GCA DIGEST

(A publication of Government Contract Associates)

Third Quarter 2009 Vol 12, No. 3

CASE STUDY – INDIRECT RATE ALTERNATIVES AND SHIFTING COSTS FROM G&A TO OVERHEAD

(*Editor's Note. The following article is part of our ongoing practice to provide real life case studies from our consulting engagements that we believe will have relevance to our readers. As usual, we disguise the client name – referring to "Contractor" – and other private information. We were asked to evaluate Contractor's indirect rate structure with respect to whether it provides the best possible indirect rates for pricing its government work, consider alternatives, conduct a quantitative analysis of viable alternatives and once the best candidate was selected, consider how expenses previously charged to one pool could be charged to another. The following is a summary of our analysis.*)

Background Information

Contractor is primarily a professional services company with a small portion of prototype work that has a mix of federal government (80%) and commercial clients. The government work is with several government departments with one large cost type contract having significant subcontract work as well as time and material and fixed price work having little to no subcontract work. Currently, Contractor has three indirect rates: (1) overhead allocated on a direct labor cost base (2) G&A allocated on a value added base consisting of all costs excluding direct material and subcontracts costs (M&S) and a (3) subcontract/material handling rate allocated on a direct subcontract and material cost base. The M&S rate is a little more than 1 percent where Contractor believes it could charge the government a higher rate if its cost structure provided for it but the government would not be happy about an add-on exceeding 10 percent.

Alternatives

We generated five alternative indirect rate structures that we believed were worthy of consideration. Though there were variations within each here is a simplified version of the alternatives:

A. *Current method.*

B. *Increase handling rate.* This alternative kept the current structure but reassigned dollars to different pools. (*At this stage, we did not attempt to determine whether the reallocation of costs could be justified but only reassigned costs to see whether there might be a better result for pricing purposes.*) We deducted an amount from the G&A cost pool and added these costs to the M&S pool so the result would be to double the M&S rate. Alternatively, costs could be taken from the overhead rather than G&A pools or a portion from each.

C. *Eliminate handling rate.* Both the G&A pool and base are increased to absorb the costs that were included in the M&S pool and base. A modification might include increasing the overhead pool for the costs included in the M&S pool and increasing the G&A base for the subcontract and material direct costs.

D. *Reduce the G&A rate to a more palatable 10%.* Under all three alternatives above, the result was a G&A rate far in excess of the 10 percent level the government would accept as an add-on to subcontract costs. In order to achieve the desired 10 percent rate, approximately $700,000 of costs included in the G&A pool would have to be reallocated to overhead which would lower the G&A rate by both (1) decreasing costs in the pool and (2) increasing the costs in the G&A base.

E. *Charge fringe benefits direct as a percentage of direct labor and change the overhead base to direct labor plus fringe.* This change provides the appearance of lowering the overhead rate (both direct costs and fringe costs rather than only direct costs are in the overhead base) and making changes identified in D above would yield the 10% G&A rate.

Sensitivity Analysis

We conducted a three step analysis to determine which of the five approaches would provide for maximum recovery.

1. The first step consisted of reassigning costs from one pool and base to the other, without considering whether the reallocations could be justified. For example, we moved costs from the G&A pool to the

M&S pool under Alternative B approach and we moved $700K of G&A costs to overhead under the Alternative D approach.

2. Once we made the reassignments of costs we took the second step of calculating the resulting indirect cost rates.

3. After verifying the past mix of direct costs would not vary significantly in the future, we used the most recent incurred cost proposal data to lay out the mix of costs experienced under most large contracts in each category of contract type (e.g. cost type, T&M, fixed price). Next we applied the resulting indirect cost rates generated from Step 2 above to the appropriate direct costs for each contract and then compared the total cost recoveries under each of the five approaches.

The results were clear – Alternative D provided the best cost recovery under the large cost type contracts that included significant subcontract costs while the current method provided the best results for T&M and fixed price work where there were minimal subcontract costs. Since the cost type work with significant subcontract costs were expected to predominate near future work (next 2-3 years) Alternative D was the preferred structure.

It is one thing to see the benefits of Approach D – eliminating the M&S rate and reallocating $700K of G&A costs to overhead – and quite another to make the changes required with, hopefully, gaining acceptance of the changes by the government. Could the reallocation of $700K of G&A costs to overhead be made? The next step was to examine the G&A costs and see whether a reallocation of costs would be considered to be reasonable on cost allocation grounds. Our working definitions of overhead and G&A are quite common – overhead costs are indirect costs not identifiable with any one particular project but incurred in support of projects while G&A costs are those indirect costs more closely associated with supporting the company as a whole. The list of significant G&A costs and our analysis of whether some or all of the costs could be reassigned to overhead follows.

Contract administration. Currently, contract administration costs are included in the subcontract handling pool. Since those costs need to be reassigned, the question is do they belong in overhead or G&A. Though both treatments are fairly common, one can argue they belong in overhead since contract administration normally supports contracts (hence the name) as opposed to the company as a whole.

Office Lease. Again, both overhead and G&A treatments are common. More precision can be obtained by establishing a facilities cost pool where not only office leasing costs but also other facility related costs like utilities, repairs and maintenance, landscaping, any building related depreciation would also be included in the facilities pool. Then those costs could be allocated to overhead versus G&A on a square footage usage basis. An ideal method would be to somehow calculate the space taken up by G&A versus overhead functions. However, when allocating service or cost center costs, less than ideal solutions are usually sought. For example, an acceptable basis might be headcount or labor cost basis where, for example, the percentage of direct labor and overhead related employee expenses versus G&A labor expenses might form the basis of allocating the facilities related costs that would be a surrogate measurement for a square footage allocation.

Business Management. If by "business management" you mean marketing and sales, those costs are most likely oriented to G&A. However, if by the term you mean administrative or contract related supervision, then that may be primarily overhead.

G&A Salaries. It's quite common to include the costs of entire functions into one pool However, it is probably more accurate to split out the functions and assign the corresponding costs to appropriate pools. For example, the head of HR may properly be included in G&A because their activities relate more to overall corporate activities while the HR staff time is more commonly focused on supporting direct labor personnel and hence properly allocable to overhead.

Legal fees. Similar to G&A salaries, either the head of the legal department or certain functions of outside attorneys may be related to overall corporate matters and hence G&A (if significant, these efforts may be unallowable if related to mergers and acquisitions, corporate financing, etc.). However, many legal duties are more closely related to support of projects (employee suits, environmental issues, vendor disputes).

ESOP. These costs, like payroll taxes and fringe benefits should follow the labor costs if they are assigned to specific individuals.

Depreciation costs. Depreciation costs should, of course, follow the assets so treatment of such costs should be based on usage of the assets. Building depreciation should be included in the facilities cost

pool. Computer depreciation costs could be allocated by headcount, especially if everyone has similar computers while shared assets like printers, reproduction and servers might follow computer depreciation cost allocations. Alternatively, since most asset use is derived from headcount or labor related costs, such costs may be included in the facilities cost pool if a similar basis for allocating facilities costs is logical or a separate IT cost pool may be created where allocation could be on a similar allocation basis. Exact or ideal precision is not required or, in most cases, even desired since the effort and cost of such precision is usually high – only reasonableness of assumptions is needed.

Professional Insurance. Though it is not uncommon to treat all "insurance" costs the same, the purpose of the insurance is a better gauge. So, whereas general liability insurance may more properly be considered G&A, professional insurance that applies primarily to project employees is more logically allocable to overhead.

Recruiting and relocation. These costs certainly follow the people they are associated with. Recruitment and relocation of employees primarily engaged in project or overhead functions should be allocated to overhead while if related to hiring a corporate executive more properly to G&A.

Office staff. Staff may be assigned to one or multiple functions. If primarily in support of either G&A or overhead personnel, their costs with associated fringe benefits should follow. If mixed, then either assignment to one pool or the other would be acceptable or for more precision, ask them to use timesheets if it is common for non-direct people and assign costs to the efforts reflected on the timesheets.

Internal accounting costs. Though often simply charged to G&A, a breakdown also can make sense. For example, like HR costs discussed above, the CFO and corporate controller might be considered G&A because their efforts are primarily related to the company as a whole (e.g. corporate policies, corporate financial statements) while subordinate accounting staff are more commonly associated with support of projects and hence overhead (e.g. payroll, AP, AR). Outside accounting and audit fees, on the other hand, are more commonly considered to be G&A costs.

Business Development. This function is usually G&A because costs of sales and marketing are generally associated with expanding the overall company base. It is not unreasonable, however, to distinguish between new contract work – either commercial or government which would be charged to G&A and expanding existing work which might be considered overhead. However, it should be realized that charging any "marketing" or "sales" costs to overhead is unusual and hence may generate a red flag.

Though our discussion with our client about how to divulge the changes that adoption of Alternative D would entail is beyond the scope of this article, all contractors need to consider the proper timing of such a significant change as the adoption of alternative D. When disclosure is made to the ACO and or DCAA, it is likely that a write-up detailing the changes, why they were made, justifying them and showing a gross cost impact on the changes can be expected. Also, depending on the timing of the change, there may need to be an adjustment of provisional billing rates and or an adjusting invoice where a DCAA audit can be predicted.

Knowing Your Cost Principles and Cost Allocation Requirements...

CAS 409 – DETERMINING AND ALLOCATING DEPRECIATION COSTS

(Editor's Note. As part of our continuing series on important cost principles and cost accounting standards, this is the second standard addressing capitalized assets and depreciation costs we have addressed. A good understanding of the standard will provide flexibility in how to amortize capital assets over various time periods so some of our discussion will be oriented in that direction. As is quite common with CAS, many of the provisions of the standard would, in practice, apply to non-CAS covered contractors since provisions of the standards are normally considered to be proper accounting practices. In our research we have used a variety of texts but relied most heavily on Accounting for Government Contracts – Cost Accounting Standards – edited by Lane Anderson as well as our own experience. Though the standard provides some potentially complex issues, we will focus on those issues having the greatest practical significance to our subscribers.)

Introduction

CAS 409 is the second cost accounting standard to treat the general area of fixed asset accounting. Whereas CAS 404, which we covered in the 1Q08 issue, establishes criteria for determining the acquisition costs of tangible capital assets that are to be capitalized, CAS 409 addresses issues of

depreciating the costs of tangible assets over their lives. It provides criteria for assigning depreciable costs to cost accounting periods and for allocating those costs to the cost objectives for the period.

Summary

The standard requires the cost, less its estimated residual value, be assigned to the cost accounting periods representing the assets' estimated life and that its cost be assigned in a manner representing the pattern of consumption of services over the life of the asset. Estimated lives must be based on a reasonable estimate of their expected actual periods of usefulness. "Depreciation" is the process of allocating the amortized costs over their estimated useful life. CAS 409 considers the depreciation method used for financial accounting purposes to be the default method used for contract costing purposes unless that method does not reasonably reflect the expected consumption of services or is unacceptable for federal income tax purposes. Gains and losses on disposition of tangible assets are generally considered to be adjustments of depreciation costs previously charged in prior years where they are to be recognized in the period when disposition of the assets occur. The following provides details of the standard that we consider most relevant to our readers.

Basic Considerations

Residual Value. Residual value is an estimate of the proceeds expected to be received from either selling the asset or scrap value or its fair value if traded in. The estimate can be based on prior experience or publicly available information but in many cases can be difficult to ascertain and hence many contractors simply assume a zero value.

Service Life. Physical life provides the upper bound for service life of the assets. Physical life can vary according to the purpose for which it is acquired e.g. heavy use versus light use can vary the physical life. The service life is usually less than the physical life where, for example, technological change can make the asset obsolete, assets purchased for one contract may be useful only until the end of that contract or its follow-on or management policy may limit use to a three year period after which newer models are purchased. Since service life cannot be known with precision, depreciation is charged over the estimated service life.

Depreciation costs. CAS 409 permits contractors to account for its assets either on an individual basis or by combining two or more assets as a single accounting unit. The depreciable cost of the asset (or group of assets) is the capitalized cost less the estimated residual value. The standard provides that the residual value need not be deducted from the capitalized cost if it does not exceed 10 percent of the capitalized costs or the contract uses either the declining balance (the asset is never fully depreciated so the remaining values is considered the implicit residual value) or the classic life asset range system. We occasionally receive questions on how to treat the investment tax credit the IRS sometimes provides the public. The issue is not addressed in the FAR and though contractors commonly ignore the effect of the credit with little resistance from auditors, a Comptroller General Opinion stated that failure to reduce the value of the asset by the credit "is not favored."

Considerations for Estimating the Service Life

Since the estimate of service life is the primary factor that provides contractors flexibility in how they will amortize the value of a capital asset, it is worth some discussion.

Basic Requirement. The basic requirement is that a contractor must use the estimated service life to determine the number of cost accounting periods it will depreciate the asset which must be based on a reasonable approximation of the expected actual periods of usefulness. The typical pattern is assets get utilized from the point of acquisition to some point of reduced economic potential at which time it is disposed of or traded in. The standard also recognizes that some assets are removed from active use and placed in standby or incidental use status until eventual disposal so it provides the estimated periods of usefulness need not include these additional periods. Thus assets are to be depreciated over their period of expected use – either acquisition to disposal or acquisition to withdrawal for standby.

♦ Determining Period of Usefulness

General factors. In making service life estimates, the contractor should consider both physical and economic factors. Physical factors are the outer limit and include considerations of wear and tear and decay. The economic or functional factors can be classified under three categories: inadequacy, supersession and obsolescence. Inadequacy results when an assets ceases to be useful to the contractor because higher demands have increased e.g. need for a large building. Supersession is the replacement of one asset for another more efficient or economical one.

Obsolescence is a catchall phrase for situations not involving inadequacy or supersession. Sometimes physical and sometimes economic factors are more important where the CAS 409 lists the following as being the factors to be considered: (1) quantity and quality of expected output and timing (2) costs of repairs and maintenance and timing factors (3) standby or incidental use and (4) expected technical or economic obsolescence of the asset(s) or the product or service it is involved in producing.

The standard provides an illustration of where three companies estimate service lives on identical milling machines: (1) 14 Years - using an individual asset base and looking at experience from similar machines (2) 12 Years – using asset groupings determined average period for all machine tools (3) 10 Years – grouping all machinery and equipment, determined an average replacement life for all.

Records of past experience. The requirement to maintain records to support its periods of usefulness is one of the most burdensome requirements we find for contractors who are CAS covered. Without them, not only can they be considered non-compliant with CAS 409 but their depreciation costs may be questioned or it may be alleged they are using a shorter period than justified on new asset purchases. These records should show the age of the assets at either past retirement or where available, withdrawal from active use. The records should show acquisition dates, dates the assets were retired and any other factors affecting asset life. The records need not be maintained for only support of asset lives but may be records used for other purposes such as property insurance, property taxes or maintenance records. If no data exists (e.g. newly CAS covered) when a new asset is acquired, the estimated service life may be based on a projection of the expected actual period of usefulness but may not be less than the mid-range for asset guideline classes established by the IRS that are in effect as of the first day of the cost accounting period the assets were acquired. The standard also allows for use of sampling where either statistical samples or even small samples are commonly accepted.

Modifying past experience or negotiating a service life. The standard permits contractors to modify years an asset will be used from prior records. If the service life is shorter than the records would indicate, the burden falls on the contractor to justify the period where the contractor should be prepared to specifically identify the factors that will cause the change e.g. physical usefulness such as changes in output quantity or quality, economic usefulness such as technical or economic obsolescence. It is advisable to obtain an agreement as soon as possible with the ACO.

There are times when a contractor may believe shorter service lives are necessary but cannot support it from the records. CAS 409 allows the contracting parties to agree on estimated service lives of individual assets where (1) there are unique purposes for which the equipment was purchased warranting a shorter life or (2) a shorter life can be predicted. The standard provides an illustration where a test facility purchased for a new government program has an estimated 10 years of physical life but the program will be completed in six years and will not be expected to be required for other programs for the contractor. In that case, the contracting parties may agree to depreciate the facility over six years.

Method of Depreciation

The basic requirement is that the method of depreciation selected for assigning depreciation costs to cost accounting periods must reflect the pattern of consumption services over the estimated service life. With certain exceptions the method used for financial accounting purposes must be used for contract cost accounting. If this method does not reasonably reflect expected consumption or is unacceptable for financial tax purposes then another method may be selected.

Factors to be taken into account for estimating the consumption of asset services are the same ones used for estimating service life discussed above e.g. quantity and quality of expected output, costs of repairs and maintenance. Examples of how these factors of output may be measured include hours of operation, number of operations, number of units or number of miles. An acceptable surrogate measurement for output or activity might be a monetary measurement of output such as estimated labor dollars, total cost incurred or total revenues. Contractors are often concerned about the evidence they should have available to support their depreciation method but CAS 409 offers no guidelines. Absent reliable data for measuring asset services, the expected consumption of services may be represented by the passage of time.

Though many accounting texts provide for many different types of depreciation methods the standard provides for three categories of methods: both straight-lie and accelerated methods are mentioned

by name and though not mentioned by name but alluded to in concept is the units-of-production method. When a contractor chooses to associate depreciation with a group of assets rather than individual assets, the standard permits contractors to group assets in either of two ways: group depreciation – two or more assets with similar useful life are treated as a single group or composite depreciation – same as group except the assets in the group have varying useful lives.

Special Issues

♦ Allocation of Depreciation Costs Directly to Cost Objectives

(*Editor's Note. We commonly encounter government resistance of reimbursing contractors for asset purchases used only on a contract even when there are no other uses for it but the government nonetheless will often accept direct charges of depreciation costs if such treatment is part of its accounting practices.)* CAS 409 recognizes that depreciation costs may be charged both directly and indirectly. Unless one of the conditions for direct charging exists, the normal procedure is to include depreciation costs in appropriate indirect cost pools. Depreciation costs may be charged directly to a cost objective if (1) the charges are made on the basis of usage (in effect, requiring the use of units-of-production method of depreciation) and (2) depreciation costs of all like assets used for similar purposes are charged in the same manner. So, if direct charged depreciation costs represent a group of similar assets the amount charged for usage will be an average charging rate based on costs of those assets. The contractor must be capable of determining the amount of variance between the charges and actual costs and be able to dispose of the variance in its accounting records (unless a fixed amount can be negotiated, which is highly recommended). Another method of direct charging depreciation costs is through a service center where those costs are included as a part of a function or organizational unit whose costs are charged to cost objectives on the basis of service provided. The standard is silent on the base or bases used for charging service center costs.

♦ Gain or Loss on Disposition

The standard provides some rather detailed requirements governing the treatment of gains or losses on disposition of assets which are not fruitfully addressed here. The general requirement is that the gains or losses are considered to be adjustments to depreciation costs previously charged and should be assigned to the cost accounting period the disposition of the assets occur. Firms commonly write off assets for financial purposes prior to disposing of them but such write-offs are not allowable costs until the assets is physically disposed of. Questions concerning treatment of gains and losses when an asset is exchanged for like property, involuntary conversions, grouped assets, mass or extraordinary dispositions or other than arms-length transactions should be answered by looking at the standard.

♦ Usage Charges for Fully Depreciated Assets

(*Editor's Note. We find that contractors seldom take advantage of opportunities to have usage rental charges.*) Though CAS 409 does not address the issue of how to handle fully depreciated assets the appeal boards have maintained the right of contractors to rent or charge a reasonable amount for use of those assets. FAR 31.205-11 states in determining the charge the contracting parties should consider the cost, total estimated useful life, effects of increased maintenance or decreased efficiency due to age and amount of depreciation previously charged on contracts. The last item refers primarily to cost type contracts so if say 30% of depreciation costs were charged to cost plus contracts that amount should be reduced from the basis of costs to be written off for usage charges.

NEW CONTROVERSIAL PROPOSAL ADDRESSING REQUIRED FORMAT FOR SUBMITTING INCURRED COST SUBMITTALS

(Editor's Note. A subscriber brought our attention to a recent August 10 proposal by the FAR Council intended to revise quick-close out procedures that includes requirements as to what constitutes an adequate incurred cost proposal. Though the revisions to the quick close out procedures are widely agreed to be beneficial to both the government and contractors it is the "clarifications" as to what constitutes an adequate incurred cost proposal that is generating a storm of controversy. When some of our staff were actually DCAA auditors it was not uncommon to receive 1-3 page submittals by a contractor where, for example, my first incurred cost audit was based on a one page proposal of a company having over $500 Million of auditable contracts. Now we see failure to submit proposals in the exact format of DCAA's Incurred Cost Estimate (ICE) model being rejected for all sized companies and even when

used, multiple rejections occurring when there are minor inconsistencies or information missing.)

The Proposal

The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (known as the FAR Council) issued in The Federal Register Vol. 74, No. 160 Thursday, August 20, 2009 a proposal to amend the Federal Acquisition Regulation to "revise procedures for closing out contract files" in the FAR Case 2008-020. The summary section of the proposal states the revisions are for clearing final patent reports and quick close out procedures and "sets forth a description of an adequate final indirect cost rate proposal and supporting data." The proposal follows the Director of Defense Procurement and Acquisition Policy (DRAP) May 2007 assessment that changes to improve contract closeouts needed to be made. The Council is proposing:

1. The addition to language in FAR 4.804-5 setting forth the timeframe for clearing a required final patent report.

2. Addition of language in FAR 42.708 that increases the threshold and the percentage limitation to be able to use quick-closeout procedures. Whereas the current quick close out procedures are supposed to apply to only relatively smaller contracts whose total amount of unsettled indirect and direct costs could not exceed 15 percent or could not represent more than $1,000,000 of the contractor's total amount of unsettled cost type contracts, those thresholds are now increased to no more than $4,000,000 or 20% of the unsettled contracts. The language also is based on a contracting officer's risk assessment that the procedures are appropriate. The risk assessment is to include a consideration of the contractor's accounting, estimating and purchasing systems; amount of direct and indirect costs; other concerns of the cognizant auditors and any other pertinent information.

3. Addition to FAR 42.705-1 for the cognizant auditor to determine the adequacy of the contractor's proposal for audit and provide language referencing FAR 52.216-7(d)(2).

4. Addition of language in FAR 52.216-7, Allowable Cost and Payment setting forth a description of what data is to be submitted in an adequate indirect cost proposal (ICP) where contractor "may refer to the Model Incurred Cost Proposal in Chapter 6 of DCAA's agency Pamphlet No. 7641.90, what supplemental data, required for audit, may also be submitted with the proposal and a requirement for the contractor to update cumulative costs claimed and billed within 60 days of rate settlement."

In addition, there are three more sections that provide for language changes that allow contracting officers to withhold fixed fees "to protect the government's interest and to encourage the timely submission of an adequate final indirect cost rate proposal."

Critical Commentary

All of the published comments we have encountered have expressed approval of the threshold and percentage increases to quick closeout procedures and none have expressed disapproval of the fee withhold provisions since they are not really substantially different than what went before. However, the apparent changes to the ICP have generated a great deal of commentary where there is encouragement to voice your opinion to the FAR Council before the October 17 deadline. We will focus on a commentary written by the Beason and Nalley group since it is typical of the commentary we have seen.

The FAR case basically codifies what has become an inappropriate expansion of what is considered to be requirements of an ICP and supporting data which comes directly from DCAA's guidance in Chapter 6 of DCAA Information for Contractors. It shifts long standing authority from the contracting officer to DCAA as to what constitutes an adequate ICP. The proposed FAR 42.705-1 provision would state "(ii) The cognizant auditor will make a written determination on the adequacy of the contractor's proposal for audit." Of added interest the same FAR provision, which has traditionally provided the justification for varying the ICP format, will retain the statement "The required content of the proposal and supporting data will vary depending on such factors as business type, size and accounting system capabilities". However, FAR 52.216-7 will add verbiage that basically eliminates any flexibility on the format where specific schedules, information and data will be required of all contractors regardless of type, size and accounting system. The writers state such requirements will impose "an enormous burden on many contractors" who will, for example have to develop information, adapt existing information in prescribed formats and adopt administrative actions that provide no value to accomplishing the FAR objective of timely settling final indirect rates with the least amount of supporting cost data.

The writers state that the FAR amendments were likely drafted by DCAA and provides confirmation on what the "requirements" for an adequate ICP are which they have been using as the basis for rejecting "hundreds of ICPs as inadequate." The proposal is consistent with what the DCAA Director has gone on the record as stating DCAA opinions should be mandatory with respect to "business systems." The writers state the proposal to have only the cognizant auditor determine adequacy of ICP is consistent with "DCAA's quest to be the deciding official as opposed to be advisory to a contracting officer."

Looking at the history of the development of the current FAR case, the writers emphasize the intention was to come up with changes to improve the contract close out process, including quick close out procedures. Though the DRAP included mention of indirect cost proposals, the writers express confusion on how a proposal to improve contract closeouts grew to include the need to provide Schedules A through O and supplemental schedules mirroring DCAA prescriptions.

Though DCAA has long argued that their ICP requirements help the contract close out process, there is no empirical evidence to support this contention. Though there has been recent success in closing out large numbers of contracts such success has nothing to do with the expansive requirements of the DCAA Model ICP. Rather it has been due to the common sense approach of closing out huge numbers of task orders by use of audit sampling applied to batch processing of final vouchers as opposed to 100% review. Rather than helping the process, the writers contend the extensive list of requirements including supplemental schedules has delayed the process that include routine rejections of ICPs for inconsequential shortcomings such as failure to include supplemental information at the same time as "required" schedules.

The ICP requirements include numerous schedules that have no connection to contract close outs, citing such supplemental schedules as "annual internal audit plans for the future" where future plans should have nothing to do with historical costs. Further, for those schedules that do facilitate contract closeout they state there is no logic or evidence why DCAA insistence that data contained and reasonably available in the contractor's books and records must be converted into DCAA prescribed schedules. The writers go on to state conversion of accounting data into other formats is in defiance of FAR 52.215-2(d)(2) that states access to records "may not be construed to require the contractor or subcontractor to create or maintain any record the contractor does not maintain in the ordinary course of business or pursuant to a provision of law." Additionally, the conversion of data from it native form to a different application creates an unnecessary opportunity for error.

One new requirement of the new case violates even prior DCAA practice. The proposed rule will require the contractor to update cumulative costs claimed and billed (the Cumulative Allowable Cost Worksheet) within 60 days of rate settlement while also including the schedule in the ICP. The real benefit of this significant schedule is after the indirect rates have been finalized so the parties will have a convenient schedule to see audit determined costs. In fact, the prior DCAA Director recognized the need for the schedule but only after rate settlement where its long standing practice was to accept an ICP without the schedule as long as the contractor agreed to prepare it after the rates were finalized. That has now been changed.

The writers add that the model ICP, with its exhibits and supplemental data have no connection with facilitating contract closeouts but, instead are designed to shift resource costs from DCAA to the contractor. So instead of having DCAA spending the time to perform an audit step as it has done in the past, the contractor is now require to complete a schedule for the auditor. For example, Schedule H-1 that breaks down indirect rate bases by contract type has no relevance to cost allowability or allocability nor contract closeouts but does provide the auditor with information for audit risk. Further, required supplemental data comparing current and prior expense data only helps the auditor identify audit risk but has nothing to do with the basic requirement of an ICP to present the costs of the current fiscal year.

There are numerous other schedules that do not enhance contract closeouts. One could make the argument that a standard ICP will result in more efficient and predictable outcomes of DCAA audits which do help the closeout process. However, the writers assert, there is no empirical evidence that audits have been speeded up. In fact, because DCAA audits are no longer subject to due dates and budgets like they were in the past, there is neither evidence audits have been processed quicker nor are there any predictions of when audits will be completed to help the closeout process.

The writers make the last point that the assertion that the changes are expressed as "clarifications" rather than

new is incorrect. The significance of the distinction, they point out, is if the proposed rule is considered new, DCAA actions to reject hundreds of ICPs as inadequate because they were not consistent with the model or subsequent rescinding of direct billing privileges or assertions of inadequate billing because of inadequate ICPs would be considered to be DCAA enforcing a non-existent regulatory requirement. Hence the need to assert the proposal is a clarification. The writers disagree that the proposal is merely a "clarification" of existing rules. First, why insert a long list of requirements describing an adequate ICP when there is already a reference to a model ICP that accomplishes the objective. Next, DCAA's model ICP was incorporated into the FAR as an "example" as opposed to the current "requirement." Moreover, DCAA has made extensive changes to the model over the years since it has been an example but if they were existing rules than such changes have not gone through the FAR rulemaking process.

Both the writers and other commentators point out that interested parties should submit written comments to the FAR Council before October 17.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2008

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and the Comptroller General say they are, we are continuing our practice of summarizing some of the significant decisions last year affecting grounds for successful protests of award decisions, grounds for dollar entitlement for claims and cost issues. This article is based on the January 2009 issue of Briefing Papers written by Miki Shager, Counsel to the Department of Agriculture Board of Contract Appeals. We have referenced the cases in the event our readers want to study the cases.)

Protests of Award Decisions

♦ Interested Party

To have standing to protest a procurement, a protester must be an interested party – an actual or prospective offeror whose direct economic interest would be affected by the award or failure to obtain the award (*E-Management Consultants, Inc. v US, 84 Fed. Cl.*) A protester is not an interested party if its proposal was eliminated from the competitive range (*Femme Comp. Inc v US, 83 Fed. Cl. 104*), is not a bidder (*Defense Technologies, V US, 81, Fed. Cl. 375*), a nonresponsive bidder challenges the awardee's responsibility (*OSG Product Tankers v US, 81 Fed. Cl. 297*) or a large business challenges a small business set-aside (*Int'l Mngt Svrcs v US, 80 Fed. Cl, 1*). However, it is an interested party if its proposal would be in line for award if its protest is sustained (*ECI Defense Group, Gen., Dec B-400177*), it is a successor in interest to an actual offeror who stands in the shoes of the offeror (*Integrated Systems v US, 84 Fed. Cl. 768*), did not submit a proposal where submission would have been futile (*CAN Corp V US, 81 Fed. Cl. 722*), a non-bidder challenges a sole-source award as improper (*Savannah Fin'l Svcs v US, Fed. Cl 300*) or an offeror in a best value procurement whose price is low even though another had a higher technical score (*Native American Indus. Distr. Comp. Gen. Dec. 310737*). *We will refer to Comp. Gen. decisions by the name of the company and the case number).*

♦ Standards of Selection

In evaluating the technical evaluation of a proposal during a protest the Board will not reevaluate proposals but will rather examine the record to determine whether the evaluation was reasonable and consistent with evaluation criteria and applicable regulations. A protester's mere disagreement with the agency's evaluation does not render it improper (*Integrated Mmgt. Resources Group, B-400550*). While agencies must evaluate proposals in accordance with the terms of the solicitation, any evaluation considerations not expressly stated in the solicitation must have "a clear nexus between stated criteria and unstated considerations" (*Consol. Engrtg Svcs, B-311313*). Protests are sustained if the records lacked documentation to support agency's decisions (*Apptis Inc., B-0299457*) or point scores cannot be used as a substitute for adequate documentation of the evaluation conclusions (*Burchick Construction, B-400342*). But documentation, although brief, was sufficient to permit review and support of the agency's decision (*Precision Lift, B-310540*). However, the Court of Federal Claims Protests does seem to provide greater latitude to supplement the record than does the GAO. The Court provided a list of circumstances where it is appropriate to supplement the records with declarations and attachments providing information on the protester's financial management system's capabilities to meet agency needs (*Savannah*) and the court suggested supplementing the "scant" record with material that provided it a basis to review the agency's actions (*CHE Consulting V US, 552 F.3d 1351*).

♦ Unbalanced Bids

A bid is unbalanced if it is based on prices significantly less than cost for some work and significantly overstated for other work and there is some reason to doubt the bid will result in the lowest overall cost. An acceptance of a proposal with unbalanced pricing is not, in itself, improper provided the agency has concluded that the pricing does not impose an unacceptable risk and the prices the agency is likely to pay is not unreasonably high (*Accumark, B-310814*). Below-cost pricing is not prohibited and the government cannot withhold an award merely because its low offer is or may be below costs (*JV Penauille/BMAR, B-311200*). Evan a contract subject to the Service Contract Act may propose below SCA costs (*Group Multimedia, B-310716*), agency may accept a proposal characterized by protester as "unreasonably low" (*Global Solut Network, B-298682*) or attempting to buy in is not illegal (*Femme*). However, it is improper for an agency to accept risk presented by offeror's unrealistically low labor rates (*MCT JV, B-311245*) or an agency may assess an offer as unrealistically low where it assesses the risk in the offeror's approach (*Guam Shipyard, B-311321*)

♦ Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals. However, the RFP must describe the factors and significant sub-factors to be used to evaluate proposals and their relative importance and agencies must evaluate the proposals according to the criteria established in the solicitation (*Sherrick Aerospace, B-310369*). Agencies must evaluate proposals in accordance with criteria spelled out in the solicitation (*Serco Inc v US, 81 Fed. Cl. 463*). Protests were sustained where the record showed the agency (1) improperly treated subfactors on a pass/fail basis rather than a descending order of importance as stated in the RFP (*Helicopter Transport Svcs, B-400295*) (2) essentially made an award to a lowest priced technically acceptable offer contrary to RFP requirements (*Information Sciences Corp. v US, 80 Fed. Cl. 759*) (3) where the RFP did not disclose relative weights of evaluation factors they should be considered equal in weight (*Fintract Inc. B-311462*) (4) a technical evaluation was flawed because the agency considered an undisclosed evaluation factor (*Consolidated Engrg Svcs, B-311313*) and (5) the agency improperly relaxed requirements for an awardee ruling that all competition must be conducted on an equal basis (New *Jersey & H Street, B-311314*).

Agencies must consider *cost or price* in evaluating competing proposals and ruled that a competitive range determination was invalid because price was not properly considered (*USGC Inc B-400184*). The GAO ruled that a competitive range determination was invalid where price was not properly considered (*Information Sciences Corp*) but it was not improper to consider price under two separate evaluation factors (*Eomax Corp. B-311391*).

There were many cases addressing firms' *organizational conflict of interest (OCI).* An incumbent status by itself was insufficient to create an OCI where though it may have had access to information other offerors did not possess the agency properly disclosed the nonpublic information thereby eliminating unequal access (*Alabama Aircraft Indus, v US, 83 Fed. Cl 966*). Claims of OCI must be based on hard facts not mere suspicion or an allegation of what "could" happen (*Lumetra v US, 84 Fed. Cl. 542*) or allegations that employee may use information gained during performance to benefit themselves or employers in future endeavors is too speculative (*Savannah*).

♦ Past Performance

FAR 15.304 requires that past performance be one evaluation factor that must be considered in all negotiated procurements and the boards and courts are defining how this new factor will be applied. When negotiated awards are to be made with discussions offerors are to be given the opportunity to clarify adverse past performance while negotiated awards that do not provide for discussions *may* be given the opportunity to clarify past performance. An agency is not required to communicate with offerors past performance information where discussions are not held unless there is a clear reason to question the validity of the past performance information.

Past performance surveys were held to be fatally flawed where personnel conducting the surveys were inadequately trained, relevant questions were not asked and there were failures to provide transcripts of survey references for corrections (*Serco*). The agency improperly gave equal consideration to all awardee's past performance resulting in finding the agency did not properly consider the relevance to the solicited contract (*DRS C3*). Other findings confirm the agency has broad discretion in making its decisions: (1) the resumes the protester submitted lacked detail to confirm they had relevant experience (*Superior Landscaping, B-310617*) (2) agency had properly considered more relevant past performance experience where it had been a prime contractor rather than a subcontractor (*PMC Sltns, B-310732*) (3) no basis to reverse a decision that protester's past performance was "marginal" (4) contracts based in

Iraq were not as relevant as those for Afghanistan (*Aegis Defense Svcs, B-400093*) (5) there was no basis for protester's argument that it should have received an exceptional rating based on its performance as incumbent because RFP stated performance on *similar* not identical contracts would be most relevant (*New Breed, B-400554*).

It is the contractors responsibility to provide sufficient evidence to establish its past performance history. Where the protester asserted the agency did not properly evaluate its past performance the GAO ruled the protester did not show prejudice since its price was nearly twice the awardee's and it was unlikely to have received the award even if its past performance rating was exceptional (*Horizon Inds, B-310542*). An agency is only required to use reasonable efforts to contact references and its efforts were reasonable where protester only provided an email address and had apparently failed to ensure its references' cooperation (*Guam Shipyards*).

An agency properly may *attribute* the experience or past performance of a parent or affiliated company to an offeror where the proposal demonstrates the resources of the parent or affiliate will affect performance of the offeror. Past performance of proposed subcontractors may properly be considered in evaluating past performance of an offeror where the solicitation does not expressly prohibit it (*McGoldrick Const Svcs, B-310340*) or where it will perform a significant share of the work (*Aegis Defense*). Also past performance of a parent company was properly attributed to awardee (*Femme Corp*).

♦ Discussions

FAR 15.306 requires the CO discuss with each offeror being considered for award significant weaknesses, deficiencies or other aspects of its proposal that could be altered or explained to enhance the proposal's potential for award. Discussions should not be confused with *clarifications* which are limited exchanges with offerors to allow correction of minor or clerical errors or to clarify proposal elements (*Femme Corp*). Communications were considered to be clarifications where neither offer was given the opportunity to revise its offer (*Colson Svcs Corp, B-310971*) or an agency's exchanges were more akin to clarifications than discussions as no offeror was allowed to modify its quotation as a result (*USGC*).

It has been held there is no requirement that all areas of a proposal be addressed during discussions but only *significant* weaknesses e.g. those that prevent the offeror from having a reasonable chance of receiving the award need be addressed (*DRS C3*). While an agency must conduct "meaningful discussions" (i.e. discuss areas in a proposal requiring amplification or revision) an agency is not required to have discussions that are "all encompassing" or extremely specific in describing the extent of the agency's concerns (*Burchick Const, B-400342*). Discussions are not considered inadequate if a weakness that was not addressed during discussions later becomes a determinative factor between two closely ranked proposals (*Int'l Bus and Technical Consultants, B-310324*). However discussions were held to be inadequate where agency told protester it could improve its technical score by providing additional amenities but this was conveyed to all offerors rather than specific concerns the agency had with it (*New Jersey & H Street*) or that the agency identified a narrow weakness in a staffing plan related to price but failed to mention it believed its entire staffing plan was insufficient due to lack of detail or specificity (*AT&T Corp. B-299542*).

Costs

Equitable Adjustments. An equitable adjustment is the difference between the reasonable cost of the work required under the contract and the actual reasonable cost to the contractor of performing the changed work, plus a reasonable amount for overhead and profit. A contractor carries the burden of proving the amount by which a change increased its costs of performing on the contract (*Hedlund Const. v US, CBCA No. 105*) while the government bears the burden of a downward adjustment in contract price (*Metric*). Though the government argued the contractor was entitled to damages based on the government's estimate, the Board ruled the damages were to be based on actual costs incurred (*States Roofing, ASBCA No 54854*).

Termination Settlement Costs. A termination for convenience is often characterized as converting a fixed price contract to a cost reimbursement contract that entitles the contractor to recover allowable costs incurred in the performance of the terminated work, a reasonable profit on work performed and certain additional costs associated with the termination. Once the termination for default is converted to one for convenience, the contractor becomes entitled to costs related to unpriced changes, constructive changes, suspension of work, differing site conditions, defective specs and even some work that might not have been complied with in all respects but if the government can show the contract was in a loss

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position, profit is not allowed (*Abcon Assocs, PSBCA NO. 5291*). Under a cost sharing arrangement the contractor is nonetheless entitled to the full amount of its costs under a termination for convenience but not for profit if the contract did not provide for it (*Jacobs Engrg Group v US, 434 F.3d 1378*).

Legal Costs. Legal fees incurred in the successful defense of qui tam claims under the False Claims Act are allowable where the contractor prevailed but are not recoverable where it was found liable (*Boeing Co v DOE, CBCA No. 337*). Legal costs associated with violations of the Clean Water Act brought about by a third party were deemed unallowable when they were incurred in an unsuccessful defense because they are considered to be "similar or related" to legal proceeding costs disallowed by FAR 31.205-47(b) (*Southwest Marine v US, 535 F.3d 1012*).

Contract Administration. For a long time boards and courts have distinguished between unallowable costs of prosecuting claims and allowable costs of contract administration where in a seminal case (*Bill Strong*) the basic guidance is that if the costs are incurred to permit a negotiated resolution of the problems that arose during contract performance they are presumably allowable costs of contract administration while if they are incurred to begin the process of litigation they are unallowable. The board found incurred costs for a claim preparation and consulting fees incurred before submission of the claim was for the purpose of furthering the negotiation process and hence allowable where the Board found the amount of entitlement to be that at the employee's hourly rate rather than the amount quantified by the contractor (*SUFI Network Svcs, ASBCA No 55306*).

Limitation of Funds. Both the Limitation of Cost (FAR 52.232-20) and Limitation of Funds (FAR 52.232-22) clauses are prescribed for cost reimbursable contracts where the LOC is used when the contract is fully funded and the LOF is used when incrementally funded. Both clauses require the contractor to give timely notice of impending cost overruns and relieve the government of liability over costs in excess of the ceiling amounts but there is a subtle difference of remedies for the contractor between the two clauses. Under the LOC clause, the government and contractor are entitled to negotiate an equitable distribution of all property produced or purchased under the contract when a contract is either terminated or *"the estimated cost is increased"* while under the LOF the contractor is entitled to the property only when the contract is terminated. Since the contracts (incrementally funded ones) were covered under the LOF, the contractor was not entitled to an equitable distribution since the contract was not terminated (*System Integrated, ASBCA No. 54439*).

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