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Oldie but goodie…

GRANT THORTON SURVEY ON PROFESSIONAL FIRMS

(Editor's Note. For the last several years we have been happy to summarize the results of the Grant Thorton Annual Government Contractor Industry Survey. The survey benchmarks important financial and contracting data for firms that offer primarily professional services to the US Government market. Unfortunately, Grant Thorton has informed us that they will not be publishing the survey this year due to a shortage of respondents. Since many of our subscribers have been asking us where the survey is we decided there was sufficient interest to offer last year's survey results with a little modification rather than simply omitting it. Since there are not significant changes from year to year, we believe the results shown here are similar to those that would be reflected in a 2013 survey.

Company Profile

53% of the surveyed companies are classified as large and 47% as small where 18% had sales less than $10M, 10% between $10M-20M, 17% between $20M-50M, 13% between $50M-100M and 42% over $100M. The vast majority of surveyed companies sell professional services – consulting, IT, research, engineering, general business services, science and technology, training and education, other services - while less than 5% sell products. 84% said their primary customer is the federal government. 47% of their revenue came from the Defense Department, 37% from other federal agencies, 7% came from state and local government and 9% was commercial. The survey shows government business trends are lower where 36% of respondents had increased revenue over the prior year (50% in 2011), 26% had no significant change while 38% had reductions (compared to 29% in 2011). Indications are that 2013 and 2014 will see even more reductions.

Indirect Headcount Breakdown

12.5% of total headcount is represented by management and support functions. There is an overall downward trend over the last several years which is attributed to more outsourcing of support services such as HR, legal, internal audit, contract compliance as well as some larger contracts allow for direct billing of normal indirect support costs. The breakdown of certain functions are finance and accounting (2.9%), contract and procurement administration (1.7%), sales and marketing (2.1%) and other indirect (5.8%). Though not reported this year, facilities costs as a percentage of revenue in 2011 last year was reported by 80% of respondents as less than 5%, 14% reported 6-10% and 6% said it was greater than 10%.

Government Contracts

Breakdown of Revenue by Contract Type. 40% of revenue from federal contracts came from cost type contracts compared to 45% in 2011, 20% are fixed price (equal to 2011) and 40% are time and material (compared to 35% in 2011) indicating a decrease in cost type and a corresponding increase in T&M.

Fees. Though fees were not tracked this year, the results for 2011, which is pretty consistent from year to year, were average negotiated fees for cost type contracts was 6-7%, T&M contracts had an average of 8-9% while firm fixed contracts had 9-10%. It should be noted that these negotiated profit rates are computed after deducting unallowable costs and before income taxes so actual profit rates are lower than negotiated rates.

Proposal Win Rates. Surveyed companies stated their win rate on non-sole source proposals was 30% and 50% when they were the incumbent. Win rates when either a special business unit or joint ventures were created was 50%, higher than 43% in 2011.

Bid and Proposal costs as a Percent of Revenue. 14% reported less than 1%, 41% 1-2% while 44% reported greater amounts.

Claims and Terminations. Identifying out of scope work, whether it comes from an easy to recognize direct change or sometimes difficult to recognize constructive changes, provides an important opportunity to receive additional entitled revenue. 30% of the respondents said their procedures for recognizing out of scope work are very effective, 52% said somewhat effective and 18% said not effective. 85% of respondents said the government requests out-of-scope work either occasionally or frequently without issuing contract mods. 23% of respondents who have performed out-of-scope work indicate they have filed either requests for price adjustments and/or claims indicating the majority of firms are performing out-of-scope work without compensation. The authors assert this high level partially explains the lower profit levels discussed below. As for terminations for convenience the survey found that 32% of all respondents had a contract terminated for convenience in recent times where 40% submitted a settlement proposal while 60% did not. As for partial terminations, where an increase in contract price is usually justified due to allocating fixed or semi-fixed costs over a smaller base, 32% of those experiencing a partial termination actually negotiated a price adjustment on continuing work (up from 17% the prior year) while 68% did not.

Contractor Business Systems. The survey notes recent changes to contractors either fully or modified CAS covered are now subject to audits of six business systems (cost accounting, EVMS, estimating, purchasing, material management and accounting and property management) where future surveys will focus on results of these audits. For now, the survey found that 33% of respondents had already undergone at least one of these audits and that 29% said they had made improvements to their business systems in order to comply with these new rules.

Financial and Cost Statistics

Profit. Contrary to common public perceptions, government contracting does not generate abnormally high profits where the survey defines it as profit before interest and taxes as a percent of revenue. Profit rates appear to be plunging compared with prior years where 56% of survey companies had profit rates between 1-5%, 31% between 6-10%, 5% between 11-15% and 4% above 15%. 4% of respondents reported no profit. These figures would be even lower after deducting interest and taxes. Compared to 2011, there has been a substantial decrease in profit where this year 60% of surveyed companies either did not make a profit, experienced a loss or posted a 1-5% profit rate compared to 37% last year.

Fringe Benefit Rates. Fringe benefit pools consist of payroll taxes, paid time off, health benefits and retirement benefits (some include bonuses while others do not). Fringe benefit rates as a percentage of total labor averaged 36.4% when bonuses were included and 34% when excluded which is an increase from last year.

Medical Expenses. Despite widespread concerns about health care costs increases, most contractors have apparently not made any changes to health coverage. In response to questions asking what percent of health benefits are paid by the company the survey results were: 5% reported the company pays for less than half, 12% pays 51-60%, 20% pay 61-70%, 36% pay 71-80%, 9% pay 81-90% and 18% pay 91-100%. With respect to health costs as a percentage of labor costs, 6% of respondents incurred health costs less than 4% of labor costs, 5% between 4.1-5%, 11% between 5.1-6%, 13% between 6.1-7%, 9% between 7.1-8%, 5% between 8.1-9%, 12% between 9.1-10% and 39% over 10% of labor costs.

Overhead Rates. These costs are considered to be in support of direct staff working directly on contracts and hence are normally allocated as a percentage of direct labor costs. Some companies include fringe benefits associated with direct labor in the direct labor base while others do not – the result when they do is to lower overhead rates. Average overhead rates are as follows: (a) on-site direct labor (on-site means performed at company sites) - 84% compared to 80% in 2011 (b) on site direct labor and fringes – 43% compared to 48% in 2011 (c) off-site direct labor – 38% as opposed to 48% in 2011 (off-site is lower because facility related costs are normally borne by the customer at their facilities) (d) off-site direct labor and fringes – 21% compared to 23% in 2011. When companies used multiple overhead rates logic used for them were location (52%), labor function (13%), customer (28%) and products versus services (7%).

G&A Rates. The survey states that general and administrative rates are typically those incurred at the headquarters and include executives, accounting and finance, legal, contract administration, human

resources and sales and marketing as well as IR&D and bid and proposal costs. G&A costs are most often allocated to contracts on total cost input (direct operating costs, overhead, material, subcontracts) or a value added base that generally includes all the above costs except material and/or subcontracts. Average G&A rates under a total cost input base was 12% (13.5% in 2011) while those using a value added cost input was 15% (15.4% in 2011).

Material handling and subcontract administration costs. 24% of surveyed companies used a material handling and or subcontract administration rate as a burden chargeable on direct material and subcontract costs (higher than 2011's 22% and 19% the previous year). The survey notes that in service industries a handling rate is established in conjunction with use of a value added G&A base to reduce burden applied to pass-through subcontract and material costs. Average material handling rate was 3.0 and subcontract handling rate of 3.4% (2.7 and 2.5% in 2011).

Labor multipliers. Multipliers, a term commonly found in the commercial world, are fully loaded labor multipliers used to price out work and are derived by dividing total burdened labor cost by base labor cost. The average labor multiplier was 2.2 for on-site work and 1.9 for off-site work. Almost all respondents expressed a belief their labor multipliers were competitive with their industry. It should be pointed out that the labor multipliers are overall averages where many companies commonly use different multipliers for different markets.

Uncompensated overtime. (*Editor's Note. Uncompensated overtime refers to hours worked exceeding the normal 40 hour work week by those salaried employees exempt from the Fair Labor Standards Act.*) 60% of respondents said their employees work uncompensated overtime (UOT) while 40% said no. 80% of the companies working UOT use total time reporting while the other 20% report only 40 hours per week. 78% use a rate compression method of accounting (e.g. computing an effective hourly rate dividing salary by hours worked) while 22% use a "standard/variance method" that charges an hourly standard rate and then credits an indirect cost pool for the difference between labor costs charged to projects.

Charging Subcontractor hours on T&M contracts. We have frequently reported on new regulations that provide that subcontract labor can be charged at fixed rates provided in the prime contract as opposed to the older way of simply billing subcontractor costs plus applicable prime indirect rates. 80% of surveyed companies bill the cost of subcontract hours at the fixed rates in the contract or subcontract while 20% bill on a cost reimbursable basis (i.e. as an ODC). This change has led to a different audit focus from merely auditing hours charged to ensuring labor skills being billed meet contract requirements.

Dealing with the Government

The Defense Contract Audit Agency, because of their Defense Department contracts or contracts with other agencies that use the audit agency, audits most of the contractors in the survey. Regarding the respondents' opinions of DCAA audits, 47% say auditors' opinions are substantiated with appropriate references and 53% are arbitrary and not substantiated while 40% of auditors are open-minded and receptive to contractor rebuttals and 60% say auditors are inflexible and are rarely receptive. Contracting officers receive higher ratings where 60% of their opinions are considered substantiated with references and 56% are considered open-minded and receptive. When asked if their relationship with DCAA has changed, 71% said it had stayed the same, 19% reported the relationship had worsened (compared to 2% in 2011) while 10% said it had improved. In an effort to measure the quality of relationships with ACOs and DCAA, the survey found 18% of respondents resolve issues efficiently where the remaining 82% say the government was inefficient where 56% say they believe DCAA is the primary cause for delays of resolving issues while 26% believe it is the ACO. The most frequent types of costs questioned by DCAA are executive compensation (23%), consultant costs (7%), incentive compensation (17%), labor charging (11%), indirect cost allocations (12%), legal expenses (9%) and employee morale (5%). Most frequently cited violations of cost accounting standards were CAS 401, consistency (2%, compared to 16% last year), CAS 403, home office expenses (3%) and CAS 405, Unallowable costs (9%, compared to 4% last year). Costs questioned as a percent of revenue were less than 1% of revenue (61%), 1% of revenue (11%), 2% of revenue (6%), 3% of revenue (3%), 4% of revenue (0%) and 5% or more of revenue (19% compared with 4% last year). Of those companies experiencing audit issues, 18% were very

satisfied with the resolution of the issues, 61% were somewhat satisfied and 21% were not satisfied.

Executive Compensation

(*Editor's Note. Care should be used if our readers consider substituting the following results for a bona fide compensation survey where sometimes hundreds of firms are surveyed. However, the results shown below are interesting. If you want to escalate the results below for 2013, applying a 3% escalation factor would be a conservative approach.)* Surveyed companies provided information on the four highest paid executives in the company and the results are presented by company size measured by revenue for 25th, median and 75th percentiles. The following is a summary of the results.

Highest Position (in thousands)

Revenue	25%	Med.	75%
$0-10 M	250	320	447
$11-50M	260	349	500
$51-150M	275	407	585
>$150M	300	410	708

Second Highest Position

$0-10 M	170	262	432
$11-50M	225	294	444
$51-150M	250	339	479
$>$150M	280	372	646

Third Highest Position

$0-10 M	160	242	300
$11-50M	180	269	379
$51-150M	225	279	450
>$150M	260	357	565

Fourth Highest Position

$0-10 M	144	189	267
$11-50M	157	228	310
$51-150M	208	241	344
>$150M	218	322	395

Companies whose executive compensation was challenged by DCAA and provided rebuttals and/or additional information state 30% of their positions were sustained, 30% stated a reasonable compromise was achieved and 40% stated either DCAA's position was sustained by the ACO or an unreasonable compromise was put forth.

Case Study…

RESPONDING TO A DISALLOWANCE OF BONUS, MARKETING AND CONSULTING COSTS

Editor's Note. As a continuation of our commitment to address real life issues we are providing a highly edited version of a response we prepared for our client who was confronted with two Form 1's issued by DCAA questioning bonus, marketing and direct consulting costs as a result of two years of incurred cost proposal audits. Our client chose to be highly critical of DCAA's actions where though risky was intended to question their actions. We are disguising the name of our client calling it "Contractor" and the dollar amounts. Though unsuccessful in changing DCAA's position, our client's position was largely sustained by the ACO.

Bonus Costs

- **DCAA's Position**

DCAA is questioning $325,000 of bonus expenses paid to two of its executives because "the contractor does not have adequate policies and procedures" as provided in FAR 31.205-6, Compensation for Personal Services. The audit report quotes the FAR provision: "(1) Bonuses and incentive compensation are allowable provided the – (i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment." The audit report disallows the costs because there is not a written agreement nor a plan or policy in place. DCAA is not questioning the total amount of executive pay but rather the bonus portion of that compensation.

- **Our Response**

We presented the following facts. In response to inquiries made by DCAA, Contractor stated that for

the two years in question board resolutions approved payment of the bonuses but the DCAA auditor did not review the resolutions. Contractor asserted the bonuses were intended to be part of the two executive's compensation where its relatively low salary of $120,000 compared to comparable companies is augmented by a bonus when the company can afford to pay it. The total compensation, salary and bonus, paid to the two executives is well below total compensation levels paid to those of comparable companies. The type of bonus, where the amount differed year to year, had been made for more than five years prior to the years being audited where the company asserted "an established practice" has been demonstrated. Contractor asserts the DCAA auditor should have reviewed the bonus history of the two executives but did not do so.

All of the questioned costs represent bonus payments to the two executives only. The auditor is selecting one part of the FAR 31.205-6 criteria for bonus costs – is there a written policy. Such a policy is not the sole criteria for acceptability where in this case the far more important consideration is the historical practices of Contractor. A written policy may be important for the initial bonus payment to show an agreement is in place in spite of no prior practice but once a bonus payment practice is established, where here it is for eight years, there is little need for a written policy. In fact, though a written policy did not exist, the historical payments of the bonuses do demonstrate an actual policy did exist. The absence of a written policy is particularly common for small businesses who normally do not spend the time and expense developing formal written policies and procedures covering all payments.

In addition the auditor confuses the need to have an agreement in place with a *written* agreement. Neither the FAR section nor even DCAA guidance puts forth a requirement to have an agreement be in writing. The auditor imposes a criterion which is not important and fails to inquire into the more important criteria that is specified in both the FAR cost principle quoted and DCAA's own guidance mainly are there practices in place that "in effect constitutes an agreement." The answer is unequivocally yes. First, the two executives were paid a similar bonus for five years prior to the years in question. Second, a bonus plan existed for 8 years. Third, all the elements of an agreement were in place – long history, board approval of the bonuses and the payment of the bonus was consistent with a rational business purpose – pay an unusually low salary and augment it with a bonus when sufficient cash flow existed where the total compensation did not exceed comparable companies.

Marketing Costs

- **DCAA Position**

DCAA is questioning $120,000 of marketing costs. Its audit report states "while testing, Contractor was unable to show how the costs in question were in accordance with FAR 31.205-1, Public Relations and Advertising Costs." Despite a recognition the costs are for marketing DCAA quickly changes its characterization of these costs as advertising and public relations costs which are unallowable in accordance with FAR 31.205-1 when it sees the costs are related to obtaining federal business.

- **Contractor's Response**

During the audit Contractor explained the marketing firm was used to find business opportunities in both the state and federal market place and once identified, assist in the proposal creation process. Contractor provided the firm's published material and emphatically explained that the marketing firm's role did not at all include any advertising or public relations functions nor was such functions a part of its expertise. Contractor states DCAA was remiss in not reviewing the mission of the firm.

Despite explanations of the nature of the efforts involved, the auditor inexplicitly substituted a different category of costs – advertising and public relations – for the actual category of costs that were incurred – sales and marketing as well as B&P. We can only conclude the auditor had a preconceived idea the costs incurred should not be allowed and then created an erroneous category and accompanying cost principle that would tend to support that preconceived idea.

There is an apparent erroneous assumption that costs incurred to promote sales to the government are not sales and marketing or B&P costs but rather are advertising and PR costs. However, a long history of court cases have concluded that whether sales and marketing or B&P costs are incurred to promote military sales, commercial sales, foreign sales or other sales is irrelevant to their allowability (e.g. *Federal Electric Corporation*, ASBCA No. 11324; *Daedalus*

Enterprises Inc., ASBCA No. 43602). All such costs are considered allowable because they contribute to expanding contractors' cost base which, in turn, benefits the government by lowering indirect costs.

Consulting Costs

- **DCAA Position**

DCAA is questioning $90,000 of direct consulting costs. The audit report states the reason the costs are being questioned is because Contractor does not have "adequate supporting invoices and agreements for consulting costs" per 31.205-33.

- **Contractor's Response**

Contractor provided the following facts. It states that Consultant consists of one engineer who worked solely on one contract in one location and provided extensive documentation to support the evidence requirements of FAR 31.205-33. These included (1) actual work product - monthly reports (2) availability of the engineer for DCAA to interview (3) documentation the costs were incurred by reconciling invoices to payments made (4) documentation a bona fide consulting agreement existed that identified (i) billing rate and maximum hours per month for work described (ii) Consultant will provide invoices under this contract (iii) invoices are to be submitted to and approved by the named CEO and (iv) specific tasks are described in some detail (5) actual invoices provided all information about hours worked, hourly rate, total owed and nature of work and were approved by the CEO and (6) adequate work product existed where related documents were provided such as trip reports, minutes of meetings, subjects discussed and reports

Interaction with DCAA

During the audit Consultant repeatedly offered copies of the consulting agreement, invoices, work product and access to the consultant to the auditor but there was apparently little interest in reviewing them where on two occasions the auditor stated they should be provided to DCMA. This is, in our opinion, a flagrant violation of auditing standards by failing to consider highly relevant information where the failure to do so resulted in assertions that the evidence did not exist. An even superficial review of the consulting agreement, invoices and work product would clearly demonstrate the provisions of FAR 31.205-38 were met.

WHEN DOES AN OFFERED PRODUCT OR SERVICE QUALIFY AS A COMMERCIAL ITEM

(*Editor's Note. In a recent article we wrote about pricing considerations for commercial items which generated a great deal of inquiries from clients and subscribers on clarifying what are the rules for eligibility of characterizing an offered product or service as "commercial" and what does the contractor need to do to justify using this powerful pricing tool. Offering the government commercial item pricing has become a hot topic where several clients and subscribers are asking about opportunities to charge their products and services at commercial prices rather than prices based on cost build up estimates. We also thought it would be a good idea to revisit this area since today, more than ever, there is increased resistance by the government to allow qualifying items as commercial. Commercial item opportunities can exist for the entire products and services offered to the government, some elements offered even when the entire item does not qualify such as certain supplier offerings or even intracompany transfers from other segments. The source of this article is a recent seminar we participated in offered by Public Contracts Institute and presented by Jason Workmaster and Phillipp Seckman of McKenna & Long as well as our own experience helping clients qualify their products and services as commercial items.)*

Designating an item as commercial has significant appeal to both the government and contractors. From the buyer's perspective, it allows for streamlined procedures (FAR 12.6), minimizes administrative costs and limits the need to obtain certified cost or pricing data. From the seller's perspective it means the contract is not subject to CAS, Truth in Negotiations Act (e.g. defective pricing allegations) or business systems rules, allows commercial firms that would normally not be able to participate in the procurement process to do so and perhaps most significantly, to realize higher prices than a cost build-up approach would allow.

The seminar presenters start out with a decision chart and then fill in the important elements during most of the presentation. The first step of making a commercial item determination (CID), whether items or services are offered, is to see whether there

was a prior determination of commerciality. If the determination was yes and there are no clear reasons to the contrary then the CID would be yes. If the answer is no then the second step involves a series of questions.

For items:

Step 1. Is the item commonly used by the general public or is it "of a type" that is commonly used by the general public?

Step 2. Has the item been sold, leased or licensed or been offered for sale to the general public?

Step 3. Is the item an evolution from a Step 1 item but is not yet available in the commercial marketplace but will be to satisfy the government's needs?

Step 4. Is the item one that would meet conditions in Steps 1, 2 and 3 except it is undergoing modifications that are commonly available in the commercial marketplace or are minor mods needed to meet government needs?

For Services:

A CID would apply if the services such as installation, maintenance, training or other services in support of one of the items in Steps 1-4 above or are providers of the same work for the general public under similar terms and conditions.

In addition, any combination of the items in Steps 1-4 and qualifying service if it is of a type commonly combined and sold to the general public is a CI.

Finally, there is a key documentation step that must reflect your analysis of Steps 1-4 or a qualifying services assessment that would be contained in the prime or subcontract files.

The following discussion elaborates these concepts.

1. For an item or services, the term "offered for sale, lease or license" does not mean it must have been sold. Rather if market research (discussed below) indicates it is a CI then that is acceptable because it is presumed that commercial forces establish a price that is fair and reasonable.

2. A CID applies if "any service 'of a type' offered and sold competitively based on catalog or market prices for specific tasks performed or specific outcomes to be achieved and under standard terms and conditions." The term "catalog price" means a published price reflecting recent prices for sales to the public." Think Sears Catalog for the pure catalog while market prices means current or recent actual sales prices that the government can use to verify the price is fair and reasonable.

3. The phrase "of a type" was intended to broaden the CI definition. It means an item need not be identical to the one being offered in the commercial marketplace to qualify as a CI. As discussed below, there has recently been considerable "pushback" to "of a type" grounds for establishing the commerciality of an item in response to perceived abuses of allowing an excess number of items to be classified as CI. The "of a type" item can be either one sold by your firm or offered by another firm. You can expect greater audit scrutiny of an item claimed to be "of a type" of item offered by another firm than one offered by your firm.

4. There is a hierarchy of justification for a CID determination. The closest to a pure CI is a catalog price. It should be noted the purest form of catalog is one provided to the public (again, think Sears Catalog) as opposed to say an internally used price list. The next closest thing to a pure CI is a commercial off the shelf (COTS) item. COTS items are commodities, say a No. 2 pencil, that are sold in substantial quantities to the public and are not subject to any modifications. The farther an item or service is from this catalog or COTS item the more audit scrutiny can be expected and the tighter the documentation needs to be.

5. The definition of CI at FAR 2.101 also references commercial nondevelopmental items. The government wants to offer the advantages of CID to items that are not sold to the general public but rather sold exclusively to the government. A nondevelopmental item is any previously developed item used exclusively for government purposes by a federal agency, a state or local government or a foreign government in which the US has a mutual defense cooperation agreement. A nondevelopmental items may also include minor modifications of a type customarily available in the commercial marketplace in order to meet the requirements of the procuring agency. Such nondevelopmental items can be considered CIs if two conditions are met: (1) it was developed exclusively at

private expense and (2) is sold in substantial quantities on a competitive basis to State, local or certain foreign governments. When we asked the presenters whether "exclusively at private expense" can include IR&D or other costs included in an indirect cost rate and allocated to government contracts the presenters answered in the affirmative.

A question arose during the presentation about whether subcontract items that are sold to prime contractors which are then ultimately charged to the government can be considered sales to the general public and hence a CI. The presenters said this is really a gray area which is being litigated now.

7. Documentation from the Buyer's Perspective. A CI is considered desirable because the presumption is that a commercial marketplace drives competitive prices down. In addition to increased resistance to CIDs, the biggest change we have seen is the emphasis on proper documentation by both the buyer and seller. From the buyer's perspective, a proper CID is based on market research which is considered to be the primary means of determining the availability or suitability of CIs and hence whether a price is fair and responsible. Market research is usually conducted before developing new specs and before soliciting bids or proposals. The extent of market research depends on the urgency of the procurement (e.g. less if more urgent), estimated dollar value, complexity of the item and past experience in procuring it. Market research topics include what are the sources, is the acquired item a supply or service item and what are industry practices and trends. Market research techniques include contacting knowledgeable individuals regarding market capabilities, reviewing results or recent market research reports, publishing requests for information, internet research, gathering market pricing information, reviewing industry catalogs and product literature and attending trade shows.

8. Increased pushback and increased audit scrutiny. DCAA issued guidance in Sep. 29, 2011 requiring its auditors to assess prime contractor CIDs and their price and cost analyses. They are also cautioned not to place "excessive reliance" on prior CIDs. The presenters say contractors should be cognizant of other guidance in DFARS 244.402, FAR 15.404-3 and DFARS PGI 215.404-1 that address prime contractors' responsibilities to document their subcontractors' CIDs and for the contracting officer to assess the prime contractor's assessment. Failure for the prime contractor to properly document the CID can result in the entire subcontract amount being questioned as unsupported. The presenters state that auditors and other government representatives will scrutinize CIDs more closely the farther they are from catalog pricing or COTS justification. That is, the more CIDs rely on "of a type", offered for sale as opposed to actual sales in some quantifies or that involve modifications the more scrutiny of the CIDs can be expected.

One of the strongest indications of current resistance to commercial item pricing is a recent DOD proposal to change the commercial item definition to (i) remove the "of a type" designation and (ii) add the requirement that goods and service be actually sold in "like quantities" to those being acquired. This proposal was rejected but there are several groups that are opposed to "of a type" so we can expect the issue to be raised again.

9. Documentation from the seller's perspective. In this era of pushback for CIDs, contractors should be aware that the farther a claim for a CI is from a pure catalog or COTS, the more persuasive its documentation should be. The presenters suggest and we concur that contractors should do some market research themselves to show their items qualify for a CID. Though not discussed in the seminar, we find that inclusion on GSA schedules are also strong evidence of commerciality so contractors anticipating significant use of CIs should seek to be included on GSA schedules. Contractors are well advised to put together a package to help the buyer feel more comfortable in the CID. In addition, commercial item offers must show (a) a technical description of the items being offered in sufficient detail to evaluate compliance with the requirements of the solicitation (b) terms of any express warranty (c) price and any discount terms (d) a copy of the representations and certifications found at FAR 52.212-3 and (5) past performance information when it is included as an evaluation factor.

10. Implications of misclassified CI claims. Being attorneys the presenters would be expected to identify potential "bad news." Contractors are particularly vulnerable to the False Claims Act where a suit can be brought by the government or a "qui tam relator." The FCA imposes liability on knowingly false invoices where treble damages can be imposed plus

civil penalties. The relevant elements of a cause of action is (a) a claim (e.g. invoice) (b) falsity (said the item was a CI and it is not) (c) knowledge the claim was false – here intent is not required but "reckless disregard" or "deliberate ignorance" is enough and (d) materiality. The presenters state the best defense for FCA assertions is to document well the CID.

11. Summary of FAR Part 12. This section of the FAR prescribes the policies and procedures that are unique to the acquisition of CIs as defined in FAR 2.101. FAR Part 12 seeks to implement the federal government's preference for acquiring CIs that are contained in Title VIII of the Federal Acquisition Streamlining Act of 1994. It requires agencies to (a) conduct market research to determine whether CIs are available to meet agency needs (b) acquire commercial items when they are available and (c) requires contractors to incorporate, to the maximum extent practicable, CIs as components of items. As is common with rules that have been in place for a while, the requirements for CIDs expanded from 17 in the 1990's to 50 now. In addition there were approval requirements added in March 2012 (Fed. Reg. 14480) that require higher level approvals for CIs for purchases >$1 million one level above the CO and when CID is based on "of a type" or "offered for sale." This approval is not required for acquisitions to facilitate defense of recovery from nuclear, biological, chemical or radiological attack.

Knowing Your Cost Principles…
PRECONTRACT COSTS

(*Editor's Note. The following represents our continuing presentation of important FAR Cost Principles and Cost Accounting Standards. This is particularly timely since some recent cases addressing precontract costs are challenging long held rulings that these costs are clearly allowable. Our source for this article is an article written by Karen Manos in the November 2013 issue of the Cost and Pricing Report.*)

The cost principle covering precontract costs at FAR 31.205-32 constitutes two sentences and has not changed since it was first published in the Armed Services Procurement Regulation in 1959. However, several cases and expert commentary do provide some important clarifications. The cost principle states "costs incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award where the incurrence of such costs is necessary to comply with the proposed contract delivery schedule. Those costs are allowable to the extent that they would have been allowable if incurred after the date of the contract (See 31.109)."

Overview

As a general rule, government contractors may recover only those costs incurred after award of a contract. However, FAR 31.205-32 makes an exception for costs incurred in anticipation of a specific contract provided the costs satisfy the circumstances prescribed by the cost principle. In referencing FAR 31.109 the cost principle suggests, but does not require, the parties enter into an advance agreement to avoid disputes over the allowability of the precontract costs. But many agency FAR supplements do require an advance agreement in order for the precontract costs to be allowable.

Case Law Interpretations

For a simple two sentence rule, the provision has generated a surprising amount of litigation.

To recover precontract costs the contractor must establish three elements: (1) the costs were incurred directly pursuant to the negotiation of the contract and in anticipation of award (2) the costs were necessary to comply with the proposed delivery schedule and (3) the costs would have been allowable if they were incurred after award (*Penberthy Electromelt Int'l Inc. v US, 11 Cl. Ct. 307*). Though the cost principle does not expressly state the precontract costs that do not meet these conditions are not allowable, it has been interpreted as making such costs unallowable by implication (*Codex Corp., ASBCA No. 17983).*

Lets clarify the meaning of these three elements.

1. "Directly pursuant to the negotiation and in anticipation of the contract award."

The two phrases "directly pursuant to the negotiation" and "in anticipation of contract award" are generally read in tandem rather than as two separate elements. The FAR Council has interpreted the two phases as meaning as a result of the solicitation and award process.

It is not necessary for the government to agree to pay for the precontract costs for them to be allowable. In fact, the precontract costs need not even have been discussed during the negotiation (*AT&T DOT, BCA No. 2007, 89-3*). For example in one case precontract costs were allowed even though it was a sealed bid contract.

Precontract costs have been held to be allowable even when the government told the contractor not to incur them. During negotiations of a sole source cost type contract Radiant was told not to incur costs for providing liners for Navy aircraft where shortly after award it gave notice under the Limitation of Cost clause it was about to exceed authorized funds due largely to precontract costs it had incurred. The CO denied the request for precontract costs stating (a) because the hardware was not due until six months after contract award there was no reason to start work before the award and (b) precontract costs are allowed only if the CO authorizes them in writing. The Appeals Board rejected both arguments saying it had satisfied each of the requisite conditions for allowability. With respect to the government assertion it should be precluded from recovering precontract costs because the government told it not to incur the costs it was "without contract significance" because Radiant was fully aware it was taking a risk in incurring the expenses where if it was not awarded the contract it would not be entitled to recovery of the costs it incurred since it had no advance agreement. The Board also rejected the government's assertion that there was no advanced written approval by the CO stating FAR 31.109 makes it clear though advanced agreements are desirable they are not mandatory (*Radiant Techs, ASBCA No.38324*).

However, if a contractor who has incurred precontract costs and subsequently is awarded a fixed price contract without ensuring the precontract costs are part of the price or without reserving the right to make a claim for them the contractor will be precluded from later trying to recover them (*Mid States Mgt L td, ENG BCA No. 5203*).

The author strongly warns that two recent cases do confuse the results of these earlier cases holding that precontract costs are not allowable unless the government has agreed to pay for them. In one case, ILSS spent a lot of money before contract award on numerous items that were rejected and excluded from the statement of work. Though it would have been non-objectionable to disallow the costs because they were not needed for the contract the Board went a step forward ruling that for the preaward costs to be recoverable the government must agree not only to the scope of work but it must also agree to reimburse the costs (*Integrated Logistics Support Sys. Int'l vs US, 47 Fed. Cl. 248*). In its ruling on this case the Court cited many of the cases we discussed above asserting they confirm the proposition that the government must provide its prior approval for expenditures for them to be allowable where in fact the cited cases support exactly the opposite proposition.

In another recent case, the government refused to reimburse the contractor for consulting services and other expenses that were incurred prior to an engagement to prepare a financial plan where the Court stated "generally, except in special circumstances not shown here, those costs incurred prior to the actual execution of a contract are not recoverable" where it cited the Codex case that had actually ruled the opposite. The author states that "regrettably" other cases are starting to cite Integrated Logistics' incorrect conclusion that in the absence of an advanced agreement precontract costs are not allowable.

2. "Necessary to comply with the proposed contract delivery schedule."

This second element is the one most likely to make otherwise allowable costs unallowable because they were incurred before the effective date of the contract. Seaworthy performed tasks under an ID/IQ contract where some of the tasks were incomplete by the end of the contract. Since the agency wanted a continuity of service Seaworthy continued performing the tasks during the brief period between the time the first contract ended and the second follow on one was awarded. The Appeals Board held the costs incurred before the second contract was awarded were unallowable because the contractor did not establish they were necessary to meet delivery schedules but it allowed costs after the second contract was awarded even though no task orders were issued reasoning that nothing states the contractor shall not be reimbursed costs on a task order after the second contract was awarded but prior to issuance of a task order as long as the work was within the scope of that task order once it was issued (*Seaworthy Systems Inc., ASBCA No 41202)*

In a dispute about the allowability of legal costs for a pre-award and post-award protest of an unsuccessful offeror, the Board ruled that the pre-award costs were not allowable because the protester did not present any evidence to indicate the costs were incurred "in order to meet the delivery schedule" (*Jana Inc., ASBCA No 32447* .

In another case, the government rejected Radant's claim for precontract costs on the grounds that at the time the delayed contract was awarded the government schedule for the flight test had slipped and hence it was unnecessary to incur the flight tests to meet the schedule. The Board sided with Radiant ruling it is not necessary for the contractor to prove that the incurrence of the costs was actually necessary to meet the delivery schedule but rather what is required is for the contractor to reasonably believe it was necessary where here, Radiant did believe the test was required (*Radiant Techs., ASBCA No. 38324*)

3. Advance Agreement and meaning of "at risk."

As many of the cases have observed, the contractor that begins work before a contract is awarded undertakes a significant risk in doing so since if the award is not made it cannot recover the costs. The advance agreement contemplated in FAR 31.109 does not obviate this risk.

A contracting officer generally has no authority to obligate the government outside of a contract under the FAR and is prohibited under the Anti-Deficiency Act to obligate the government in advance of or in excess of appropriated amounts. The risk that is mitigated by an advanced agreement only applies *if* a contract is awarded where if a contract is not awarded the advance agreement does not provide a way for the contractor to recover its precontract costs.

CRITICISM OF USING TABLE FAR 15-2 MOUNTS

(*Editor's Note. Contractors have traditionally submitted their proposals containing cost and pricing data either in their own format or in formats prescribed by individual RFPs with little objections from auditors or selection officials. However, that loose approach has been changing where increasingly both federal and state acquisition officials and auditors are rejecting proposals on the grounds they do not "conform" with the requirements of Table 15-2 in the FAR where such objections are holding up acquisitions and in some circumstances resulting in rejections of proposals as inadequate. The following article by Steven Feldman in the June 2014 issue of the Nash & Cibinic Report is a good example of the opposition we are beginning to see.*)

Recent guidance established by DCAA – Accuracy Checklist for Forward Pricing Rate Proposals – states that contractors who submit proposals requiring submission of certified cost or pricing data must do so in a format consistent with Table 15-2. Consistency with Table 15-2 apply both to forward pricing rate agreements (FPRA) that are based on a forward pricing rate proposal (FPRP) or proposed rates that are included not in a FPRP but in a specific cost or price proposal where the contractor "is bound by the format/content" of Table 15-2. So, Table 15-2 requirements will apply equally to FPRPs and specific price proposals. In addition, the Defense Department and National Aeronautics and Space Administration has put forth lengthy checklists (DFARS 252.215-7009 and NFS 1852.215-83) that are supposed to be "aids" in complying with FAR Table 15-2. Nonetheless, these aids for submitting certified cost and pricing data checklists "are no more informative or streamlined than Table 15-2" where when they were proposed they were criticized as being wasteful and tending to increase costs to industry.

Table 15-2 in FAR 15.408 for the submission of certified cost or pricing data under the Truth in Negotiations Act (TINA) is a five page table that is a detailed list describing what is expected. Companies are not very good at reading and following Table 15-2 while government representatives rarely have a complete understanding. The author states "in all my years of federal service as a procurement attorney, I have yet to see a contractor – whether a small or large business concern – fully meet the Table 15.2 submission/formatting requirements. Similarly, it would be the very rare contract specialist or Contracting Officer who has the competence or time to make the painstaking review that the table requires."

While the instructions might be explicit and detailed they "seek a mountain of detail on various cost elements which is well beyond what the government needs to make a reasoned judgment." Nonetheless cases have confirmed that an agency properly rejected contractors' proposals where it was shown they did

not follow the Table. To illustrate the point the author takes as an example the required breakdown of proposed material and services costs (where the information must be consistent with the contractor's accounting system). These costs are separate from other cost elements of a proposal such as direct labor, indirect costs, other direct costs and cost of money which have their own detailed Table 15-2 instructions.

For the proposed material and service costs the offeror must:

1. Provide a consolidated price summary of the individual material quantities in the various task, delivery or contract line items and the basis for pricing such as vendor quotes or invoice prices.

2. Include raw materials, parts, components, assemblies and services to be produced or performed by others.

3. Identify all items and show the source, quantity and price.

4. Conduct price analysis of all subcontractor proposals.

5. Conduct cost analysis of all subcontracts when certified cost or pricing data is submitted by the subcontractor.

6. Include these subcontract analyses as part of the prime's own certified cost or pricing data submissions for subcontracts expected to exceed the threshold in FAR 15.403.

Along with these burdensome requirements, Table 15-2 has a page of single-spaced instructions for demonstrating adequate price competition and "All other" items. After the offeror plows through these directives he must go through two pages of formatting instructions. Further, Table 15-2 covers required subcontractor certified cost or pricing data in FAR 15.403-4(c)(3). When one considers that contractors generally provide cost or pricing data during different times (e.g. initial proposal, interim reports, final submissions) the administrative burden multiplies.

The author contrasts the extensive detail of Table 15-2 with TINA's more straight forward objectives. The Act merely ensures that when the government buys at a price not tested in the competitive marketplace that it has a "roughly equal" informational footing. Before negotiations commence, contractors and subcontractors need only disclose the facts relevant to those negotiations and certify those facts are accurate, complete and current.

Other than the unnecessary burden imposed on contractors and the government, the author puts forth additional criticisms of the Table. First, it requires more than cost or pricing data. Under TINA, the term "cost or pricing data" means only those "facts that as of the date of agreement on price of a contract (or the price of a contract mod) a prudent buyer or seller would reasonably expect to affect price negotiations significantly." No prudent buyers would give a thought to the bewildering array of required information in Table 15-2. The table requires disclosure of all factors that could conceivably affect price negotiations. For example, any contingency included in the proposed price must be disclosed where all proposals include a vast array of contingency assumptions where the disclosure requirement would be almost unlimited.

Second, the required volume of Table 15-2 is inconsistent with FAR 15.402(a) that states the contracting officer should not obtain "more data than is necessary" in determining the reasonableness of an offered price. Third, the cost of providing this data which may include expensive pricing and estimating systems will be borne by the taxpayer. Finally, the mass of information flowing to the government is one way but not the other way from the government to the contractor. As a result, Table 15-2 unfairly disadvantages the contractor where there is not just information parity but informational superiority.

The author concludes that Table 15-2 (which is, in fact, not a statute) should be thoroughly overhauled. Though the Table might be justifiable for a large sole-source award imposition of it for other procurements is a perfect example of imposing a one-size-fits all requirement. In the meantime, he says contracting officers should bypass the table where FAR 15.405-5)b)(1) generally allows "alternative formats" which includes the "contractor's own format." He says that use of one of these alternatives are more sensible by eliminating the need for both the government and contractors to slog through the table. He advocates that submission of a proposal in accordance with TINA along with a certificate where the result is "no fuss, no muss" where both sides should be satisfied that this approach provides the facts that prudent buyers and sellers need to provide.