The *Comprehensive Resources Strategic Solutions* and some of the single sheet *inserts* are used for, at least, one of the following purposes – "technical information" to a constituent, liaison with news media or government and most commonly responses to inquiries on company activities and policies or communication with various constituents such as the "public, press, stockholders, creditors and customers."

Some of the material consists of plain paper with one or two colors while some use glossy paper and multi-colors where the latter may be associated with traditional advertising material. However, the days when there was a significant price difference between one to three colors printed on nondescript paper and multi-colored, glossy paper where the later was reserved only for "advertising" are gone. Now, there is little price difference between the two types of material so the existence of material printed on glossy paper using multiple colors does not mean the material is for advertising – we maintain that different types of printed material can and is used for allowable communications purposes.

Penalty

Since the cost is unallowable in accordance with FAR 31.205-1 DCAA is recommending that a penalty be imposed equal to 100% of the questioned costs applicable to relevant cost type contracts in accordance with FAR 42.709-1 and FAR 52.242-3, "Penalties for Unallowable Costs." (*Editor's Note. The purpose of responding to the imposition of penalties is not so much to change DCAA's mind as to lessen the contracting officer's interest in seeking penalties. Though its guidance does not necessarily require it to do so, DCAA often takes a rather expansive view of what is expressly unallowable – if a FAR 31.205 cost principle can be cited the questioned cost is usually considered expressly unallowable and hence subject to penalties. When DCAA does take this position, we usually find them unwilling to budge but we are frequently successful when arguing the point at the contracting officer level.*)

We disagree that the costs are "expressly unallowable." (*For a detailed discussion of Penalties on Unallowable Costs see our GCA DIGEST article in the Fourth Quarter 1999 issue*). "Expressly unallowable cost" is really a narrow term where both the FAR and CAS 405.30(a)(2) define it as "a particular item or type of cost which under the express provisions of an applicable law, regulation or contract is specifically named and stated to be unallowable." In explaining the term, Preamble A to the original promulgation of CAS 405 refers to "costs whose unallowability is obvious" and costs that are "obviously unallowable." In their discussion of an example, entertainment costs, the authors of the Preamble concluded the definition of "expressly unallowable cost" is limited to obvious costs that are explicitly unallowable in *all* circumstances under the FAR 31.205 cost principles.

Court and board decisions have further confirmed this narrow definition and limited "expressly unallowable costs" to those cost principles where the cost is unallowable under "any circumstance". In *Emerson Electric Co.* (ASBCA 30090) the Board defined expressly unallowable cost as a type of expense that a cost principle states is unallowable in its entirety, using the term "clear beyond cavil." Several cases have pointed to specific costs being expressly unallowable because they were unallowable in "all" circumstances (e.g. entertainment, claim prosecution, bad debts, amortization of goodwill, alcoholic beverages). Few other types of costs found in FAR 31 are "obviously unallowable" because some type of costs are allowable while similar costs are not. Just because the cost principles make a cost unallowable does not make it "expressly unallowable." The courts have also ruled that the existence of a reasonable dispute as to a costs' allowability means that cost is not expressly unallowable. In *Martin Marietta* (ASBCA 35895) the court ruled a reasonable dispute exists when the contractor's position that the cost is allowable has sufficient validity to create more than a little doubt regarding its allowability.

Here, the questioned costs do not meet the conditions for being expressly unallowable. First, FAR 31.205-1 does not make every advertising (e.g. help wanted adds, disposition of excess material) and public relations expense unallowable. Since not all costs addressed by this cost principle are unallowable, they do not meet the condition of being unallowable "under any circumstance." Second, the nature of the costs in dispute plausibly correspond to allowable types of public relations costs. As a reasonable dispute certainly exists hence the disputed costs do not meet the condition of "clear beyond cavil."

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2003

(Editors Note. Where we have traditionally addressed significant GAO, Appeals Board and Court decisions from the previous year, we have received some requests to add important regulatory changes. The following briefly summarizes the significant statutes and regulations of 2003 where we have used the Briefing Papers January 2004 edition written by Marshall Doke of the law firm of Garere Wynne Sewell L.L.P. as well as the 2003 issues of the GCA Report. We will report on the significant decisions in the next issue.)

FAR Amendments

1. Federal Acquisition Circular (FAC) 2001-12 provides for award fees and performance and delivery incentives to be used on commercial item acquisitions (Fed. Reg. 13,201).

2. FAC 2001-13 states that progress billing requests under IDIQ contracts must be submitted under each individual order as if each order were a separate contract (Fed. Reg. 13,206).

3. FAC 2001-14 deleted the transportation cost principle (FAR 31.205-45) and revised Cost of Money (FAR 31.205-10) to state it must be measured, assigned and allocated in accordance with Cost Accounting Standard 414 or 417. Also, the same FAC requires agencies to pay interest penalties when it makes payments on cost type contracts for services later than 30 days after receipt of a proper invoice and agencies may now accept electronic signatures in connection with government contracts (Fed. Reg. 28,091).

4. FAC 2001-15 revised the compensation for personal services cost principle (FAR 31.205-6) by providing a new definition for compensation, adding "closely held corporations" to types of organizations requiring special consideration for individuals and added a new section addressing severance pay. FAC 2001-15 explained that a clarifying restructuring to the selling cost principle was intended to make any gray areas (e.g. not made specifically allowable by the FAR cost principles) unallowable (Fed. Reg. 43,871).

5. FAC 2001-16 requires all contractors to register in the Central Contractor Registration (CCR) database before award of any contract or blanket order agreement and also requires existing contracts whose period of performance goes beyond the end of 2003 to be amended to require such registration (Fed. Reg. 56,669). The same FAC also provides that the Federal Business Opportunities website at www.fedbizopps.gov become the single governmentwide point of entry for electronic public access to procurement actions exceeding $25,000 (Fed. Reg. 56,676).

6. FAC 2001-18 merged Standard Forms 254 and 255 into a new SF 330 to create a single streamlined form to provide essential information about qualifications and experience, to facilitate electronic usage and reflect disciplines and technologies (Fed. Reg. 69,227). The same FAC also provided new debriefing information that must be provided to unsuccessful bidders such as an agency's evaluation of weak or deficient areas, overall evaluated cost or pricing and technical rating of successful and debriefed offerors, overall ranking of offerors when ranking was developed, a summary of the rationale for award and reasonable responses to questions posed by the debriefed bidder (Fed. Reg. 69,257).

Agency Regulations

The Defense Department (1) provides an alternative to the FAR clause 52.232-7 that requires the CO to withhold 5% of the amount due to a maximum of $50,000 under T&M and Labor hour contracts until the contractor executes a release to the government of final payment. Now, the CO is not required to withhold the 5% and if they do, substitutes the $50,000 requirement for an "adequate reserve" not to exceed $50,000 (Fed. Reg. 69,631). (2) Provides for payment of provisional award fees under cost-plus-award-fee contracts where payments may be made not more often than monthly and are limited to no more than 50% of the fee evaluation for the initial evaluation period and 80% of the evaluation score for the prior evaluation period times the award fee available for the current period (Fed. Reg. 64,561). (3) Requires more audit rights of traditional defense contractors under "Other Transaction" Agreements for prototype projects in excess of $5 Million and "should" have audit rights of nontraditional defense contractors (Fed. Reg. 27,452).

The General Services Administration (1) amended the GSAR to allow state, local and tribal governments to make purchases for information technology items under Federal Supply Schedule contracts. The orders placed by the state and local governments will be under separate contracts and the FSS contractors are

not required to accept the orders (Fed. Reg. 24,372). (2) Gives the FSS the unilateral right to change the percentage rate of the Industrial Funding Fee (IFF) in multiple award schedule contracts. The announcement stated the FSS intended to lower the IFF rate from 1.0% to 0.75%, effective January 1, 2004 (Fed. Reg. 41,286).

The Department of Homeland Security issued regulations to provide liability protection to sellers of "qualified anti-terrorism technologies" to give incentives for needed development. The regulations provide procedures and criteria for (a) "designation" of qualified anti-terrorism technologies (b) "certification" of an approved product for establishing a rebuttable presumption of the applicable government contractor defense and (c) "indemnification" rights (Fed. Reg. 59,684).

The Department of the Treasury established interest rates at 4.25% for the period January 1 to June 30, 2003 (Fed. Reg. 78,566) and 3.125% for the period July 1 to December 31, 2003 (Fed. Reg. 39,185). These rates apply to (a) interest contractors must pay the government under the Interest clauses of FAR (b) the rate the government must pay contractors for successful claims under the Contract Disputes Act (c) rates the government must pay under the Prompt Payment Act and (d) cost of money calculations in FAR and CAS.

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.

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 placed 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 were general remarks made 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 unless the contractor relied on the misinformation during bid preparation. If the report contains information about 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, 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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