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Know Your Cost Principles and Cost Accounting Standards…
LEGAL COSTS

(*Editor's Note. In our continuing series on cost principles and cost accounting standards, we address legal costs in this issue. These expenses are often significant and are considered a high risk account (i.e. potential for including unallowable costs) by government auditors. For our discussion of cost allowability and allocability we have relied on an article by Karen Manos of the law firm of Howrey LLP in the April 2005 issue of Briefing Papers and the Defense Contract Audit Agency's Contract Audit Manual for our discussion of DCAA's audit guidance.*)

This article will provide an overview of the two provisions of the FAR cost principles that govern allowability of legal fees: FAR 31.205-33, Professional and consultant costs and FAR 31.205-47, Costs related to legal and other provisions. Though we focused on FAR 31.205-33 a few years ago in our discussion of consultant costs, this discussion will primarily address the costs as they relate more directly to legal costs. Since Ms. Manos selects very pertinent board and court decisions we will also discuss some of her selections that pertain to interpretations of cost allowability and allocability issues as well as notable guidance by DCAA.

Professional and Consultant Costs

FAR 31.205-33 governs costs of professional and consultant services rendered by persons of a particular profession or have special skills but are not officers or employees. It operates in tandem with FAR 31.205-47 and other cost principles that limit allowability of costs associated with certain activities such as FAR 31.205-3, Bad debts; FAR 31.205-27, Organization costs; FAR 31.205-28, Other business expenses; FAR 31.205-30, Patent costs and; FAR 31.205-38, Selling costs.

The general rule is that reasonable costs of professional and consultant services are allowable except when (1) incurred in any of the circumstances listed in paragraph (c) of the cost principle (i.e. making unallowable costs arising from illegal or improper business practices) (2) limited by other applicable cost principles (e.g. bad debts, organization, certain patent or selling costs) or (3) are contingent upon recovery of costs from the government. So, in *RRP Construction* where a consultant prepared the contractor's termination settlement proposal and was paid an initial fee of $100 plus 10% of the settlement amount, the court ruled only the initial fee was allowable.

Paragraph (d) of FAR 31.205-33 lists eight factors the contracting officer is required to consider in determining allowability of professional and consulting costs which include such things as the necessity of contracting for the service, whether it can be performed more economically by employees, qualifications of the consultant, customary fees charged for the services and adequacy of the contractual agreement. The government has generally not succeeded in challenging the reasonableness of the contractor's decision to retain professional services. For example, in *Cramp Shipbuilding*, the Court ruled it was reasonable for the contractor to retain outside legal and accounting services rather than use in-house services. In addition, FAR 31-205-33(e) imposes additional conditions to support allowability of retainer fees (i.e. fees paid to provide professional services for a specific period of time on as-requested basis).

In response to the "Operation Ill Wind" criminal investigation in the mid-80's where illegal payments were disguised as consultant expenses, FAR 31.205(f) was issued that provides for fees to be allowable they must be "supported by evidence of the nature and scope of the service furnished." In addition, the costs must be supported by evidence in each of the following three categories: (1) details of the agreement and actual services performed (2) invoices or billings, including detail as to time expensed and nature of services provided and (3) consultants' work products and related documents such as trip reports, minutes of meetings, reports, etc.

Ms. Manos believes that DCAA guidance issued in May 2002 addressing documentation requirements

under section (f) may prove "problematic." The guidance said that earlier impressions that only one of the three categories was required and that work performed by attorneys and CPAs was exempt under attorney-client privilege rules were incorrect. The guidance also stated that if consulting costs are claimed as indirect expenses and the contractor does not have the required evidence then a penalty under FAR 42.709 can be imposed. Ms. Manos says it is long established that a cost principle may not override court-recognized privileges such as the attorney-client privilege and to disclose such information violates court sanctions. As for penalties, she stresses that it is inappropriate to impose them if evidence is insufficient or a contractor fails to provide it under attorney-client privilege rules. Penalties are appropriate only for "expressly unallowable costs" which are defined as costs specifically named by express provisions of law, regulation or contract. The ASBCA has held that to impose penalties "the government must show that it was unreasonable under all the circumstances for a person in the contractor's position to conclude the costs were allowable" and the professional costs are not made expressly unallowable because DCAA is dissatisfied with the contractor's supplied evidence.

♦ DCAA Guidance

Chapter 7-2105 of the DCAA Contract Audit Manual (DCAM) provides insight into areas of particular concern when professional services costs are being audited. In addition to reiterating FAR requirements, auditors are told to:

(1) Ensure other unallowable costs (e.g. political donations, bribes) are not included in this category of expense.

(2) Though auditors are told not to substitute their judgment for explicit documentation requirements (e.g. agreement details, invoices and work products) they are told to use their judgments to determine if documentation is adequate.

(3) Where auditors used to commonly disallow costs if "work product" was not deemed adequate, new guidance significantly changes the work product criteria where "other evidence may suffice" to determine the nature and scope of work performed.

(4) The burden of producing adequate evidential matter to support claimed costs falls on the contractor. If additional support is needed, the auditor is told to ask for it and give the contractor a reasonable time to comply after which if not provided, the costs are to be questioned as "expressly unallowable" in accordance with FAR 31.205-33(f). (*Editor's Note. The term expressly unallowable is normally meant to be a green light to recommend imposition of penalties up to three times the questioned amount.)*

Costs Related to Legal and Other Proceedings

FAR 31.205-47 governs allowability of legal costs incurred for particular types of proceedings. Whether it be costs of professional services covered by FAR 31.205-33 or legal services under FAR 31.205-47, most legal costs are allowable but those incurred under the following circumstances are always unallowable: (1) attempts to improperly obtain, distribute or use information or data protected by law or regulation or to improperly influence the contents of solicitations, the evaluation of proposals or selection of sources for contract or subcontract award (2) services obtained, performed or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest (3) services performed that are not consistent with the purpose and scope of the services contracted for (4) defense against federal government claims and appeals or prosecution of claims or appeals against the federal government (5) organization, reorganization (including mergers and acquisitions) or resisting mergers and acquisitions (6) defense of antitrust suits (7) defense of suits brought by employees or ex-employees under the Major Fraud Act of 1988 where your company was found liable or settled (8) defense or prosecution of lawsuits arising from (a) an agreement or contract concerning a teaming arrangement, a joint venture or similar arrangement of shared interest and (b) dual sourcing, or production or similar programs unless (i) incurred as a result of compliance with specific terms and conditions or written instructions from the CO or (ii) when agreed to in writing by the CO. (9) patent infringement litigation unless otherwise provided in the contract (though general counseling services such as advice on patent laws and regulations are allowable) (10) representation of or assistance to individuals, groups or legal entities which your company is not "legally bound" to provide, arising from an action where the participant was convicted of a violation of law or regulation or was found liable in a civil or administrative proceeding or (11) bid protests or defense, unless the costs of defending against the protest are incurred pursuant to the CO's written request.

Except for actions brought by employees under the Major Fraud Act or qui tam relators under the False Claims Act, legal costs incurred in connection with defense against suits brought by nongovernmental parties are generally considered allowable. Legal costs incurred in connection with suits brought by your employees other than those alleging fraud against the government are generally allowable. Backpay resulting from violations of federal labor laws or Civil Rights Act should be allowable provided it represents additional compensation for work performed for which the employee was underpaid and is not compensation for other violations such as improper discharge or discrimination.

FAR 31.205-47 was significantly revised in 1989 to implement the Major Fraud Act of 1988. The revisions made unallowable under any covered contract any costs incurred in connection with criminal, civil or administrative proceeding brought by the US, state, local or foreign government if the proceeding (1) relates to a violation or a failure to comply with a federal or state statute or regulation and (2) results in one of four outcomes: (a) criminal conviction or plea of *nolo contendere* (b) a determination of contractor liability in a civil or administrative proceeding involving an allegation of fraud or similar misconduct or imposition of a monetary penalty (c) final decision to debar or suspend contract or rescind, void or terminate the contract for default or (d) a disposition by consent or compromise if the action could have resulted in one of the outcomes. Even if the proceeding does not result in one of the enumerated dispositions, the allowable costs may not exceed 80% of the otherwise allowable costs incurred. FAR 31.205-47 applies to wrongdoing "by the contractor (including agents or employees)." The incurred costs may be allowed if the proceeding is settled by consent or compromise and the settlement explicitly provided the costs are allowable. Costs incurred in a proceeding brought by a state may be allowed if the agency head determines that such costs were incurred as a result of a specific term of the contract or specific written instructions of the agency.

♦ DCAA Guidance

The guidance says that outside and inside legal services are considered to be a specific kind of professional service covered by FAR 31.205-33. Significant guidelines on FAR 31.205-47 include:

(1) In-house costs includes not only salaries and fringe benefits but secretarial and other support costs such as other services, space, utilities and library services.

(2) Recognizing that all activities of legal expenses are lumped together, it states the auditor should not undertake nor request the contractor to conduct an analysis to classify costs by activity or type of effort unless an overall review indicates an obviously excessive or significant amount of legal effort on unallowable activities.

(3) States that a penalty does not include a payment to make a unit of government whole for damages or interest accrued on the damages. Rather, a penalty is in the nature of a punitive award or fine.

(4) Clarifies that the maximum amount limited is not to exceed 80 percent (it can be less) of the otherwise allowable cost where the unallowable portion (amount above the 80%) is considered to be a co-payment to encourage contractors to incur costs responsibly even when winning a case. The cost ceiling does not apply to (a) defense suits brought by employees or ex-employees under Section 2 of the Major Fraud Act of 1988 (e.g. qui tam suits) or (b) assistance to entities found to have violated the law or regulation where the contractor is not "legally bound."

(5) The contractor is not required to anticipate whether a routine inquiry or action will result in a potentially unallowable cost proceeding so cost segregation and identification need not begin until the contractor has notice of the proceeding.

(6) Based upon the history of the regulation, the following guiding principles should be followed: (a) the government should not pay for wrongdoing, defense of wrongdoing or the results or consequences of wrongdoing (*as discussed below, this principle is the source of much controversy*) (b) the government should not encourage litigation by contractors (c) government contractors should not be put in a better position than contractors in the commercial arena and (d) the government should not discourage contractors from enforcing the government's rights and protecting its interests.

(7) Auditors should evaluate the internal controls of the contractor over approval and payments of bills submitted by outside legal services where they should include: (a) written policies/procedures of allowability of legal costs (b) policy regarding types of information and provisions to be included in

agreements with outside legal firms (c) a designated reviewer(s) of bills and (d) procedure to be followed when reviewer believes the legal firm has duplicated or billed excessively.

(8) Contractors' responses or support of DCAA audits should not be considered proceedings subject to disallowance of the cost principle.

Challenges to Allowability and Allocability

♦ Reasonableness

The requirements for allowability are the legal fees must be (1) reasonable (2) allocable to a contract (3) accounted for in accordance with cost accounting standards, if applicable or generally accepted accounting standards (4) permitted under the terms of the contract and (5) not limited by any specific cost principles. In *Hirsch Tyler Co.* the ASBCA rejected the government contention that legal costs incurred in an unsuccessful defense of an employment discrimination lawsuit were in themselves unreasonable because it was found the contractor violated the Civil Rights Act. The Board held the costs did not fall within any categories of cost principles that made them unallowable and the company followed prudent business practices to defend a litigation, no matter what the outcome, and they are of the type generally recognized as ordinary and necessary for the conduct of business. The case was considered consistent with the US Supreme Court ruling that "in an adversary system of criminal justice, it is a basic tenant of our public policy that a defendant in a criminal case has counsel to represent him." Nonetheless, DCAA continues to challenge costs of legal fees on reasonableness grounds based on the nature of the underlying wrongdoing rather than the reasonableness of the contractor's actions in defending themselves. For example, in DCAA guidance published April 13, 1995 auditors are advised to question as unreasonable costs incurred by contractors in defending against stockholder derivative suits related to contractor wrongdoing.

♦ Concept of Benefit to the Government

In *Northrop Worldwide Aircraft Services*, government attorneys tried a new tack, arguing the costs of an unsuccessful defense of a wrongful termination suit were not allocable and therefore were unallowable because there was no "benefit to the government" for incurring the expense. The case involved a cost reimbursable contract where employees claimed they were fired because they refused to participate in a contract-related fraud against the government and the state court ruled in favor of the employees. Following the rationale of the *Hirsh* case discussed above the Board ruled the costs were reasonable and allocable to the contract but the Federal Circuit disagreed stating the contractor "must show a benefit to government work from a cost" it claims is necessary for the overall business and concluded there was no benefit to the government of the contractor's defense of the wrongful employee termination. Ms. Manos states the Federal Circuit confused the concepts of allocability and allowability. Unlike reasonableness, which turns on a qualitative judgment about the nature and amount of the costs, allocability is strictly an accounting concept for logically distributing costs to cost objectives (e.g. contracts). Unlike a determination of allowability, allocability does not involve any judgment about whether, as a policy matter, the government should or should not reimburse the costs.

The ASBCA took the rationale from *Northrop* one step further in *Boeing North American, Inc.* A group of shareholders charged that Rockwell (predecessor of Boeing) failed to maintain adequate controls resulting in numerous penalties and fines being imposed by the government. Rockwell settled the suit by agreeing to pay a portion of legal costs with no admission of wrongdoing and claimed the legal costs in its G&A pool where the CO disallowed them on reasonableness grounds. The Board sustained the CO's action asserting it could "discern no benefit to the government for the contractor's defense." In addressing the *allocability* issue of the costs, the Federal Circuit court rejected the "benefit to the government" argument on similar grounds Ms. Manos put forward above, namely allocability is an accounting concept where there is no requirement that a cost directly benefit the government's interests for the costs to be allocable. To do otherwise is to allow an "amorphous inquiry into whether a particular cost sufficiently benefits the government."

♦ Direct vs. Indirect Costs

Legal fees are generally treated as indirect costs and included in the contractor's G&A pool because legal services benefit the business as a whole. However, several cases have held that when legal or accounting costs are incurred specifically for and can be identified with a particular contract they must be allocated directly to that contract. For example, in *Jana, Inc.* the

board held the costs of defending against a protest were chargeable directly to its cost type contract. Similarly in *FMC Corp*, the Court held that costs incurred in litigating a claim under a purchase order were directly chargeable to that PO and could not be included in the contractor's G&A pool. Ms. Manos points out that this line of cases can present problems for recovery of legal costs under fixed price contracts where we have seen numerous instances of DCAA questioning inclusion of costs in contractors' G&A pools, asserting they were allocable to a specific fixed-price contract. As a practical matter, when negotiating the price of a fixed price contract contractors typically do not include an estimate for litigation or investigations that may arise. Incurrence of these costs would not entitle them to a price adjustment unless a constructive change to the contract had occurred. Ms. Manos also questions whether this line of cases would withstand scrutiny under CAS 402 which requires consistent treatment of all costs incurred for the same purpose under like circumstances concluding where CAS conflicts with the FAR cost principles, CAS prevails.

♦ Claims and Appeals

It has long been held that legal, accounting and consulting costs incurred in connection with the performance or administration of a contract are allowable while costs incurred in connection with prosecution of a claim under the Contracts Dispute Act (CDA), an appeal or defense against government claims are unallowable. The timing of submitting a claim can affect both the allowability of professional services costs related to it as well as when the interest clock starts, which is only after the claim is submitted. Whether a cost is an allowable cost of contract administration or an unallowable cost of a claim depends upon the purpose for which it was incurred. There is a "strong legal presumption" that costs incurred before a CDA claim is submitted are allowable. Moreover, because only costs associated with the "prosecution" or "defense" of a claim or appeal are unallowable, even after a CDA claim is submitted, the costs may still be allowable provided they are incurred for the genuine purpose of materially furthering the negotiation process. In the important *Bill Strong Enterprises* case the Court left open the question of whether costs incurred after submission of the claim but in pursuit of contract administration are allowable. Subsequent cases have split on the matter, where the ASBCA has held they can be while the Court of Federal Claims holds they cannot.

Classic Oldie...

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 (925-363-5880). We asked him to provide some practical insights and discuss recent developments he encounters in the bidding and awarding of contracts. Tim informs us that there are several more recent cases since the original article was written in 2203 that confirms the points made in the article so we simply left the original article as is. 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 though 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.

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.

USE OF MULTIPLE INDIRECT COST RATES – A CASE STUDY

(*Editor's Note. The following article is an edited version of a position paper we prepared for a client. Our client asked us to evaluate their indirect rate structure – method of allocating indirect costs to final cost objectives – since they were expecting some of their contracts to become covered by the cost accounting standards (CAS) and wanted to determine if they had potential compliance problems. We decided to present the position paper here because it illustrates many of the issues that contractors need to consider when designing or altering their indirect rate structure, whether or not they are CAS covered. We have disguised our client's name – calling it "Contractor" - and names of its overhead rates and have eliminated some of the topics addressed in the paper.*)

In response to your request, we have evaluated Contractor's indirect rate structure, identified potential CAS non-compliances and recommended some relatively modest changes.

Current Practices

Contractor currently maintains five separate indirect rates. The current indirect rates are as follows:

1. General Overhead. This is the primary overhead rate that is applied to Contractor's primary lines of business such as systems engineering.

2. Capital Overhead. This higher rate is used for work requiring a relatively high level of asset utilization where the pool of costs reflect higher facilities, infrastructure and depreciation costs. The rate is applied to certain research and development as well as production projects.

3. Special Overhead. This lower rate is used for work where there is a relatively high rate of labor utilization resulting in lower non-direct labor as well as lower facility and equipment costs.

The allocation base for the three overhead pools identified above is a direct labor dollar base consisting of direct labor of individuals assigned to the respective pools, as well as B&P/IR&D labor dollars.

4. Material and Subcontract Handling. For purchases of direct material, direct subcontract and direct consulting dollars in excess of $50,000, Contractor segregates and accumulates the indirect expenses associated with these purchases (e.g. subcontract administration, purchasing) and allocates these costs on a base consisting of these direct expenses.

5. General and Administrative (G&A). Contractor's G&A pool includes expenses related to operating the entire company and includes a prorata share of home office expenses. The allocation base is a modified value-added base consisting of all costs except those costs included in the material and subcontract handling base. Note the G&A base includes direct material, subcontract and consulting expenses that are less than $50,000.

Conclusion

Our conclusion is that Contractor's current rate structure represents the best alternative for its needs at this time. We believe its current practices should remain in tact and we should focus on ensuring the government accepts your practices.

First, and perhaps most important, your various overhead rates as well as material handling versus G&A rates applied to certain Other Direct Costs (ODCs) provide great pricing flexibility. Contractor's system allows the company to provide low prices for price sensitive, highly competitive bidding (Special Overhead), profitable yet competitive pricing in its primary lines of business (General Overhead) and higher more profitable pricing in less price sensitive circumstances (Capital Overhead). Its treatment of direct materials, subcontracts and consulting costs allows the company to maintain a healthy G&A rate while still providing opportunities for add-ons to high dollar subcontracts and material purchases when price is based on cost-build ups.

Second, the fact that DCAA has reviewed Contractor's structure and has not expressed objections is quite positive. We attribute some of this acceptance to having an usually accepting group of auditors and audit office. Many companies with less controversial structures are occasionally challenged on their structures, particularly when new auditors/supervisors take over. Contractor should not assume things will be so accepting if the audit office is consolidated or a different audit team takes over. But be that as it may, DCAA's acceptance of Contractor's structure means it has an established practice where the burden of change should fall on the government. Also, prior acceptance of Contractor's current practices should minimize assertions of inadequate allocation practices in the past which should mean little chance of having to prepare onerous cost impact analyses or giving back funds already received.

Third, though open for challenge, I believe Contractor has some solid rationale for its practices. However, we should realize that prior acceptance goes a long way if you are not CAS covered, but new coverage will likely trigger a fresh look at your practices - often different personnel and supervisors are responsible for these determinations.

Discussion of Issues

In the light of our analysis and our preliminary discussions the remaining portion of this report will address three issues:

1. Application of the capital overhead rate to both research and development and production projects.

2. Different treatment of direct material, subcontract and consulting expenses.

3. Potential problems using the special overhead rate

(*Editor's Note. Though too extensive to recount here, we provided a detailed analysis of CAS 418 with particular emphasis on what constitutes "homogeneous" costs. Let it suffice here to define "homogeneous allocation of costs" as making sure the pool of costs, base used to apply them and resulting allocation to contracts are all balanced and appropriate and the result is "equitable" where it does not result in a disproportionate allocation of indirect expenses.)*

Applying the Capital Overhead Rate to R&D and Production Effort

♦ Appropriate Pool

Contractor has established a separate capital overhead rate to apply to all contract effort that utilizes a relatively high level of equipment and facilities assets. The pool represents similar costs of other overhead pools (e.g. indirect costs, fringe benefits, rent, etc.) as well as a higher level of asset-related costs. The asset utilization aspect is the criteria used to apply the capital overhead rate. The indirect costs in the capital overhead pool include a higher level of costs related to certain activities of the company. Some projects of the company, such as certain production and direct research and development effort, utilize a high level of equipment and facilities-related expenses and hence the pool includes relatively high levels of depreciation expenses resulting from capitalized assets, facilities expenses and infrastructure costs. The creation of a separate overhead pool for certain work requiring a high level of asset and facility utilization clearly meets the requirement for a homogeneous indirect cost pool. The costs in the pool (e.g. indirect expenses plus relatively high level of asset and facilities-related expenses) are homogeneous because they have been incurred to support certain types of projects (e.g. those utilizing a high level of asset and facilities-related support).

Conversely, inclusion of these capital asset and facilities-related expenditures in a pool of costs where the direct projects do not utilize those assets would be considered non-homogeneous. If these asset-related expenditures were included in one of the other two overhead pools, the two conditions of non-homogeneity established by the CAS Board would be met: (1) allocating substantial asset-related costs to direct projects not utilizing them represents a non-causal and non-beneficial relationship to final cost objectives and (2) if the costs were allocated separately as they are done under the current system, the allocation to final costs objectives does result in materially different cost allocations compared to using less rates. To allocate these asset-related expenses to projects not utilizing a significant amount of the assets would generate an inequitable result.

♦ Appropriate Base

Currently, the type of direct labor used for R&D and production effort varies. Specifically, direct labor required to perform R&D tasks consists of higher paid engineers while production effort is accomplished by lower paid production personnel. Consequently, Contractor is vulnerable to the assertion of non-homogeneity because a disproportionate amount of pool costs are allocated to the higher paid engineering labor. If this disproportionate allocation cannot be justified, then a direct labor *hour* base (as opposed to direct labor *dollar* base) may be appropriate. As we discussed, it is probably best to maintain the current practice since it has been used and not challenged for many years. The adoption of an alternative direct labor hour base may represent an acceptable compromise position if the current method is challenged in the future.

Different Rates Applied to Material, Subcontract and Consulting Costs

CAS 418 and the concept of homogeneous indirect pools also applies to the question of having one or separate indirect rates applied to high and low dollar material, subcontract and consulting (MSC) costs. The obvious question is whether it is appropriate to apply different rates (G&A versus subcontract handling) to seemingly similar costs, differing only in dollar value.

The support costs for MSC activity is not a linear function. That is, each MSC expenditure requires approximately the same level of administrative and supervisory effort no matter what the dollar value of the purchase is. For example, approximately the same level of G&A effort related to subcontract administration, accounting, contracts, establishing technical specifications, purchasing, etc. are required on each subcontract, no matter what the dollar value of the subcontract is. However, applying the same pool of indirect costs to the dollar value of MSCs would result in a disproportionate allocation to higher dollar value MSCs which does not reflect the equal administrative effort required on each MSC purchase.

Allocation of G&A to all other direct costs including low value MSCs is proper, meeting the criteria of homogeneity. However, application of G&A to all MSCs including high dollar ones results in a disproportionate allocation of G&A to those high value MSCs not to mention the fact most contracting officers would not allow a full G&A markup to large ODCs. This disproportionate allocation, which translates into an inequitable allocation of costs to contracts with high dollar MSCs, would render the G&A pool non-homogeneous. The same disproportionate allocation would exist if all MSCs

were included in a separate rate – support costs would be disproportionately allocated to higher dollar MSCs. To eliminate this allocation distortion, Contractor has created a separate indirect cost rate for large MSC costs only. This solution significantly reduces the disproportionate allocation of G&A or MSCs support costs to large subcontract costs.

DCAA's position on CAS 418 provides further justification for continuing the practice Contractor has been following. DCAA calls homogeneity of indirect costs pools a "significant requirement of the standard." It states that a pool may be considered homogeneous if the separate allocation of costs of dissimilar activities would not result in a materially different allocation of costs to cost objectives. Logically, the opposite would also hold – a pool would be considered not homogeneous if the costs of similar activities would result in a materially different allocation of costs to cost objectives.

However, once Contractor becomes CAS covered, there can be a problem with CAS 410. CAS 410 prescribes three acceptable bases of allocating G&A costs – single element, value added (total costs minus material/subcontracts/consulting) and total cost input. Utilization of a $50,000 threshold represents a *modified* value added base. When a CAS covered contractor wants to use a base different than the three bases used, it must obtain the approval of the contracting officer. The rationale discussed above would constitute a strong argument for obtaining CO approval of the modified base but keep in mind that a written justification and quantitative cost impact analysis would likely need to be made when Contractor does become CAS covered.

Special Overhead

As we mentioned above, Contractor's use of a special overhead rate provides an excellent opportunity to offer low bids on highly price-sensitive work. We have discussed the possibility of applying the special overhead rate to other price sensitive work where there is a high level of labor utilization. However, CAS 402 requires consistent treatment of like costs incurred under like circumstances. After discussing the issue with a couple of colleagues, we doubt whether the high labor utilization factor in itself constitutes a justifiable basis (e.g. unlike costs) to create a separate overhead rate.

To counter CAS 402 challenges, other factors need to be put forward. For example, if a contract is expected to utilize a significantly lower level of asset utilization as well as labor utilization then a more plausible justification can be made because unlike circumstances exists. Most persuasively, if the special overhead rate is used on future programs, you need to attempt to ascertain whether the nature of the work is "unlike circumstances." Examples of unlike circumstances might include a different type of service (e.g. technically, less challenging) or different labor categories performing work (e.g. technicians rather than engineers). Though it could be problematic to justify a separate rate based on the fact the contract is performed at a dedicated facility – auditors can assert that separate locations are not a basis for other work or maybe you should create location-based overhead rates – the separate location on some of the jobs using the special rate could represent additional evidence of "unlike circumstances. As you know, justifying allocation decisions are not based on solid scientific criteria – it is a matter of citing evidence to justify your decision and one of auditor judgment which can vary significantly among different auditors.

The essential requirements of CAS 402 are duplicated in FAR. Consequently, DCAA has had ample time and regulatory justification for challenging use of the special overhead rate, whether or not Contractor was CAS covered. The fact they have not done so provides some optimism that Contractor's practices will not be challenged when the company becomes CAS covered. However, Contractor needs to be careful on future acquisitions to not utilize the special overhead rate excessively in order to minimize the careful scrutiny of this unique, useful rate.

NEW CLAUSE FLOW-DOWN REQUIREMENTS

(Editor's Note. Most subcontract agreements we examine are outdated, based on models developed as far back as 1984. They are boilerplate agreements that do not reflect recent changes to the Federal Acquisition Regulations – in particular, all FAR mandatory "flow-down" clauses (clauses in prime contracts that must be included in all first tier subcontracts and usually lower tier). We have just obtained a fourth edition of the Committee on Federal Subcontracting Section of Public Contract Law group of the American Bar Association's "Guide to Fixed Price Supply Subcontract Terms and Conditions". It is intended to assist both prime contractors and subcontractors draft subcontracts for fixed price supply contracts (though it explicitly applies to "supply contracts" our inquiries to two members of

the committee who wrote it said it generally represents good guidance for labor services contracts also). This is an update to the third edition of the guidance we wrote about in the Fourth Quarter of 2002 and generally represents an expansion of mandatory flowdowns over the earlier version. The mandatory list should represent a good education tool - a study of all the FAR clauses is a daunting task but since the mandatory list represents the "key" terms and conditions of doing business with the federal government they are a good area to focus your attention.)

The Committee has identified all mandatory clauses it believes are necessary. The publication identifies the clauses for both government-wide and Department of Defense use, provides full text of them, offers other provisions that parties may want to consider including and subcontracting clauses for commercial items. We will limit this article to listing the new mandatory as well as the new, limited requirements for commercial items. You can receive the publication by calling the ABA Service Center at 1-800-285-2221.

The following provisions are now *mandatory* FAR Clauses:

52.203-6, Restrictions on Subcontractor Sales to the Government (Jul 1995). Applies to orders exceeding $100,000.

52.203-7, Anti-Kickback Procedures (Jul 1995). Applies if order exceeds $100,000.

52.204-2, Security Requirements (Aug 1996). Applies if subcontracts involve access to classified information.

52.211-5, Material Requirements (Aug 2000)

52.211-15, Defense Priority and Allocation Requirements (Sep 1990)

52.214-26, Audit and Records – Sealed Bidding (Oct 1997). This applies to prime contracts awarded by sealed bidding and to subcontracts that are expected to exceed $550,000 and require submission of cost or pricing data.

52.214-27, Price Reduction for Defective Pricing Data – Modifications – Sealed Bidding (Oct 1997). Applies if prime contract was awarded by sealed bidding.

52.214-28, Subcontract Cost or Pricing Data – Modifications – Sealed Bidding (Oct 1997). Applies if prime contract was awarded by sealed bidding and subcontracts exceed the threshold for submitting cost or pricing data ($550,000).

52-215-2, Audit and Records – Negotiation (Jun 1999). Applies if prime contract was awarded through negotiations, exceeds the simplified acquisition threshold of FAR 13 (currently $100,000) and required cost or pricing data.

52.215-10 and 52.215-11, Price Reduction for Defective Cost or Pricing Data (Oct 1997). Applies if the prime contract was awarded through negotiations.

52.215-12, Subcontractor Cost or Pricing Data (Oct 1997). Applies when prime contract over $550,000 was awarded through negotiation where certified cost or pricing data was submitted.

52.215-13, Subcontractor Cost or Pricing Data – Modifications (Oct 1997). Same conditions as 52.215-12.

52.215-14, Integrity of Unit Prices (Oct 1997).

52.215-15, Pension Adjustments and Asset Reversions (Oct 1997). Applies when any purchases will include cost or pricing data or any pre-award or post-award cost determination will be subject to the FAR cost principles.

52.215-18, Reversion or Adjustment of Plans for Post-retirement Benefits (PRB) Other than Pensions (Oct 1997). Same conditions as 52.215.15

52.215-19. Notification of Ownership Changes (Oct 1997)

52.219-8, Utilization of Small Business Concern (May 2004). Applies only if other subcontracting opportunities exist.

52.219-9, Small Business Subcontracting Plan (Jan 2002)

52.222-4, Contract Work Hours and Safety Standards Act (Sep 2000) – Overtime Compensation. Applies if this Order exceeds $100,000.

52.222-20, Walsh-Healey Public Contracts Act (Dec 1996)

52.222-21, Prohibition of Segregated Facilities (Feb 1999).

52.222-26, Equal Opportunity (Apr 2002). Only Subparagraph (b)(1) through (11) is mandatory.

52.222-35, Affirmative Action for Special Disabled and Vietnam Era Veterans (Dec 2001). Applies if order exceeds $10,000.

52.222-36, Affirmative Action for Handicapped Workers (Jun 1998). Applies if order exceeds $2,500.

52.222-37, Employment Reports on Special Disabled Veterans and Veterans of the Vietnam Era (Dec 2001). Applies to orders exceeding $10,000.

52.223-14, Toxic Chemical Release Reporting (Aug 2003). This applies if order is for noncommercial items and exceeds $100,000. Subparagraph (e) (flow down requirement below first tier) is excluded.

52.225-1, Buy American Act – Supplies (Jun 2003). Applies only is seller is supplying an item that is an end product under the buyer's prime contract.

52.225-3, Buy American Act – Free Trade Agreements – Isreali Trade Act (Jun 2004). Same condition as 52.225-1.

52.225-5, Trade Agreements (Jun 2004)

52.225-8, Duty Free Entry (Feb 2000). Applies to duty-free imported supplies in excess of $10,000.

52.225-13, Restrictions on Certain Foreign Purchases (Dec 2003).

52.225-15, Sanctioned European Union country End Products (Feb 2000). Applies only if the seller is supplying an item that is an end product under the prime contract.

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52.227-1, Authorization and Consent (Jul 1995).

52.227-2, Notice and Assistance Regarding Patent and Copyright (Aug 1996). Applies to orders exceeding simplified acquisition threshold.

52-227-9, Refund of Royalties (Apr 1984).

52.227-10, Filing of Patent Application – Classified Subject Matter (Apr 1984). Applies to orders covering classified subject matter.

52.227-14, Rights in Data-General (Jun 1987)

52.229-3, Federal, State and Local Taxes (Apr 2003)

52.233-3, Protest After Award (Aug 1996)

52.252-15, Stop-Work Order (Aug 1989)

52.242-17, Delay of Work (Apr 1984)

52.243-1, Changes-Fixed Price (Aug 1987)

52-244-6, Subcontracts for Commercial Items and Commercial Components.

52.245-2, Government Property (Fixed-Price Contracts)(May 2004)

52.245-18, Special Test Equipment.

52.246-2, Inspection of Supplies-Fixed Price (Aug 1996)

52.246-16, Responsibility for Supplies.

52.248-1, Value Engineering. Applies if order is valued at $100,000 or more while it is discretionary if valued at less than $100,000.

52.249-2, Termination for Convenience (Fixed-Price)(May 2004)

52.249-8, Default (Fixed-Price Supply and Service)(Apr 1984)

The following three clauses are considered mandatory for commercial item subcontracts. The FAR contemplates that parties will use their own commercial agreements as purchase orders.

52.219-8, Utilization of Small Business Concerns (if subcontract offers further subcontracting opportunities).

52.222-26, Equal Opportunity.

52.222-35, Equal Opportunity for Special Disabled Veterans, Veterans of Vietnam Era and Other Eligible Veterans.

52.222-36, Affirmative Action for Workers with Diabilities

52.247-64, Preference for Privately Owned US-Flag Commercial Vessels

The following two clauses, at a minimum, are recommended for review by buyer and seller under a commercial item purchase:

52.212-4, Contract Terms and Conditions – Commercial Items (Oct 2003)

52.212-5, Contract Terms and Conditions Required to Implement Statutes or Executive Orders – Commercial Items (June 2004).

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